Tax reliefs: the good, the bad and the money

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It’s easy to create headlines with tax relief stats

OTS: UK has over 1100 tax reliefs

HMRC: 431 reliefs – 192 lead to £414 bn foregone revenue (2017-18)

- £34bn on reliefs from corporate tax and CGT on business assets

Revenue foregone is large relative to UK tax and spend

- 2017-18 total spending ~ £800bn
- 2017-18 corporate tax receipts ~ £50bn

But:

- £414bn is not the revenue that would be raised if we scrapped all reliefs
  - No behavioural response or account for interactions
- Numbers have little meaning without knowing what reliefs are

There are many ways to define a tax relief

Broadly: a provision that makes tax paid less than would *normally* be expected is a tax relief

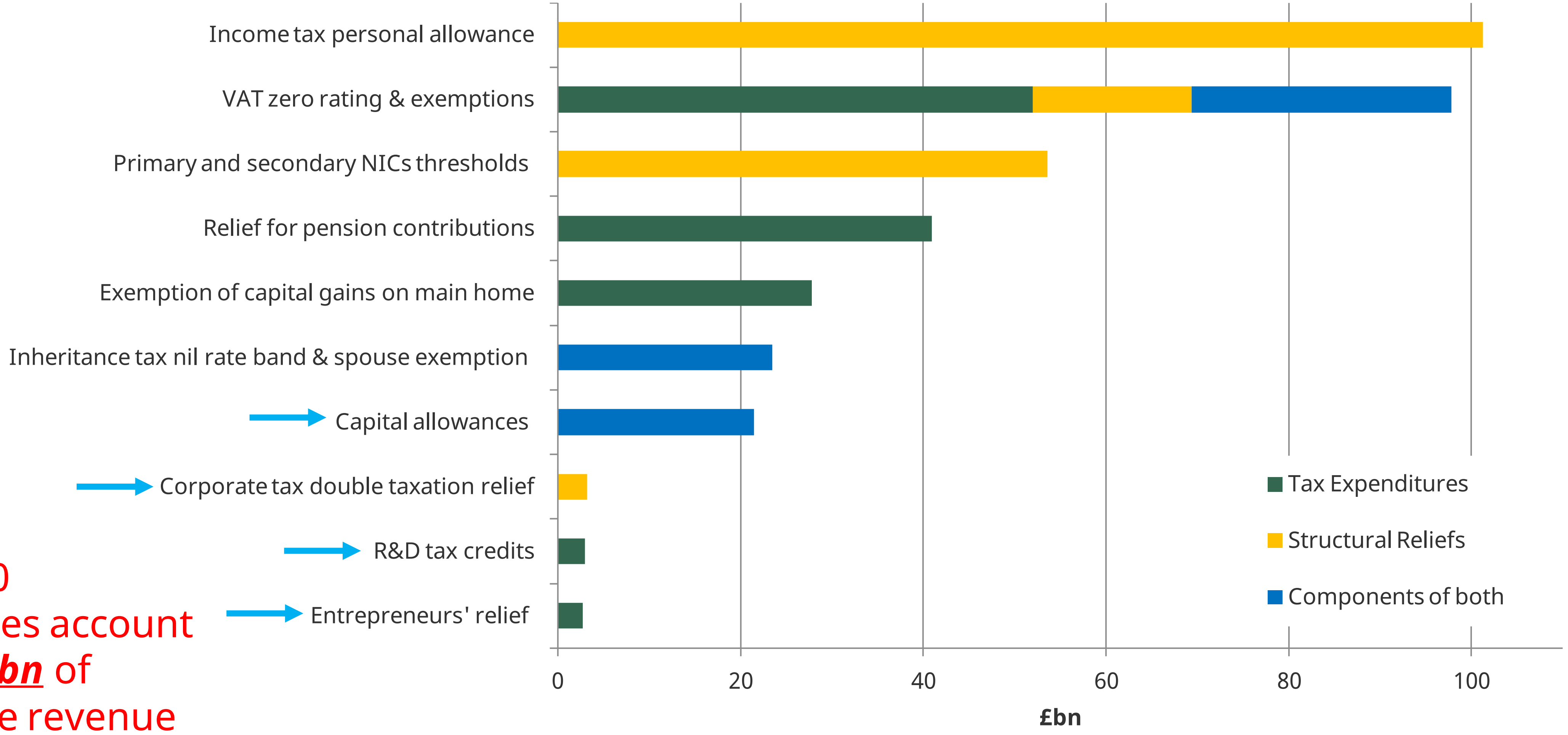
- What's normal? Need a benchmark system to define reliefs against
- Not one 'correct' benchmark; countries use different benchmarks

HMRC use a broad definition and then categorise

- **structural reliefs**: '*reliefs [that] can reasonably be regarded (or partly regarded) as an integral part of the tax structure*' **£186bn**
- **tax expenditure**: '*reliefs [designed] to help or encourage particular types of taxpayers, activities or products for economic or social objectives*' **£143bn**

Regardless of labels, underlying Q is always: what do we want to tax?

The money



These 10 categories account for ***£375bn*** of foregone revenue

How to know when a tax relief is justified?

Economists want a broad base and low rates, right?

- All taxes have distortions – don't load all distortions onto one base
- Exempting some activities/incomes creates complexity & avoidance at boundaries

Not always. Economists often want narrow base & high rates!

- Broad base/low rate rule of thumb doesn't imply zero reliefs are optimal

Better rule of thumb: Tax all income and deduct all costs of generating taxable income

- Removes double taxation of income that's saved/invested
- Good for equity & efficiency

Reasons to depart from this:

- Lower taxes on more responsive activities – improve efficiency
- Market failures (inc externalities) – depart from aim of minimising distortions
- Redistribution goals – but these best achieved through rates, not base

Capital allowances

Desirable to tax profits, not turnover

- Don’t favour low-cost-low-revenue activities over equally valuable high-cost-high-revenue activities

What’s the cost of investment and how to deduct?

- Depreciation (ala capital allowances) vs upfront cost (ala AIA)
- Financing costs –deduction for interest costs but not the equivalent cost of equity

Current UK system gets it right sometimes

- Distorts/subsidises/is neutral depending on asset & financing

More than one way to remove distortion to investment

- Need to dig into the detail of reliefs
- Punchline: deducting investment costs is part of well designed system

R&D tax credits

What's the policy justification?

- R&D can produce spillovers; means that market will underproduce socially optimal amount

Are credits well targeted …

- It's good that credits based directly on R&D expenditure
  - Don't want to only back high profit projects
  - But does tax break for projects that would have happened without tax relief

… and cost effective?

- Evaluations find that R&D tax credit boosts R&D
  - £1 of credit gets ~£1.7 of R&D and more innovation

Entrepreneur's relief

What the policy justification?

- Usually something like “to encourage risky entrepreneurial activity”
- Poorly defined. What’s activity creating spillovers or being underinvested in?

Is the relief well targeted …

- No. Given to all closely held company owner-managers
  - Unlikely to be a good proxy for entrepreneurial activities
  - Even if is a good proxy, relief only benefits those who can take income in capital gains

… and cost effective?

- No evaluation of benefits, but comes with large distortions, inc tax motivated incorporation and shifting income to capital gains

There are other policy levers

- Higher CGT rates would discourage saving & investment, but disincentives better dealt with through the tax base (capital allowances; treatment of losses; indexation)

Conclusion

Headline grabbing numbers aren’t very informative

Debate should always boils down to the design of taxes

- more transparency on policy goals would help

We should evaluate on a case by case basis

- Capital allowances: sensible rationale behind taxing profit not turnover
- R&D tax credits: have costs, but idea backed by theory and evidence
- Entrepreneur’s relief: not a clear justification & creates complexity, inefficiency and unfairness

References

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