Tax and Industrial Structure – some economics

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Tax system favours certain industrial structures

Favours debt finance… usually

- Interest deductibility favours debt
- Various venture capital schemes – EIS, SEIS, SITR, VCT

Favours business that are ‘small’ & run as a company

- Business rates relief, VAT threshold, AIA, dividend tax rates

Favours owners that hang on to their businesses

- Entrepreneurs’ relief; CGT forgiveness at death

Favours some kinds of assets & investments

- Agricultural land, some ‘green’ investments

But discourages others

- No allowance for Industrial buildings; business rates is (partly) tax on business inputs

Rules of thumb for designing taxes

Don’t tax production inputs (tax the profits not the revenues)

- Taxing inputs favours low-cost business models over equally profitable high-cost ones
- Deducting business investments (can be done upfront or stream of allowances) creates level playing field

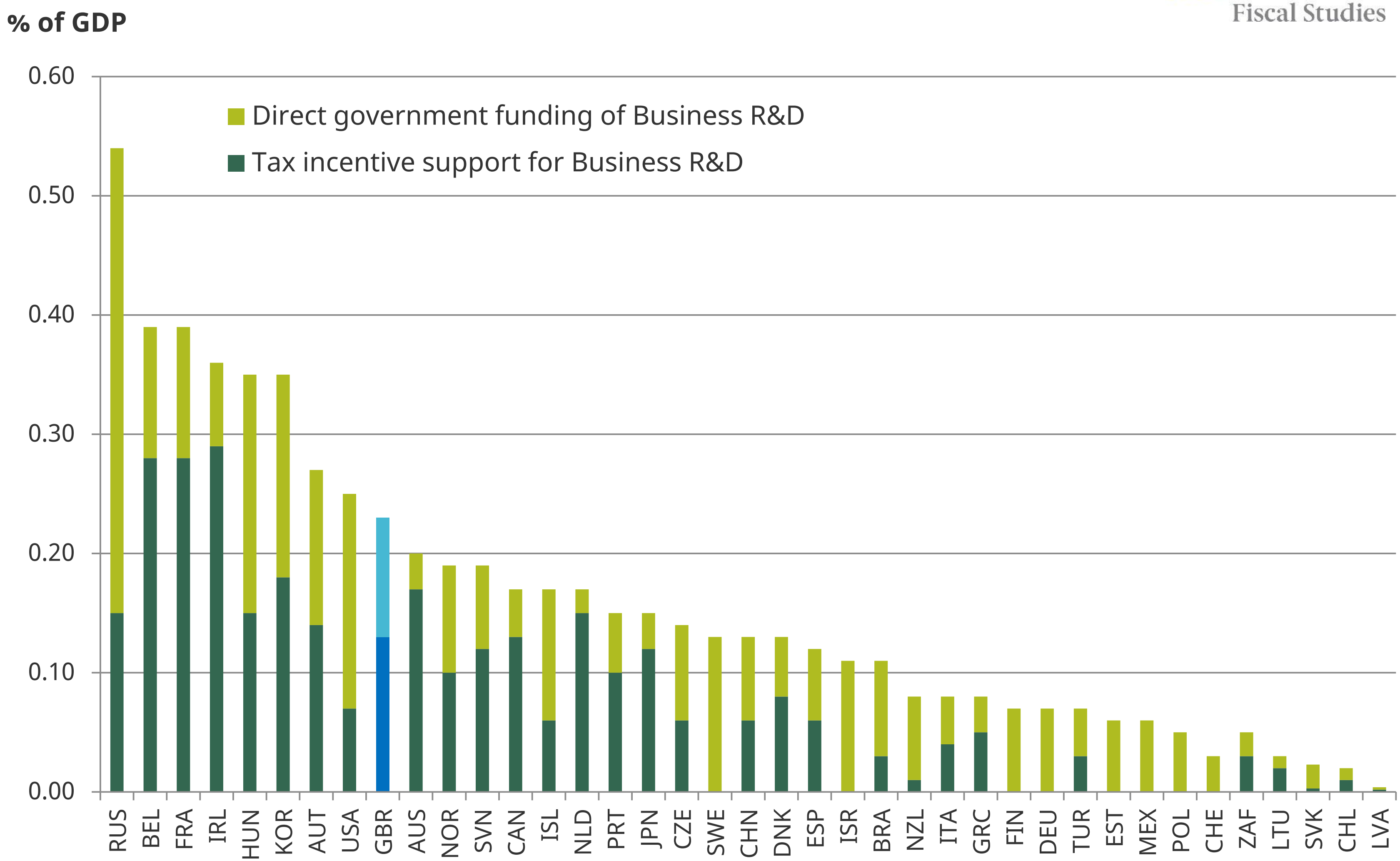
Implication: don’t add differences between similar investments

- Debt vs equity; buildings vs plant; big vs small; who owns

Only deviate from this if:

- There’s a good reason
- *and* tax is the right tool
- *and* have a well designed policy
- *and* good reason to think benefits outweigh costs of distortions (need to evaluate)

Most countries use R&D tax credits



Source: OECD, R&D Tax Incentive Indicators, http://oe.cd/rdtax, July 2017 (most data refers to years 2014 or 2015).

Lessons from R&D tax credits

Start with a clear rationale

- R&D investments create ‘spillovers’ – there’s evidence for this
- R&D is ‘good’ doesn’t count

Lessons from R&D tax credits

Start with a clear rationale ***– spillovers***

Use tax policy when want to change prices

- Encourage more investment of all types – market still allocates resources
- Direct investment or prizes may be better when specific outcome desired
- Plenty of other levers – competition, regulation, direct spending

Lessons from R&D tax credits

Start with a clear rationale ***– spillovers***

Use tax policy when want to change prices ***– i.e. when underlying market working***

Accept that a good policy can promote failure

- Spillovers can arise from ideas that fail & many successful innovations would happen anyway
- When targeting negative spillovers (e.g. pollution) may want some activities to fail

Lessons from R&D tax credits

Start with a clear rationale ***– spillovers***

Use tax policy when want to change prices ***– i.e. when underlying market working***

Accept that a good policy can promote failure ***– don’t use tax to pick winners***

Target the inputs not the outcomes

- The act of researching new ideas creates spillovers – that’s the bit we want more of
- Targeting profits that arise at later stage very poorly targeted (Patent Box, Entrepreneurs’ Relief)

Lessons from R&D tax credits

Start with a clear rationale ***– spillovers***

Use tax policy when want to change prices ***– i.e. when underlying market working***

Accept that a good policy can promote failure ***– don't use tax to pick winners***

Target the inputs not the outcomes ***– monopoly profits don't need a tax break***

Acknowledge trade-offs & evaluate whether it's worth it

- There's reliable evidence that R&D tax credits lead to more R&D
  - Recent evidence uses tax records to show especially true for small/ young firms
- This doesn't mean there aren't costs – decent chunk of relief is a deadweight cost
- International dimension – are we just shifting the deckchairs?

Lessons from R&D tax credits
- ensure tax distortions are justified and evaluated

Start with a clear rationale ***– spillovers***

Use tax policy when want to change prices ***– i.e. when underlying market working***

Accept that a good policy can promote failure ***– don't use tax to pick winners***

Target the inputs not the outcomes ***– monopoly profits don't need a tax break***

Acknowledge trade-offs & evaluate whether it's worth it ***– even well designed policies have costs***

Cheat sheet for designing taxes

Don’t tax production inputs (tax the profits not the revenues)

- Implication: don’t add differences between similar investments

Only deviate from this if:

- There’s a good reason
  - simplification, specific market failures; political preference more dubious
- *and* tax is the right tool
  - there’s also competition, regulation, direct spend & intervention…
- *and* have a well designed policy
  - well targeted
- *and* good reason to think benefits outweigh costs of distortions (evaluate)

Remove current distortions before adding new ones

- If a problem is caused by a current distortion in tax address that directly

– seriously underrated option!