

The case for a permanent investment deduction

Dynamic macroeconomic analysis – March 2023

Overview

The UK has consistently had the lowest level of business investment as % of GDP in the G7

- The UK's level of business investment has been the lowest in the G7 for close to four decades.
In 2021, business investment made up around 13% of GDP across the G7, compared to 9% in the UK.

Higher private business investment is key to higher sustainable growth

- Higher business investment can boost GDP growth in the short-term. It also results in a greater stock of capital in the economy, increasing the long-run potential growth of the UK Economy.

Investment incentives are set to fall in the UK

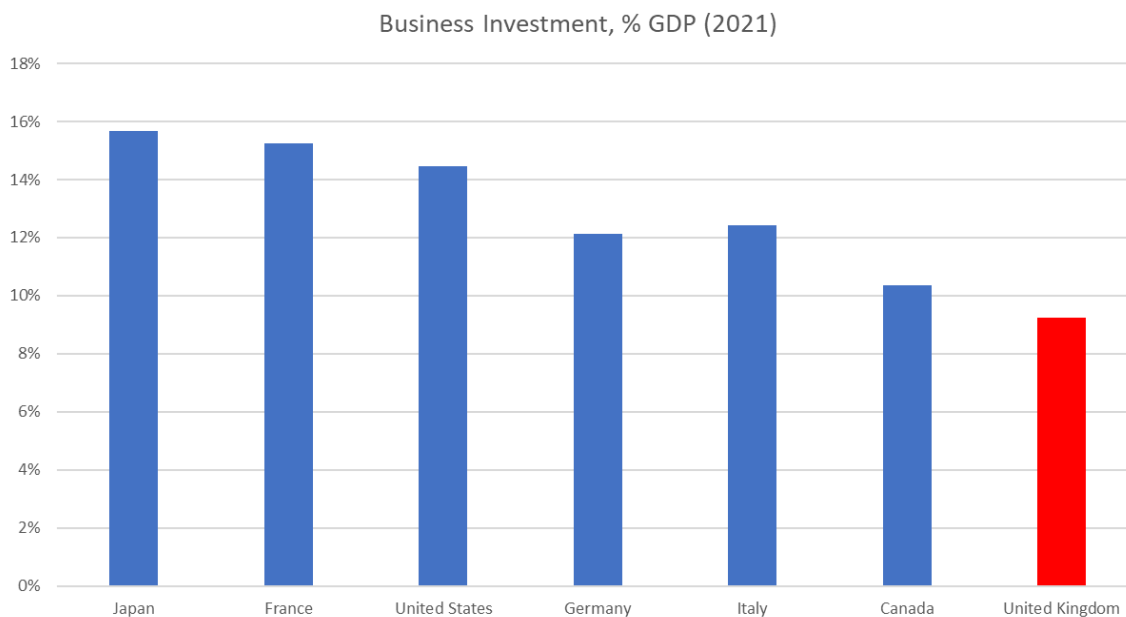
- In April 2023, the Corporation Tax rate is set to increase from 19% to 25% at the same time as the end of the super-deduction regime.
- Before the super-deduction was introduced the UK ranked 30th out of 37 countries in the OECD for capital allowances¹ and it could return there once the super-deduction ends.

A permanent investment deduction (100% full expensing) could unlock 21% extra investment per year

- CBI analysis conducted in collaboration with Oxford Economics shows full expensing could lead to:
 - A 21% (£52.8bn) increase in the level of business investment per year by 2030/31
 - An increase in the level of GDP by 2.0% (£53.1bn) by 2030/31
 - While there is an upfront cost, the long-run net balance sheet impact is positive for Government
- Under full expensing 96% of firms would factor capital allowances into their investment decision (at the moment 27% would not)
- If not introduced from 2023/24 Government should commit to a 3-year roadmap to achieve full expensing

1. Before the super-deduction for plant and machinery was introduced at Spring Budget 2021, the UK was ranked 30th in the OECD for capital recovery overall. This weighted average was made up of 31st for machinery, 25th for buildings, and 16th for intangibles.

The UK underperforms on business investment compares to its peers



The UK's level of business investment has been the lowest in the G7 for close to four decades. In 2021, business investment made up around 13% of GDP across the G7, compared to just over 9% in the UK.

How does a permanent investment deduction boost investment?

- **Free up cash flow for businesses to drive investment:** It could boost and bring forward capital spending at a much faster rate – with up to £50bn of extra investment per year by 2030/31.
- **Boost international competitiveness:** It is a strong international signal for firms that the UK is a rewarding place for investment. On the other hand, if the government does not introduce a permanent deduction, our capital allowances system could remain the significantly less competitive in the G7. A full expensing or 50% investment allowance regime will go some way in closing this gap.
- **Allow rewards to be reaped by businesses of all sizes and in all locations:** Allowing businesses to claim for all plant and machinery, in the year the expense is incurred, would vastly simplify the process. This would benefit SMEs, which are less likely to have access to specialist advice and larger businesses, which would not benefit from the permanent AIA limit of £1m to the extent their investments exceed limit.
- **Incentivise and accelerate decarbonisation:** Improving cash flow through full expensing allows firms to accelerate their green capital investments.

Reform of the capital allowances system

To understand the impact of potential reforms to the capital allowance regime the CBI conducted a survey and commissioned analysis from Oxford Economics. The survey was undertaken with 741 respondents over the period 14th to 27th July 2022, and the macroeconomic impact assessed through the Global Economic Model operated by Oxford Economics. This slide pack presents analysis on two reform options:

1. **Introduce a permanent investment deduction of 100%,** by increasing main rate plant and machinery allowances from 18% to 100%, to give businesses the confidence to make long-term investment decisions.

2. **Introduce a permanent special rate investment deduction of 50%**, by increasing special rate plant and machinery allowances from 6% to 50%, to create a truly comprehensive successor to the super-deduction.

If Government does not introduce full expensing in 2023/24, a 3 year roadmap should be set out to achieve full expensing with a 50% capital allowance from 2023/24.

The scenarios presented here analyse the impact of each regime separately from 2023/24, not as part of a combined policy roadmap.

Key forecast results

The results from the analysis showed that if these reforms were undertaken from April 2023 to follow the end of the super-deduction, it would lead to:

1. **Increase in business investment.** Full expensing would result in a 21% (£52.8bn) increase in the level of business investment by 2030/31. Increasing plant and machinery allowances to 50% (instead of 100%) would still provide nearly a 13% (£33.1bn) boost in business investment
2. **Boost in real GDP.** As a result of the higher investment, real GDP increases by 2.0% (£53.1bn) higher than it would otherwise be in the case of full expensing. The 50% investment deduction would still lead to a 1.2% (£31.0bn) higher level of GDP, over the same period.
3. **Higher economic activity results in an increase in demand for labour.** Under full expensing, the unemployment rate falls to 3.3% by 2037 while in the 50% investment deduction scenario it settles at 3.5% (compared to a baseline of 3.8% unemployment). To ensure growth was not prohibited it would be important to tackle current labour shortages alongside boosting investment.
4. **Positive net impact on the government's balance sheet over time.** The cost of the new policies is offset by a boost to incomes, expenditure and profits which increase tax receipts relative to our baseline forecast.

Overall, there is negligible inflationary impact from this measure. It remains close to baseline, and consequently there is no central bank response to the rise in investment and output.

1. Changes to Private Investment

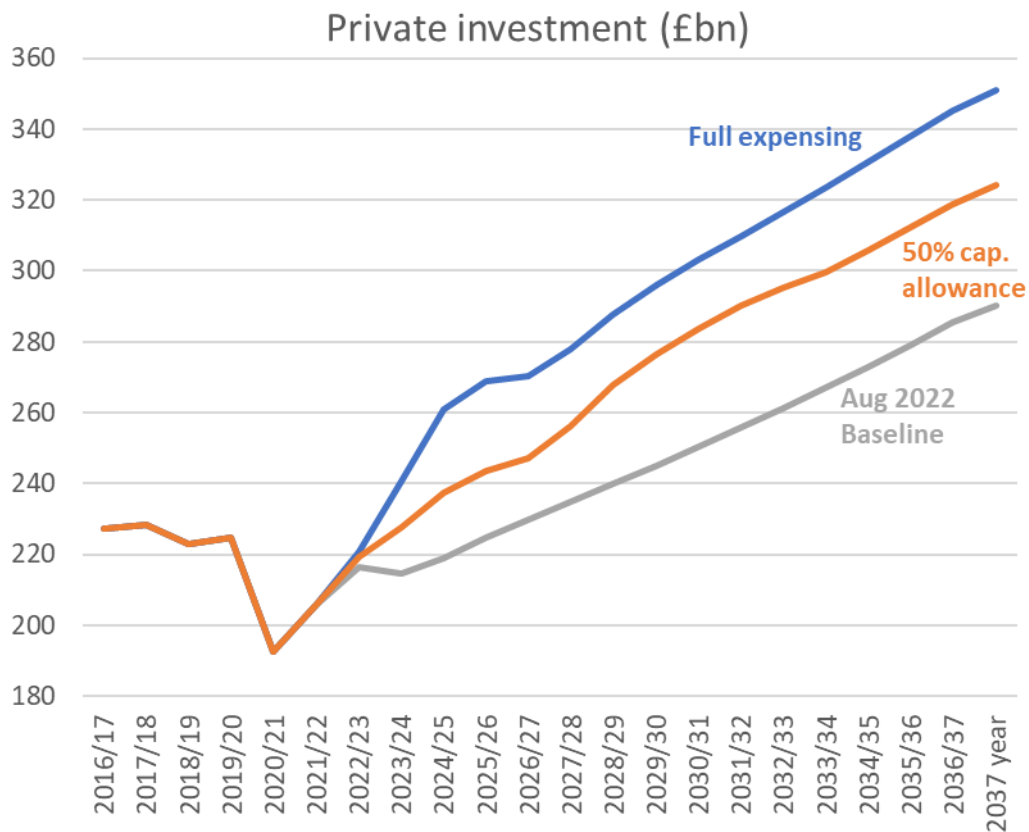
More generous capital allowances relative to baseline results in stronger private business investment

- Our analysis results show that:
 - **Full expensing:** would lead to a 21% (£52.8bn) increase in the level of business investment by 2030/31
 - **A 50% investment deduction:** would still provide nearly a 13% (£33.1bn) boost in business investment over the same period
- Despite the rise in investment across the scenarios modelled, the growth rate of private business investment slows markedly at the start of 2023, reflecting the effect of the end of the super-deduction tax, and firms not being able to gain capital quickly enough in the near-term to prevent a slow-down.

Table 1: Changes in private investment (£bn) relative to baseline

Scenario	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32	2032/33	2033/34	2034/35	2035/36	2036/37
Full expensing	26.1	42.2	44.4	40.7	43.1	48.0	51.0	52.8	54.1	55.3	56.6	57.8	58.9	60.0
50% Cap. Allowance	12.9	18.6	19.1	17.4	21.4	27.9	31.3	33.1	34.4	34.2	32.9	32.7	33.1	33.5

Figure 1



Source: CBI; Oxford Economics

2. Changes to Real GDP

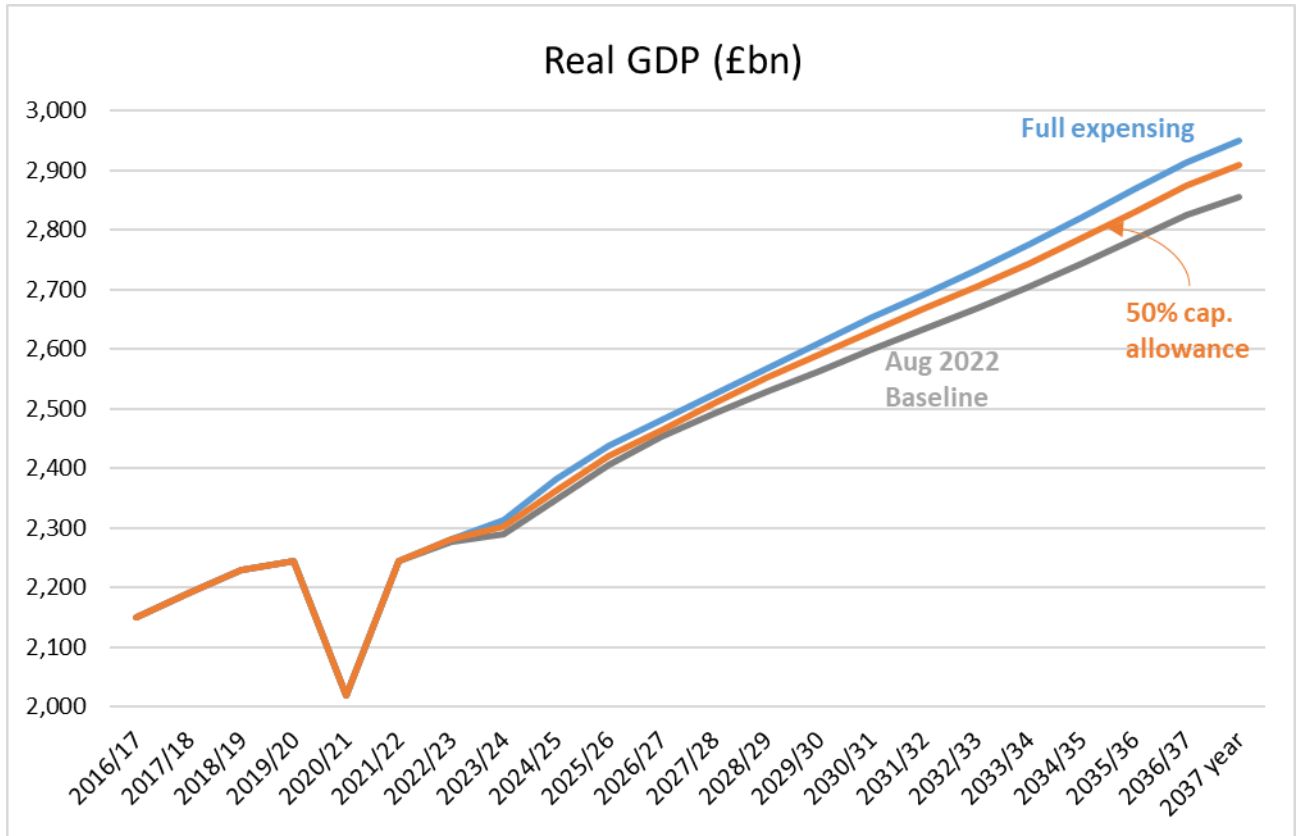
Higher business investment feeds through to higher GDP

- Higher business investment results in a greater stock of capital in the economy, increasing the long-run potential growth of the UK Economy.
- Our analysis results show that:
 - **Full expensing:** an increase the level of GDP by 2.0% (£53.1bn) higher than it would otherwise be.
 - **A 50% investment deduction:** would lead to a 1.2% (£31.0bn) higher level of GDP, over the same period.

Table 2: Changes in real GDP (£bn) relative to baseline

Scenario	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32	2032/33	2033/34	2034/35	2035/36	2036/37
Full expensing	24.0	35.2	32.4	26.8	31.0	39.8	47.0	53.1	58.9	64.8	71.0	77.3	83.4	89.4
50% Cap. Allowance	11.8	15.3	13.7	11.4	16.3	24.0	28.2	31.0	33.8	36.1	38.0	41.7	45.9	49.9

Figure 2



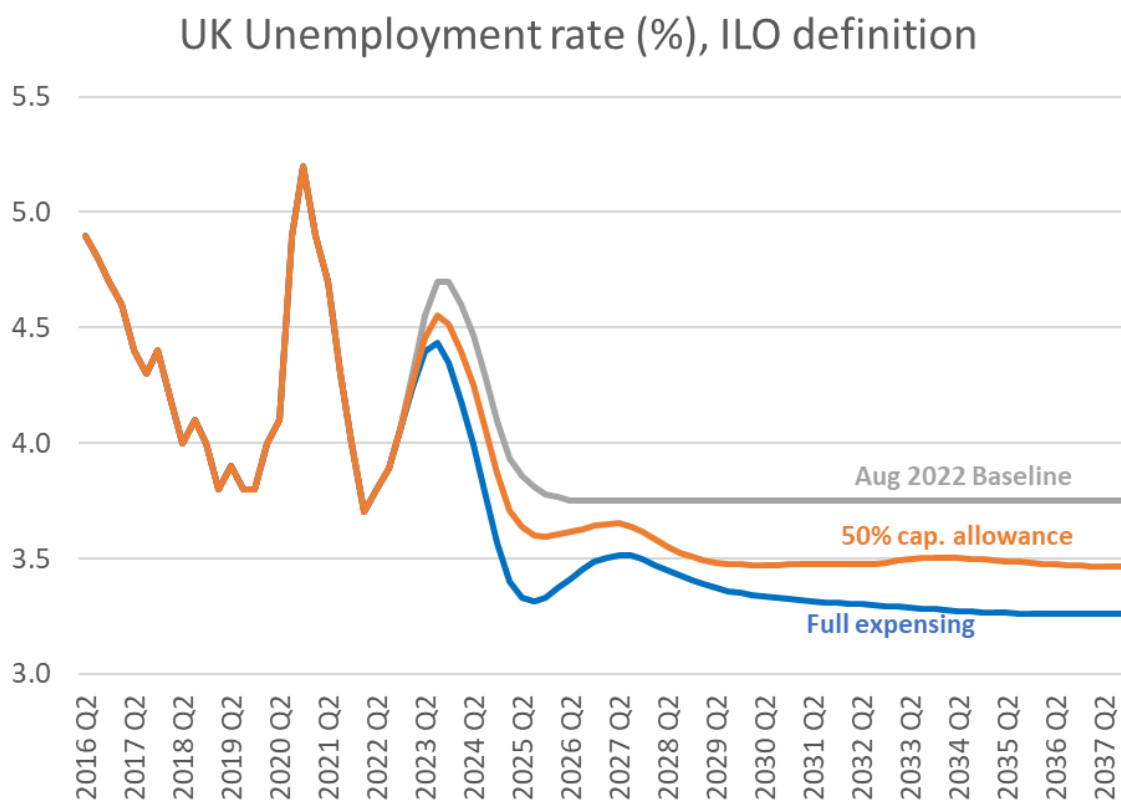
Source: CBI; Oxford Economics

3. Labour market impact

Higher economic activity results in an increase in demand for labour.

- Survey respondents were evenly balanced between those who saw investment as replacing labour and those who would increase demand “in greater proportion to the amount invested”. Labour demand is therefore assumed to move proportionally to capital investment.
- In the current environment of widespread labour shortages, the availability of labour could slow the ability of firms to increase investment to their desired level. In contrast, with greater support to boost investment, firms may turn to capital investment to boost productivity and increase automation.
- To ensure growth was not prohibited it would be important to tackle current labour shortages alongside boosting investment.

Figure 3



Source: CBI; Oxford Economics

4. Policy Costing

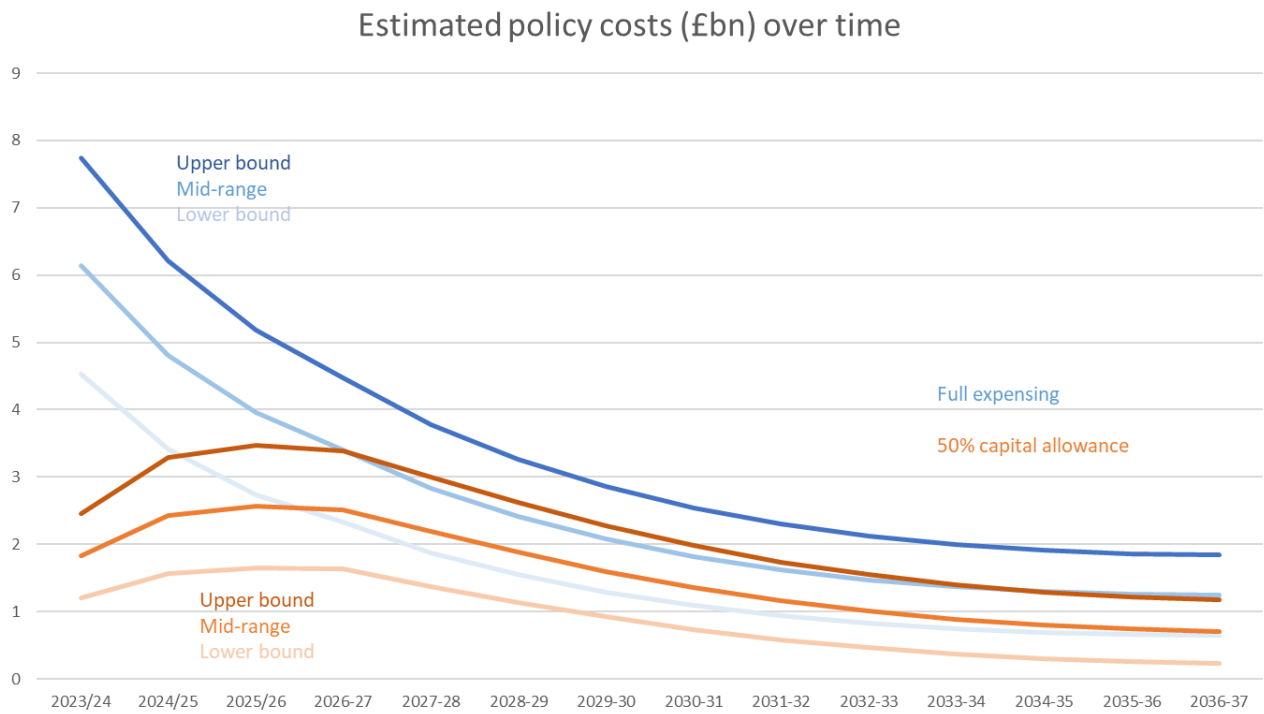
Whilst the generosity of the capital allowance regime overall is not changed under full expensing or a writing down allowance of 50%, there is an upfront cost of the deduction as it is passed through to firms quicker.

Table 3: Static costing of scenarios

	2023/24	2024/25	2025/26	2026-27	2027-28	2028-29	2029-30	2030-31
	(£bn)							
Full Expensing								
Upper bound	7.7	6.2	5.2	4.5	3.8	3.3	2.9	2.5
Mid-range	6.1	4.8	4.0	3.4	2.8	2.4	2.1	1.8
Lower bound	4.5	3.4	2.7	2.3	1.9	1.5	1.3	1.1
50% Capital Allowance								
Upper bound	2.5	3.3	3.5	3.4	3.0	2.6	2.3	2.0
Mid-range	1.8	2.4	2.6	2.5	2.2	1.9	1.6	1.4
Lower bound	1.2	1.6	1.7	1.6	1.4	1.1	0.9	0.7

Upper and lower bound figures are given because data is not available to divide investment spend on Transport Equipment into qualifying and non-qualifying expenditure. The lower bound assumes no Transport Equipment qualifies and the upper bound assumes all Transport Equipment qualifies for the relevant investment deduction.

Figure 4

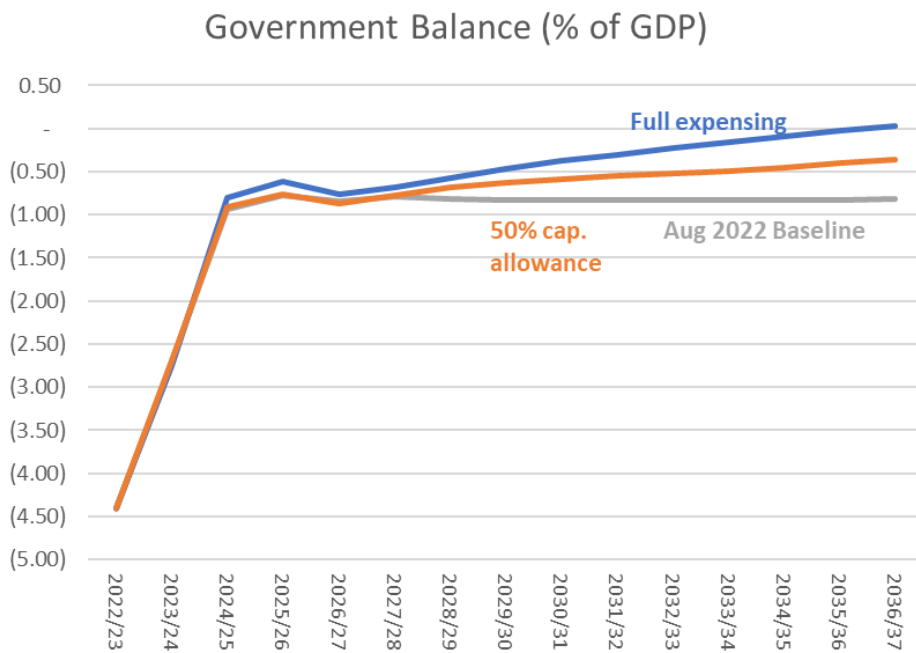


Source: CBI; Oxford Economics

5. Balance Sheet impact

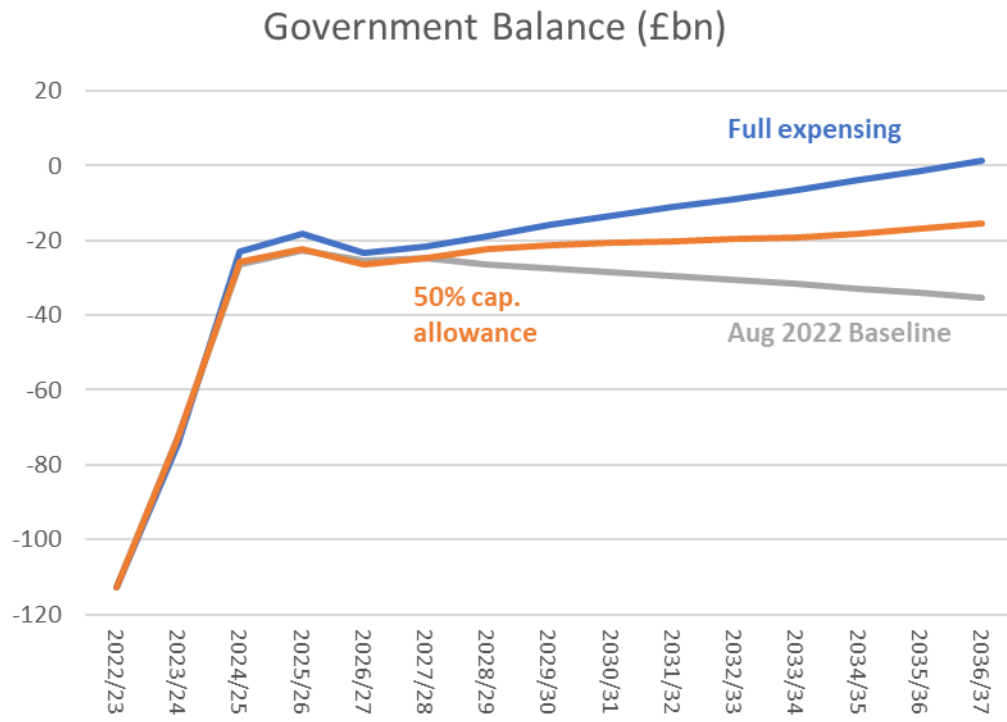
Overall, this analysis shows the long-term net impact of introducing full expensing on the government’s balance sheet is positive. The upfront cost of the new policies is offset by a boost to incomes, expenditure and profits which increase tax receipts relative to the baseline forecast.

Figure 5



Source: CBI; Oxford Economics

Figure 6

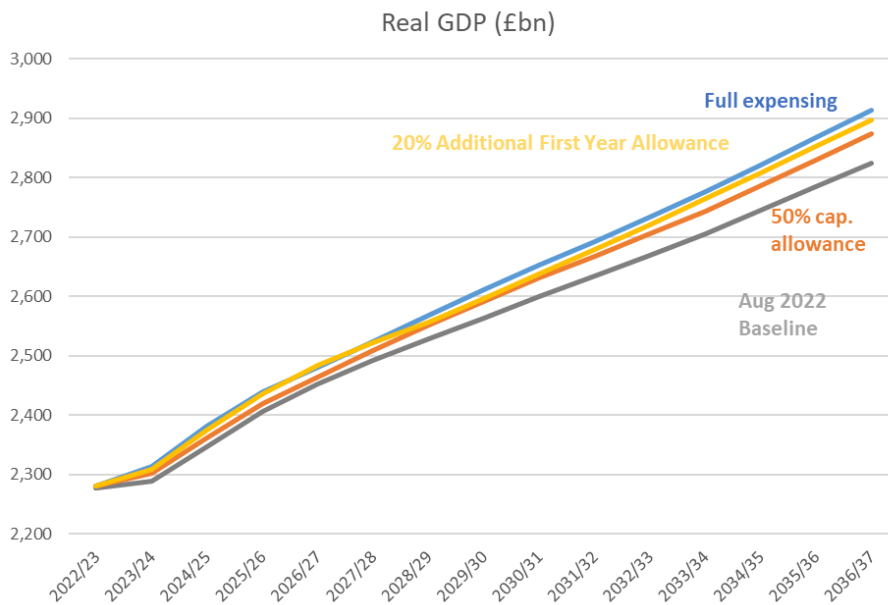


Source: CBI; Oxford Economics

Annex 1: Additional analysis: 20% Additional First Year Allowance

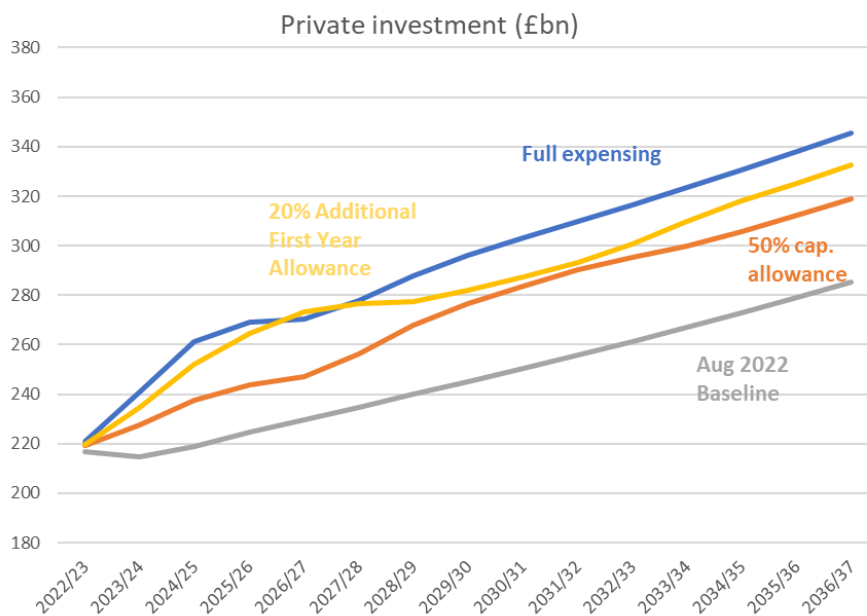
To test reform options the original survey and analysis from Oxford Economics also tested a third scenario. A super-deduction in the form of an extra 20% first year allowance on top of regular plant and machinery allowances (i.e. so 38% could be claimed in year 1, and 120% could be claimed overall). This policy was not developed further as the positive economic impact was shown to be lower than full expensing, despite a real and permanent cost to the exchequer.

Figure 7



Source: CBI; Oxford Economics

Figure 8



Source: CBI; Oxford Economics

Annex 2: Analytical Methodology

Costing assumptions

- **Qualifying business investment:** It is assumed that 'ICT and other machinery' represents most categories of business investment in qualifying plant and machinery and that investment included in the IP and 'buildings and other structures' categories would be entirely outside of the scope. It is uncertain whether transport would be qualifying so a range has been provided for each scenario from no transport being qualifying to all transport being qualifying.
- **Financial year period:** A financial year is assumed to include the last three quarters of the first year and the first quarter of the second year, which is based on the tax year period. For instance, the qualifying business investment for 2015/2016 is calculated using Q2-Q4 data from 2015 and Q1 data from 2016.
- **Special rate asset:** It is not possible to difference between special rate and main rate assets in the business investment figures. It is therefore assumed that all relevant categories of plant and machinery will qualify for the main rate - this leads to a definite overestimate of the cost of scenarios.
- **Costing forecast from 2026/2027:** Longer term forecast OBR figures are used to project the increase in business investment until 2025/26. After that point a 4% annual increase is assumed.

Forecasting assumptions

- Survey respondents' baseline planned investment is in line with OE baseline real business investment series, therefore allowing us to directly apply the % difference from baseline in each scenario.
- The investment shock is applied in real terms rather than nominal as we believe respondents to the survey will be considering their planned investment in today's prices.
- Additional capital investment does not reduce the demand for workers. We therefore allow the Global Economic Model to endogenously derive the employment rate which takes into account factors such as economic activity and real earnings.
- This is consistent with the survey, as responses "demand would be lower" and "demand would be higher in greater proportion to the amount invested" was broadly balanced for question 24. This also appears consistent with the literature: "*Tax policies that incentivise capital investment do not lead manufacturing plants to replace works with machines*" (Curtis et al, 2022)
- We have not made any explicit assumptions regarding crowding out. That is, with higher private business investment, government investment does not fall.

Forecasting methodology

- The analysis uses Oxford Economics Global Economic Model (GEM). This is estimated on a quarterly basis. As a result, the annual % difference from base provided in each scenario is first converted into a quarterly frequency. This is done through a spline to ensure the profile is smooth.
- This shock is then read onto GEM. Ex-ante shocks are read in, which means that the investment equation is left fully endogenous and allows for second round effects to feed back into private investment.
- All scenarios start in 2022 Q3.
- The private investment shocks (based on CBI's survey) are applied to OE's target capital stock variable. Given the current economic environment of supply-chain disruption and the cost-of-living squeezing firms profit margins, it would be unrealistic to expect a boom in private investment over the first several quarters of the scenario horizon.
- Through applying CBI's investment shock to our target capital stock variable, this feeds through into private investment at a 5% convergence rate. However, as CBI's shocks

contain useful information from survey respondents, the convergence rate is increased to 15% to ensure the scenario output to better aligned to CBI's survey responses. As CBI's difference is applied from base onto the long-run business investment, therefore the model converges quicker to these numbers.