In this edition of our regular Macro Policy Outlook, we focus on the single biggest measure announced in the recent Budget to boost business investment, a long-running part of the UK’s macroeconomic weakness. The Government’s ‘super deduction’ policy is an innovative way to achieve this, allowing firms to write off an unprecedented 130 per cent of their investment costs against taxable profits for the next two years. This should encourage firms to bring forward investment: a desirable outcome, given weak capital spending in recent years and the need to boost overall economic growth as we recover from the deepest recession in more than 300 years. But the fact that this is a temporary change means that the longer-term impact on investment is likely to be small. This means this policy is better suited to boosting near-term growth rather than addressing the UK’s long-standing weakness in investment. This is exacerbated by a planned increase in the headline measure of Corporation Tax from 2023-24 which provides an additional headwind to investment. The OBR expect the ‘super deduction’ to have a large effect with business investment boosted by 10 per cent at its peak in 2022-23. There are, however, reasons for thinking that the impact – or the amount of stimulus it provides to the wider economy – could turn out to be smaller. This is because the policy is focussed on import-intensive plant and machinery investment (around a sixth of the total) with incentives bigger for large firms (which at 60 per cent of business investment in 2019 are responsible for the largest share). On top of that, the large rise in corporate debt and the risk that the recovery remains incomplete means there is a high likelihood that more support for firms will be needed.

At the recent Budget the Chancellor unveiled a bold new policy to boost business investment. We start by setting out why such policy is needed given recent weakness in investment before discussing the design of the policy and its possible impact.

INVESTMENT HAS BEEN A LONG-STANDING SOURCE OF THE UK’S MACROECONOMIC WEAKNESS

Business investment has been weak in recent years. This matters because sustained rates of investment will boost the overall productive capacity of the economy and, as discussed in our previous work, weak recoveries in investment tend to be associated with weak growth for the overall economy. So a rapid recovery in business investment should be a priority for policy makers as they put in place stimulus measures design to boost overall economic growth.

In this context, recent developments have been concerning. Since the onset of Covid-19, business investment has fallen sharply (Figure 1) and remains well below its pre-pandemic level. Business investment fell 22 per cent in the second quarter of 2020 (compared with a fall in GDP of around 19 per cent) and remained 7.4 per cent below its end-2019 level by the end of last year. As suggested by the mapping in Figure 1, however, business investment usually tends to be considerably more responsive to the economic cycle than other components of GDP, falling more rapidly than overall GDP in recessions and recovering more quickly. This time the fall has been closer to overall GDP, reflecting
that the economic hit is concentrated on less capital-intensive service sectors, such as hospitality.

FIGURE 1: Business investment growth has been weak since the EU referendum

Four-quarter growth in GDP and investment, chained volume measures: UK

NOTES: Business investment after 1998, whole-economy investment prior to that. Business investment data are adjusted for the transfer of nuclear reactors from the public corporation sector to the central government in Q2 2005.

SOURCE: RF analysis of ONS, National Accounts.

FIGURE 2: Weak investment in recent years has been associated with higher uncertainty

Measures of economic and policy uncertainty and four-quarter growth in business investment (standard deviations from the sample mean): UK

NOTES: The swathe shows a range of uncertainty indicators: CBI survey measure of demand uncertainty as a factor likely to limit capital expenditure for manufacturing and services; an index of UK policy uncertainty based on newspaper articles; household survey responses on their personal financial situation and unemployment expectations; the six-month option-implied volatility for the FTSE 100; and the 12-month option-implied volatility of short sterling. All indicators are shown as number of standard deviations from the mean. The zero line shows the mean of these indicators. Business investment data are adjusted for the transfer of nuclear reactors from the public corporation sector to the central government in Q2 2005.
Figure 1 also shows that investment has tended to move closely with overall GDP. However, since the EU referendum, business investment growth has slowed relative to the overall economy, at the same time as we have seen an increase in measures of economic uncertainty (Figure 2). All this reinforces the case for policy targeted at this on-going weakness.

INCREASES IN CORPORATION TAX PROVIDE A FURTHER HEADWIND TO INVESTMENT, PARTICULARLY IN THE NEAR TERM

Against this backdrop of on-going weakness in business investment, the announcement at the Budget of a rise in the Corporation Tax (CT) rate creates a further headwind. As part of steps to repair the damage to the public finances, the Chancellor unveiled plans to raise the headline CT rate from 19 per cent to 25 per cent from 2023-24 onwards. The announcement – which is set to raise £17 billion per year by the middle of this decade – is by far the largest change to CT since the 1970s and the first rise in the main rate of CT since 1973. This policy makes sense as a way to raise revenue (indeed it was part of our own proposal to repair the public finances). But, as discussed in our analysis of the Budget, this reduces the return to future profits and so reduces the financial payoff to profitable investments. The extent to which the rise will reduce investment depends on a number of factors, such as the ability of firms to substitute labour for costlier capital. In this area, the evidence shown in some academic work (for example, published here) suggests that it will have a substantial negative impact on investment. That said, the role of such tax changes in driving investment is sometimes overstated; other key drivers, such as overall demand and levels of uncertainty, are also important, as suggested by the on-going weakness of investment over the past decade despite repeated cuts to the headline rate of CT.

But as well reducing the payoff to investing now, the fact that companies know that CT rates will rise in the future also provides them with an incentive to delay these plans. This is because firms are allowed to offset depreciation against taxable profits up to certain limits, and these ‘writing down allowances’ reduce tax bills by more if the rate of CT is high. So a pre-announced rise in CT effectively increases the amount that firms can write-off from a future date, providing an incentive to delay investment.

So, without accompanying policy changes, there was a serious risk that the increase in CT could have undermined the strength of the recovery in investment.

THE ‘SUPER DEDUCTION’ ADDRESSES THAT HEADWIND

The Government has introduced a two-year ‘super-deduction’ tax incentive policy from April 2021, at an estimated cost of £24 billion. This allows companies to claim 130 per cent relief for capital expenditure on plant and machinery without limit. This compares to the current situation under which firms can claim 100 per cent up to a limit of £1 million.

It is helpful to think about this policy change as comprising an increase in the rate at which capital expenditure can be offset against taxable profits (by 30 percentage points), and a removal of the £1 million cap. To see how this works, consider the following simple example. Suppose a firm wants to invest £10,000 in a machine that will increase pre-tax profits by £500 each year. With the tax on profits (i.e. CT rate) at 19 per cent, this investment would provide £405 a year after tax in additional profits. With the 130 per cent investment allowance, taxable profits fall by £13,000 in the year the asset is
expensed, so taxes fall by 19 per cent of that (£2,470). The post-tax cost of the machine is now £7,530, so this policy cuts the cost of investment by roughly a quarter.

In setting the rate at 130 per cent, this scheme appears to be unprecedented in its generosity. In the US in 2017 a 100 per cent relief for capital spending was introduced (so-called ‘full expensing’). Subsequent analysis of that and other similar measures (in a Brookings Paper, by the IMF and Cleveland Fed) suggested that they provided strong incentives to invest. As well as reducing the cost of capital, they improve firms’ cash flow by reducing costs at the point at which capital spending is undertaken.

But the increase in the rate to 130 per cent effectively offsets the incentive to delay investment brought about by the pre-announced rise in CT to 25 per cent (because any investment now will reduce taxable profits by $1.3 \times 19 \approx 25$ per cent of that value in the two years of the ‘super deduction’, mirroring the 25 per cent that will be the case after the CT rise).

So, although the increase in the rate to 130 per cent has received much attention, this does not actually provide much incentive to bring forward investment when taken together with the forthcoming rise in CT. Instead, it is the temporary removal of the £1 million cap that provides a stimulus by incentivising firms that would normally invest more than that to bring forward investment into the next two years.

THERE ARE A NUMBER OF FEATURES OF THE ‘SUPER DEDUCTION’ THAT WILL LIMIT ITS EFFECTIVENESS

The simple example presented above of how the scheme works misses out some elements of this policy change that will act to reduce its effectiveness, however. Below we discuss three issues.

1. When combined with other elements of the tax system, the incentive to bring forward investment is smaller than suggested by the headline changes

The extent of the boost to investment from the super-deduction depends on the amount of investment spending undertaken by each firm. Given it is the removal of the £1 million cap that provides the incentive to bring forward investment, for smaller firms, which tend to spend less on investment than the £1 million cap, the marginal benefit is reduced relative to the pre-existing tax system. This means that the incentives provided by this scheme are more powerful for large firms. As shown in Figure 3, while such firms do the majority of investment, it is by no means all: 58 per cent of investment was undertaken by large firms (those with 300+ employees) in 2019.
2. The ‘super deduction’ is temporary, so the lasting effect of this policy change is likely to be small, meaning it won’t address the perennial weakness in business investment

It is important to keep in mind that, although the removal of the investment cap will encourage firms to bring forward investment to the next two years, it won’t have a long-run impact on the amount firms invest. This is a design feature of the policy: the idea here is to bring forward investment to the recovery period, thereby providing additional stimulus. For some firms, investment cycles are too long to bring forward significant chunks of spending. However, even for those firms that can bring forward investment, the effect will be temporary. Indeed, the OBR assume the ‘super deduction’ has no long-run impact on the size of the UK’s capital stock. So this policy should be seen as a valuable support to overall levels of activity at a time when risks to demand are on the downside, but will not provide a durable solution to the UK’s perennial low levels of investment.

3. Coverage is limited to a single, import-intensive component of investment, reducing the first-round impact on GDP

As mentioned above, the ‘super deduction’ is limited to plant and machinery investment. This is a key component of investment, including, for example, ICT equipment often thought to be crucial for driving productivity growth. As shown in Figure 4, this category accounts for less than a sixth of all investment spending (although note that for tax purposes, some transport equipment is also covered by the ‘super deduction’). This means that firms which invest mainly in buildings and structures, or for some which lease capital assets, there is less benefit.
More importantly, when evaluating the effectiveness of this policy as a wider fiscal stimulus measure, it is important to keep in mind that machinery and equipment is one of the most import-intensive components of demand, with the UK supplying around half of our needs. So a boost to investment demand worth 1 per cent of GDP will raise final domestic demand by only half that in the first instance. In constrast, the other parts of private investment (such as buildings), household consumption of services and government spending are all far less import-intensive.

In the OBR forecast, the ‘super deduction’ provides a significant boost to investment

Based on the OBR forecast, the ‘super deduction’ provides a significant boost to investment over the next two years. As shown in Figure 5, the forecast for business investment is much stronger than that published in November last year. In the near term, that stronger profile reflects the stronger starting point implied by upward revisions to the data. But, looking further ahead, business investment grows more rapidly over the next two years mainly reflecting the impact of this policy. But thereafter investment weakens again, reflecting that the ‘super deduction’ will encourage firms to bring forward investment that would have happened later.
FIGURE 5: The ‘super deduction’ boosts business investment by around 10 per cent over the next two years

OBR forecasts for real business investment (index, 2019 Q4 = 100): UK

The bottom line is that the increase in the rate to 130 per cent was necessary to offset the rise in CT but the abolition of the cap should provide a temporary boost to investment

Overall, then, the ‘super deduction’ should provide a welcome boost to investment but more policy may well be needed. The policy – particularly the removal of the £1 million cap – provides an incentive to bring forward investment for large firms, boosting overall growth. The increase in the rate to 130 per cent was an important response to the increase in the headline rate of CT to 25 per cent and should offset incentives to delay investment resulting from that change. Headwinds to investment remain, however: while the successful rollout of Covid-19 vaccines has reduced uncertainty, the economy remains weak. And higher corporate debt (discussed in our previous work) is likely to remain a drag on investment as firms rebuild their balance sheets. All this suggests that more support for investment may be needed in future.

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For more information on this report, contact:

James Smith, Head of Macroeconomic Policy
0203 372 2953 | james.smith@resolutionfoundation.org

resolutionfoundation.org | @resfoundation

Resolution Foundation
2 Queen Anne’s Gate
London SW1H 9AA
Charity Number: 1114839