The Telegraph

Companies don't pay the economic costs of taxes - people do

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Jan 21, 2021

Rishi Sunak is reportedly eager to raise taxes in his March Budget. Economists have urged caution against premature tax hikes, given we have no idea yet where the budget deficit will settle once the pandemic ends. Yet the Chancellor is said to be mulling seriously the reversal of Conservative corporation tax cuts as a down payment towards balancing the books.

This would be a mistake. You don't have to be wedded to small-state economics to worry about the economic harm of squeezing the private sector just after a pandemic-induced recession. But even if you think this course prudent, newspapers claim Sunak is considering it because he believes this tax hike "fairer" than raising others, given "it targets business profits rather than people and firms who have been plunged into the red". That is misguided economics.

The Chancellor surely does not mean to suggest that corporation tax hikes will not affect people suffering through this crisis. Left-leaning politicians love to talk as if cuts to the profits tax are a pure giveaway to corporations, of course, but Conservatives have long known that the legal incidence is very different from who bears the economic cost.

Corporations don't pay the economic costs of taxes, people do. Any tax hike is ultimately borne by some combination of shareholders (through lower dividends or less valuable shares), workers (through lower wages) and consumers (through higher prices). Economists have argued for decades about how much pain each group absorbs, with theoretical results differing depending on the openness of the economy, the mobility of capital, competition in labour markets and the time period you consider.

Careful empirical studies, however, estimate that anywhere between 30pc and 70pc of the burden is ultimately borne by workers. Why? Well, because though in the short run hiking the tax hits shareholders, it also reduces the after-tax return on investment. In a world where capital can move around freely that means foreign companies face less incentive to shift operations here, UK companies see less incentive to repatriate profits earned from foreign subsidiaries, and companies in other domestic sectors are less likely to shift to the corporate world.

Combined, these reactions mean less in the way of investment in new machines, buildings and other ventures that make corporations' workers more productive. Less investment therefore invariably feeds through into lower wages for workers. In other words, because capital can shift easily across borders but people usually do not, ordinary workers end up bearing a fairly large share of the tax burden. Corporation tax hikes reduce longer-term wages from the level they would otherwise rise to.

Now some in government reject this. They say that business investment remained sluggish even though the headline rate of corporation tax rate was slashed by George Osborne and Philip Hammond from 28pc in 2010 to 19pc, where it has stayed since 2017. But nobody pretends that tax rates are the only thing driving investment decisions. Since 2010 we've experienced huge economic ruptures associated with the eurozone crisis, Brexit and now a global pandemic. The uncertainty has chilled activity at various times, swamping the effects of tax rates.

It's worth remembering too that the corporation tax rate cuts we saw through most of this period were accompanied by reforms making cost recovery on investments more stingy for businesses, neutering any incentive benefit of the tumbling rates for many investments.

Whereas the headline rate fell by nine percentage points, Oxford University's Centre for Business Taxation database shows that the tax rate on a typical new investment, taking account of rates and investment allowances, fell more shallowly from 22pc in 2010 to 17pc in 2017.

In fact, for investments in some assets, such as in industrial buildings, the effective tax rate barely fell at all over that period. Government budgets since 2017 have increased the generosity of allowances for these types of activities, but the country overall still ranks 17th in the OECD for corporation tax competitiveness because of its ungenerous cost write-offs, despite having the 4th lowest headline rate. Given this and the other headwinds, it's little surprise then that the corporation tax cuts didn't produce an investment boom.

The combination of Brexit and the end of the pandemic makes this a particularly bad time to jack up the corporation tax rate. New non-tariff barriers on UK-EU trade will impair the GDP potential of the economy, and some companies are figuring out the best places to locate or expand to serve existing or new markets. To add a tax disincentive into the mix by reducing the after-tax return on any UK investments would be a huge own goal.

It's true that the pandemic has led to very few companies being profitable this past year, meaning most will not be immediately affected. But that means it won't even raise much revenue in the short term, despite coming with the damaging disincentives that work through over time. With the potential for large, permanent shifts in consumer tastes, pent up demands, and sustained home working being realised after the vaccine is rolled out, we are going to need vast new investments in premises, machines and branding that taxes should not deter.

It's fashionable these days to say that because borrowing is cheap, the Government should do more public infrastructure spending to "build back better". But if private projects generate higher returns than public projects deliver social returns, then it would be better to actually have deficit-financed corporate tax cuts, perhaps starting with full and immediate cost write-offs for investment in plant, buildings and machinery. At the very least, the last thing we need is to hike corporation tax rates alone and compound the sluggish growth problems we've experienced this past decade.

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