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Abolishing UK’s ‘factory tax’ would help get productivity moving again

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If the Government is intent on borrowing more, it should focus that borrowing on easing Britain’s biggest economic challenge. That’s my pre-Budget advice to Rishi Sunak, the new Chancellor.

With 10 Downing Street apparently advocating looser fiscal rules, Sunak is under pressure to deliver either a Tony Blair-style public services spending binge or a Nineties Japan-inspired infrastructure splurge.

Each would leave Britain with higher government debt and, eventually, higher taxes. History suggests neither is a path to strong economic growth.

Instead, the Chancellor should focus, laser-like, on how policy might raise productivity growth. Britain has laboured since the financial crisis, with output per hour growing at a measly 0.3pc per year, compared with 2.2pc pre-crash. The consequences are all around us, even as the jobs market booms.

Average weekly earnings have only just surpassed their pre-crisis peak, savers’ returns are in the doldrums and extensive austerity was required to eliminate a stubborn resulting structural deficit.

The causes of the “productivity puzzle” are complex. But its profound impact on living standards makes it imperative to reverse any long-held policy mistakes exacerbating it. One obvious source is Britain’s weak private investment level in plant, machines and buildings, which has been the lowest in the G7 for two decades as a share of GDP.

A key cause of this is surely Britain’s stingy capital allowances for these investments within its corporation tax code – a phenomenon the Adam Smith Institute (ASI) has called a “factory tax”.

While the UK has a low headline corporation tax rate, new fixed capital investments can only be partially claimed back by businesses over time, rather than immediately written off like spending on raw materials or workers’ wages.

Given inflation and foregone uses of those funds, the effect of this inability to fully recoup these investment costs is capital-intensive industries being tax disadvantaged relative to other sectors.

Our complex system of depreciation schedules and asset lives, in other words, is an effective tax on manufacturing and factories, tilting the UK’s industrial structure away from the Midlands, Yorkshire and Wales (where manufacturing is relatively strongest) and towards the South East and London (where services and finance are concentrated).

Actually, this tax bias has become worse since 2010. Part of the coalition government's quid pro quo for lowering the headline corporation tax rate was making capital allowances for plant and machinery even less generous.

Though there was a reintroduction of a structures and building allowance and an increase in the annual investment allowance in 2018, the UK still ranks 33rd of 36 in the Tax Foundation's "capital cost recovery" rankings of OECD countries.

The last decade of corporation tax reforms taken together has therefore only seen a modest fall in the effective tax rate on new investment, which is why the business investment response of rate cuts has been so muted.

Not many policy changes could raise GDP, move the tax code towards improved neutrality and further Boris's aim for regional "levelling up" simultaneously. But removing this "factory tax" bias would do all three. In practice, that means introducing "full expensing," where businesses could immediately and fully write off investment in plants, machinery and structures from their corporation tax bills, and carry forward losses with an interest factor.

Abolishing the factory tax would eventually settle at reducing corporation tax revenues by about £9bn directly, according to ASI authors Sam Dumitriu and Pedro Serodio. Preferably any net shortfall would be made up by trimming spending.

But rather than racking up debt for near-term consumption or wasteful high-speed rail projects, any additional borrowing to finance this will at least have a big economic pay-off.

The ASI estimates the reforms would raise long-run investment in plants and machinery by 9.1pc and structures and buildings by 17.7pc, increasing labour productivity by 3.5pc (about a year-and-a-half of pre-crisis growth). Given other tax revenues would therefore rise, the tax cut would be far less costly than headline losses suggest.

Oxford Centre for Business Taxation research on UK small businesses found firms qualifying for generous first-year investment allowances had 11pc higher investment levels than non-qualifying firms.

Likewise, economist Eric Ohrn's work found US states that temporarily implemented full expensing saw investment jump 18pc, on average, with higher employment achieved at 50pc lower cost per job than through government spending.

Unsurprisingly, businesses respond to incentives. Studies generally find that a 1pc fall in the post-tax cost of investment increases investment by anywhere between 7pc and 10pc. Yet Tory politicians seem to have forgotten this insight. Perhaps because many don't fully appreciate the detail of the corporation tax reforms, they seem down on the idea of business tax cut-led growth right now.

They shouldn't be. We constantly hear that because "government borrowing is cheap … now is a good time to invest". Yet government need not be the investor.

If the Government can borrow at negative real rates over 30 years, the fact that private projects tend to generate much higher returns on capital than public projects means that business tax cuts with good pedigree for stimulating investment (like full expensing) will often be better than government-led infrastructure spending.

The March 11 Budget is a Boris-led administration's first meaningful opportunity to flesh out what its eclectic economic wishlist will mean. His ministers have promised regional rebalancing, faster growth, tax cuts and sound long-term budgeting. Threading the policy needle on these goals, given the trade-offs inherent in many of them, is extremely difficult.

Abolishing the UK's factory tax is one idea that works towards all these objectives. Carpe diem.

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