Tax and Industrial Structure – some economics

Helen Miller
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

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!