MACRO NEWS 02/08/21

Kallum Pickering, Senior Economist | Kallum.pickering@berenberg.com | +44 203 465 2672

UK CORPORATE TAX HIKES – IMPACT, OUTLOOK, RISKS

Berenberg Macro View

- ***UK headline corporate tax set to rise to 25% from 19% in 2023 – reverses 40-year down-trend***
- ***UK business taxes likely to remain competitive despite planned rises – effective rate much lower than headline rate***
- ***Rising taxes on businesses will hurt margins and could further hamper the UK's attractiveness for foreign investment***
- ***But past changes in corporate tax rates are not associated with major swings in business investment and productivity***
- ***Strong economic performance and rising profitability typically drive business investment***
- ***Benefits of stronger domestic and international economic performance should outweigh drag from higher corporate taxes***

RISING TAXES ON PROFITS – REVERSING THE LONG-RUN TREND

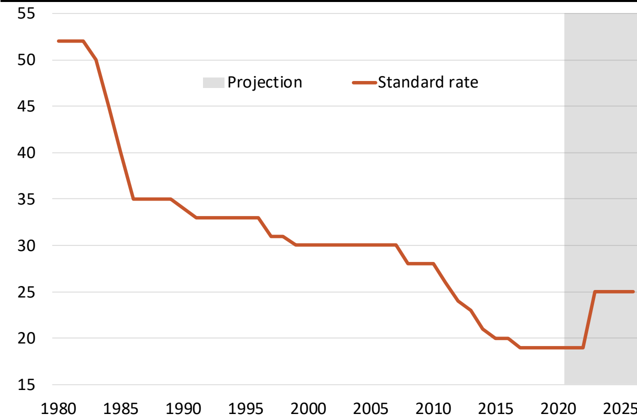
The UK government plans to raise the corporate tax rate in 2023. This ends the 40-year trend of declining taxes on profits in the UK. According to the FT, business leaders have not welcomed the plan, highlighting it as a risk to business investment in the years ahead. The decision is at odds with Prime Minister Boris Johnson's objective to make the post-Brexit UK a more business-friendly economy.

From a current rate of 19%, the UK corporate tax rate will rise to 25% in 2023. A 25% headline rate would remain well below the 30-year average of 27% (Chart 1). However, the plan reverses the long-term aim of successive Conservative governments since the party gained power in 2010 to eventually reduce the headline rate to 17% – which would be by far the lowest among major advanced economies.

The 25% rate will apply to companies with annual profits exceeding £250k – de facto all major corporates in the FTSE100 and FTSE250. A lower rate will apply to firms with profits below £250k. The plan will reintroduce the concept of lower "small profit rate", which had de facto been eliminated in 2015 when the headline rate was cut to the level of the preceding small-profit rate of 20%. The new small profit rate will remain at 19% (on profits below £50k). Firms with profits above £50k will face a tapered rate until profits reach £250k.

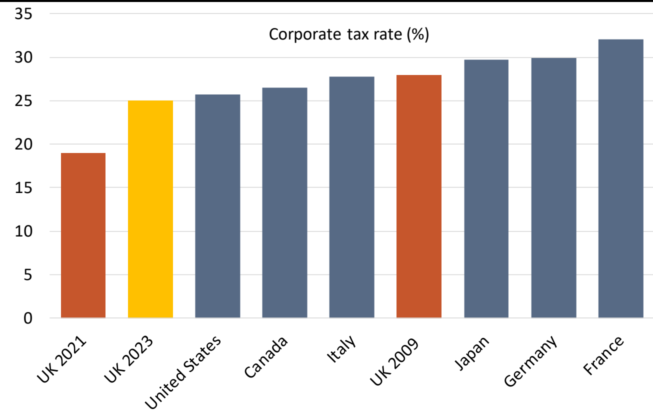
Whether the government will actually hike the tax as planned remains an open question. UK chancellors often signal forthcoming tax hikes that are later softened or delayed – often when economic performance beats the projections incorporated in the initial fiscal plans. If the economic upswing turns out stronger than the Office for Budget Responsibility (OBR) projects, quite likely, in our view, the government may hike the headline corporate tax rate by less than planned or delay it until the next parliament. Such a move could go down well ahead of the next scheduled general election in May 2024.

Chart 1: UK standard rate corporate tax (%)



Source: OBR

Chart 2: Corporate taxes in the G7 (2020 rates)



Source: OBR

STILL COMPETITIVE – BUT BEWARE OF SIMPLE CROSS COUNTRY COMPARISONS

Even with the planned rise, the UK headline rate will remain the lowest in the G7 (Chart 2) and below its 2009 level of 28%. However, among the OECD group of economies, a 25% rate would put the UK in the middle of the pack instead of the one of the few economies – along with the Republic of Ireland and Poland – with a headline rate below 20%.

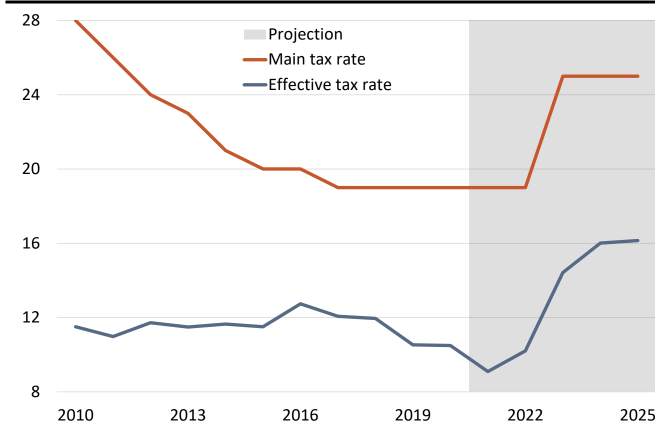
However, simple cross-country comparisons of headline corporate taxes provide only a weak guide to the relative competitiveness of the business environment. Taxes on business profits differ greatly across economies. Headline corporate tax rates do not represent the actual marginal tax on profits paid by firms. Once complex adjustments are accounted for, which can vary a lot even on a firm-by-firm basis, the effective tax rate is often decidedly lower than the official headline rate.

Between 2010 and 2017, the UK headline rate declined from 28% to 19%. However, the effective rate – adjusted for group relief, carried losses and capital allowances – barely changed over the period (Chart 3). Despite a 9ppt drop in the headline rate from 2010 to 2017, the effective rate remained broadly unchanged – averaging a much lower 11.7%.

With the planned temporary “super-deduction” capital allowance, the effective corporate tax rate will fall from 10.5% in 2020 to 9.1% this year. From April 2021 to March 2023, companies investing in qualifying new plant and machinery will enjoy 130% first-year capital allowance and a 50% first-year allowance on other qualifying assets. Thereafter, the OBR estimates that the planned rise in the headline rate to 25% in 2023 will push the effective rate to 16.1%.

Although the temporary super-deduction will lower the effective rate in the near term, the unwinding of temporary reductions will mean that the eventual rise in the effective rate by 2025 (7.1pps) will slightly exceed the planned rise in the headline rate (6ppt).

Chart 3: UK headline corporate tax rate vs effective tax rate (%)



Source: OBR

Chart 4: UK productivity growth – output per hour (% yoy)

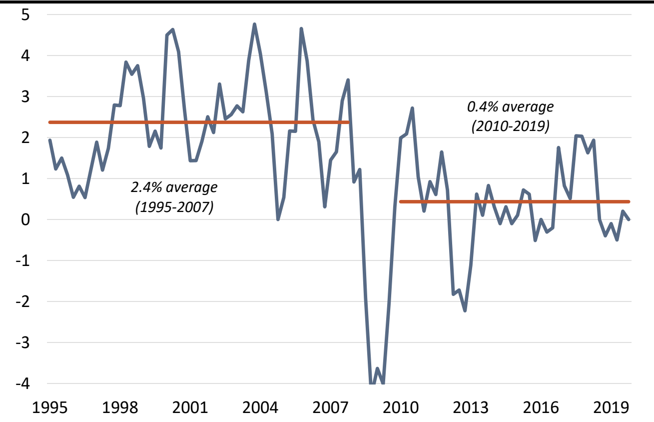


Chart shows data from 1995 up to an including 2019. Source: ONS

WHAT DRIVES BUSINESS INVESTMENT AND PRODUCTIVITY?

The UK has struggled to raise its productivity during the post-Lehman era. Household balance sheet repair, a decade of austerity, political uncertainty, Brexit and a weak global backdrop constrained economic momentum and dramatically lowered average productivity growth. From strong annual growth of 2.4% from 1995 to 2007, output per hour grew at an average of just 0.4% between 2010 and 2019 (Chart 4).

After a decade of soft productivity and GDP per capita gains, improved economic activity in the post-Covid era requires stronger gains in productivity growth and a higher proportion of investment relative to consumption – see Productivity growth: the chance for a revival. Against the backdrop of rising optimism about economic prospects for advanced economies, financial markets now wonder whether the rise in corporate taxes will harm the UK's relative performance.

Such worries are only partly justified, in our view. The planned rise in corporate taxes will reduce business profitability and may, on top of Brexit, further reduce the UK's relative attractiveness versus other advanced economies. However, when taxes are relative low – as they are in the UK – modest changes probably will not hold back sustained higher gains in business investment underpinned by a broad improvement in economic conditions at home and abroad.

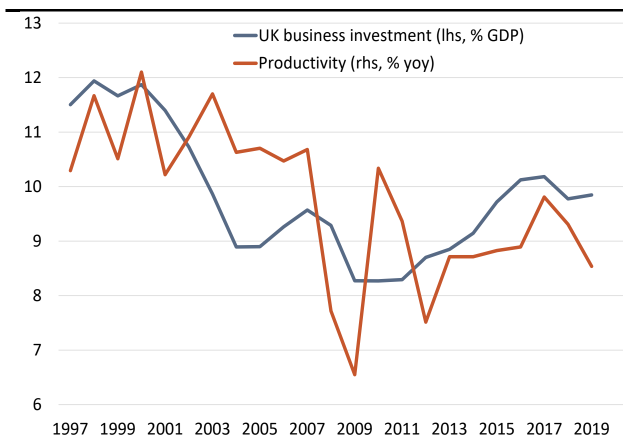
Businesses base their investment decisions on a host of factors including, but not limited to, economic conditions at home and abroad, the robustness of the legal and institutional framework, confidence in the outlook, the real cost of capital, expected real returns on investment, the complexity and burden of regulations as well as the opportunity to make efficiency gains through capital deepening. While changes in business taxes affect firms' bottom lines, a negative development in just one factor while most others are stable or improving should not deter businesses from raising investment to make the most of stronger demand in the years ahead.

Business investment as a percentage of UK GDP had started to decline well before the global financial crisis (GFC) of 2008-09. From nearly 12% of GDP when the Labour Party took office under

the-then Prime Minster Tony Blair, business investment as a percentage of GDP dropped to 8.9% in 2004-05 before hitting a low of 8.3% during the GFC. Although business investment relative to total output had already started to weaken during the early 2000s, output per hour growth in the private sector remained robust until the GFC. The strong gains in productivity despite weakening business investment probably reflect the accumulated contribution to supply potential from strong investment in previous years. Despite healthy gains in measured productivity, reflecting increasing utilisation of existing supply, underlying potential supply growth had probably started to slow markedly well before it showed up in the statistics.

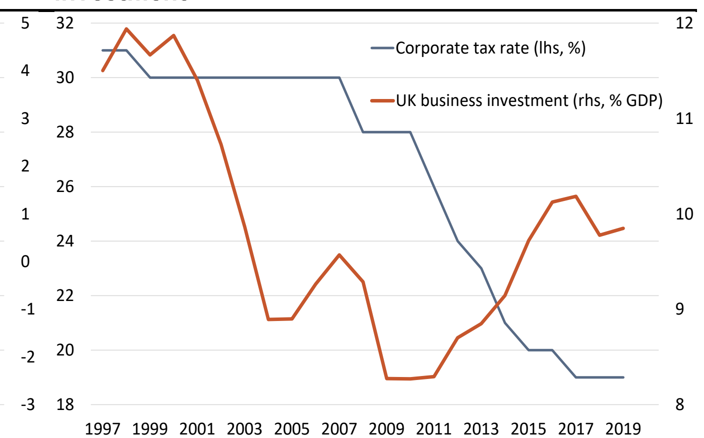
While business investment as a percentage of GDP started to rise again from 2010 onwards, which coincided with the election of a Conservative-Liberal Democrat coalition government, measured productivity growth continued to languish. This was partly due to persistent weak demand and real output growth, caused by harsh public spending cuts until 2015/16 and soft domestic demand growth from June 2016 onwards after the UK voted to leave the EU.

Chart 5: Business investment vs productivity



Productivity based on output per hour estimates for the market sector – which sector excludes central government but includes public corporations. Source: ONS

Chart 6: Headline corporate tax rate vs business investment



Source: ONS

Taken at face value, the rise in business investment as a percentage of GDP from 8.3% in 2011 to a peak of 10.2% in 2017, which correlates with the 9ppt drop in the headline corporate tax rate, supports the case that tax cuts lifted business investment. A closer inspection reveals a flaw in this argument, however. As we discuss above, the effective corporate tax rate was broadly stable over the period (and actually rose from 11% in 2011 to 12.1% by 2017). This would suggest that improving business confidence and economic activity lifted business investment, rather than the only minor changes to effective corporate tax rates.

Until the Brexit vote, UK business investment was on a sustained upward trend that would have probably lifted productivity growth from 2017 onwards if it had continued. However, real GDP growth slowed sharply after the EU referendum – from an average of 2.5% yoy in three years to the June 2016 to 1.5% in the three years after. The reduced rate of real GDP growth held back gains

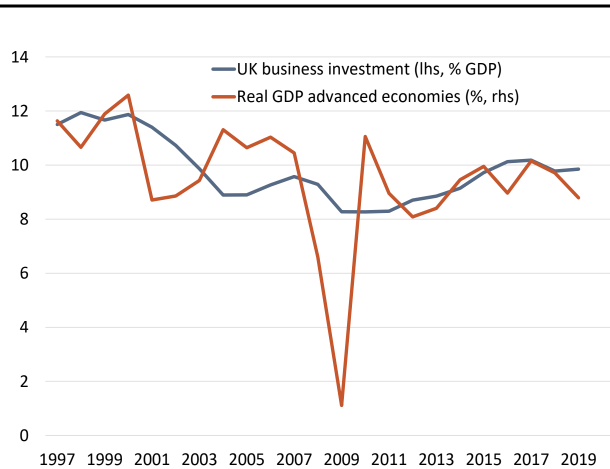
in productivity even as the labour market tightened and job gains slowed. From 4.9% in June 2016, the unemployment rate dropped to 3.9% ahead of the pandemic – its lowest rate since 1974. If real GDP growth had not slowed after the Brexit vote, tight labour markets would have likely forced firms to raise investment and labour productivity to meet the rise in demand.

Corporate tax trends do not seem to explain the performance of UK business investment or productivity since 1997. One reason seems to be that effective tax rates did not fall by nearly as much as adjustments in the headline rate would suggest. This highlights the risk that the forthcoming rise in the headline rate, which also lifts the effective rate, may play a bigger role in shaping the outlook for investment.

In contrast to past tax adjustments, broad-based economic conditions across the advanced world (Chart 7) and business profitability (Chart 8) are strongly associated with trends in UK business investment. The strong real GDP growth in advanced economies during the late-1990s coincided with a high level of UK business investment relative to GDP. It contrasts sharply with the low level of business investment as a percentage of GDP from 2009-2011 and slow growth in the wake of the GFC. Business investment picked up a little from 2013 onwards as economic performance in advanced economies improved. Business investment as a percentage of GDP peaked at 10.2% in 2017.

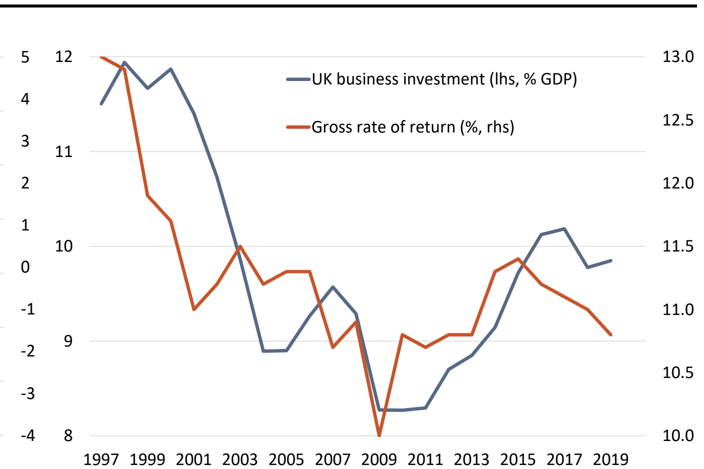
Trends in profitability – measured by gross rate of return – and business investment tell a similar story. Business profitability declined from 1997 to 2007 along with business investment as a share of GDP. Investment and profitability recovered jointly until 2015 when profitability started to decline again, followed by business investment as a percentage of GDP from 2018 onwards.

Chart 7: Business investment vs GDP in advanced economies



Source: ONS, OECD

Chart 8: Business profitability vs business investment



Source: BoE

NOT QUITE SINGAPORE-UPON-THAMES

Financial markets worry that the rise in corporate taxes will reduce the UK's attractiveness as a hub for foreign investment, hurt profits, weaken business investment and further harm the UK's already poor productivity record. Such risks need to be monitored. But although the UK will likely perform much less strongly than it would have done without Brexit and without the hike in corporate taxes, the UK looks set to enjoy sustained robust gains in investment and productivity during the post-Covid upswing nonetheless, helped by a strong global policy tailwind and the end of Brexit uncertainty.

Nevertheless, the planned rise in the corporate tax rate, in addition to the ongoing growth in the public sector, remains in sharp contrast to the ambitions of pro-Brexit Conservative MPs who hoped that Brexit would open the door for a radical pro-market shift in UK economic policy. Far from striving to shrink the tax burden on the private sector, Prime Minister Boris Johnson and Chancellor Rishi Sunak plan to increase it to 39.1% of GDP (from 37.5% in 2020) – the highest since 1984. The government plans higher taxes to finance major public investments and a sustained expansion in public services. We need to carefully watch future plans for market regulation and competition. Tax hikes coupled with an increasing regulatory burden could further depress UK potential growth (currently 1.7%) on top of the roughly 0.4ppt hit from Brexit.

It is a historical irony that, upon leaving the EU, the pro-Brexit UK government has chosen to adopt a more continental-style economic policy.

Disclaimer
This document was compiled by the above mentioned authors of the economics department of Joh. Berenberg, Gossler & Co. KG (hereinafter referred to as "the Bank"). The Bank has made any effort to carefully research and process all information. The information has been obtained from sources which we believe to be reliable such as, for example, Thomson Reuters, Bloomberg and the relevant specialised press. However, we do not assume liability for the correctness and completeness of all information given. The provided information has not been checked by a third party, especially an independent auditing firm. We explicitly point to the stated date of preparation. The information given can become incorrect due to passage of time and/or as a result of legal, political, economic or other changes. We do not assume responsibility to indicate such changes and/or to publish an updated document. The forecasts contained in this document or other statements on rates of return, capital gains or other accession are the personal opinion of the author and we do not assume liability for the realisation of these.

This document is only for information purposes. It does not constitute investment advice or recommendation to buy financial instruments. It does not replace consulting regarding legal, tax or financial matters.

Remarks regarding foreign investors
The preparation of this document is subject to regulation in the United Kingdom. The distribution of this document in other jurisdictions may be restricted by law, and persons into whose possession this document comes should inform themselves about, and observe, any such restrictions.

United Kingdom
This document is meant exclusively for institutional investors and market professionals, but not for private customers. It is not for distribution to or the use of private investors or private customers.

United States of America
This document has been prepared exclusively by the Bank. Although Berenberg Capital Markets, LLC ("BCM"), an affiliate of the Bank and registered US broker-dealer, distributes this document to certain investors, BCM does not provide input into its contents, nor does this document constitute research of BCM. In addition, this document is meant exclusively for institutional investors and market professionals, but not for retail investors or private customers. It is not for distribution to or the use of retail investors or private customers. BCM accepts responsibility for this research document's contents and institutional investors receiving this research and wishing to effect any transactions in any security discussed herein should do so through BCM and not the Bank.
Please contact Berenberg Capital Markets, LLC (+1 646 949 9000) if you require additional information.

Copyright
The Bank reserves all the rights in this document. No part of the document or its content may be rewritten, copied, photocopied or duplicated in any form by any means or redistributed without the Bank's prior written consent.

© 2021 Joh. Berenberg, Gossler & Co. KG