



The role of tax in the industrial strategy



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Foreword

As a country we face imminent challenges on a scale not seen for decades. Brexit, weak productivity growth, the increasing pace of technological change, an aging society and shifts in global economic power all raise questions as to how we should go about shaping our future. The need to have a well designed industrial strategy that is implemented in an effective way is essential, and in November 2017 the UK Government published its white paper which set out a long-term plan to boost the productivity and earning power of people throughout the UK. The 2018 IFS residential conference, sponsored by PwC, asked what role tax should play in such an industrial strategy.

When looking at how to design and deliver elements of an effective Industrial Strategy we must first be clear about what we think it is, and what it should be trying to achieve. Discussions among the many specialists and stakeholders at the conference highlighted that creating conditions for growth required a focus on skills and education, infrastructure, investment, innovation and the distribution of outcomes across our regions. Tax measures have the potential to play a real role in delivering the necessary environment if properly evaluated and implemented. In this report, Stella Amiss, PwC's UK Tax Policy Leader, explores how tax policy sits alongside many other policy levers in "Tax and the Industrial Strategy – a ready reckoner".

Where tax does have a role in supporting our industrial strategy, for example in creating a competitive environment for multinationals and incentivising greater research and development, we debated how we should design our tax system to ensure that it is effective in that role. This includes how to spot when a tax incentive was not the right tool and was doing more harm than good. Helen Miller, Deputy Director at the IFS, notes that while we shouldn't expect to see detailed tax policies filling the glossy pages of an Industrial Strategy, we should give more consideration to our industrial aims when designing tax policy and offers a guide on how to determine "When should taxes be used to steer the industrial structure?"

As is often the case with policy design, much of the devil is in the detail. The desire to attract multinational businesses to the UK must be balanced against the desire to raise revenues and for businesses to be seen to be contributing their fair share. Similarly, the desire to encourage entrepreneurship and innovation must be balanced with the costs that arise when people respond to incentives by changing behaviour in order to reduce tax bills. Neville Howlett, Tax Director for External Relations at PwC and Paul Morton, formerly Director of the Office of Tax Simplification, summarise the discussions on "How do we balance fairness and the desire to attract big companies?" and "Tax and business – the 'tail' should not wag the 'business' dog" respectively.

Alongside the issues such as productivity, that we've long been grappling with, we will also face new challenges in the future. One such challenge will come from technology, which may fundamentally change the way our society and economy operates and thereby affect the nature of jobs that are available, the skills needed to do them and the investment needed in learning, development and retraining. These factors will also impact the amount and way in which we raise taxes. In the short term, securing international consensus on how to tax digital activities that don't sit neatly within global boundaries is proving a challenge, adding further to the argument that there is a real need to properly consider more wholesale reform rather than adding to and patching up the existing system. Tax policy is important for a country's economy and society and ensuring that it remains fit for purpose and integrated coherently into broader trade, economic and fiscal strategies is crucial. Julian Sansum offers his thoughts on the future challenges in "The impact of digitalisation and artificial intelligence on the economy and the tax system – a look forward".

Designing tax policies and industrial strategies that fulfil multiple aims is not easy. Part of the key to success will be to bring together the right people to discuss how best to address the issues and to get collaboration and consensus on the best way forward by drawing from a broad range of experience and expertise. The conference made a good start. Those attending included politicians, senior officials from HMRC, HM Treasury, and the Department for Business, Energy and Industrial Strategy, along with representatives of our leading trade organisations and from business, academia and civil society.

We thank all of the participants who attended the conference in Cambridge and we look forward to continuing the discussion with the aim of helping Government make real progress in the coming months and years.



Paul Johnson
Director, IFS



Kevin Nicholson
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Article 1

When should taxes be used to steer the industrial structure?

Helen Miller

Deputy Director,
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In the UK's 256-page Industrial Strategy, the words tax or taxation crop up only a handful of times. On the face of it, that's perhaps not too surprising: tax is just one policy lever among many others ranging from education, through infrastructure and regulation to direct government investments in science. It's understandable that the Industrial Strategy gives a nod to the role of an internationally competitive corporate tax rate in attracting multinationals and reinforces support for R&D tax credits, but builds a strategic vision from policies that more directly steer the economy down a certain industrial path.

Yet, the list of ways in which our tax system affects the UK's industrial structure is long. Capital allowances favour investment in plant and machinery over investment in buildings and purchased intangible assets. The tax deductibility of interest payments favours debt over equity financed projects, while a set of venture capital schemes favour those new companies that can secure equity investments. A suite of policies favour 'small business' – where small is defined on turnover for the VAT threshold, on property rental value for Business Rates relief, on size of shareholdings for Entrepreneurs' Relief and on turnover and staff for R&D tax credits. And these are just the obvious ones. Keep digging and you find a hefty tax penalty on employment relative to self-employment, an incentive to hang on to assets with capital gains until death, various subsidies to agriculture and to investments in the creative industries, VAT zero-rates that give some products a competitive advantage, and so on.

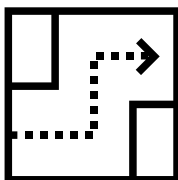
By favouring certain types of business, asset, financing or ownership we're effectively favouring certain industrial structures even if it is hard to look at a list like this and easily discern which industries are getting a relative leg up. Tax might not have a starring role in the industrial strategy, but it affects our industrial reality. What's more, the effects are usually unintended and often problematic. In light of the UK's long tail of unproductive and poorly managed firms, are we sure that policies encouraging people to start and hang on to business should be celebrated? If we are serious about financial stability, is it right to overlook tax-induced debt bias we've created?

We shouldn't expect to see detailed tax policies filling the glossy pages of an Industrial Strategy, but neither should we ignore the unintended effects that taxes can have on our industrial structure. We could start by giving more consideration to these effects when we design tax policy.



We undervalue the benefits of a neutral tax system

If we were designing taxes from scratch, a good rule of thumb would be to tax all profits (as opposed to turnovers) in the same way regardless of how they arose (i.e. no special rates for anything). This in turn would require deducting the costs of doing business – such as investing in assets – without discriminating between assets, sources of finance or ownership. Such a system would ensure that decisions were driven by what makes commercial sense rather than by the tax system. We know that taxes affect decisions – you can't prevent all hissing when plucking geese – but we at least want to minimise the extent to which taxes distort choices unless there's good reasons to think that varying taxes across activities can improve outcomes.



When to use taxes to steer the industrial structure

A neutral tax system has much to recommend it but there are reasons to deviate from neutrality by favouring some activities over others. Deviations can be justified when the benefits of a simplification (such as removing many firms from VAT) outweigh the costs of added distortions or as a mechanism to meet redistributive goals. Some distortions arise from a desire to be internationally competitive and may be a price worth paying to ensure that the UK is an attractive location for multinational investments. But, too often, the ways in which our tax system influences industrial structure arise from an ill-thought-out desire to boost activities that sound like the kinds of things we must want more of. A more structured way to design tax policies that will influence the industrial structure – and to evaluate the long list of tax breaks and special allowances – is to ask the following three questions.

1

First, is there a good reason to change a market outcome?

Markets aren't perfect or completely free – imperfect competition is the norm and government intervention already shapes how markets operate. But while the many ways in which markets fail to produce the best possible outcomes lead to multiple arguments for deviating from a neutral tax system, doing so in practice is fraught with the dangers of complexity, special pleading and unintended consequences. The first step when contemplating using policy to manipulate an outcome is to specify precisely what it is about current market outcomes that's undesirable – what is it we want more or less of and why? Wanting more robots or small businesses or UK made films because they're 'good' in some way isn't a good enough rationale. If they're good, why won't the current market create the number of robots or films that balance the overall costs and benefits to society? If people aren't willing to start a business without a subsidy, what makes us think that such a business should exist?

One specific reason that markets may fail to produce the socially optimal outcome is 'spillovers' (also called externalities). When individuals or companies make decisions they don't take account of the costs or benefits that their actions have on others – for example, they don't value the lessons that others learn when a new technology is researched or a new business concept tried. Spillovers can mean that the market will produce too much of some things (like pollution) and not enough of others (like R&D) and this can be the basis for possible government intervention.

2

Second, is tax the right tool?

Knowing that there is an outcome we'd like to change is only the first step. There are rationales for the government to try, for example, to reduce pollution, problem drinking and childhood obesity while boosting R&D and entrepreneurship. But tax may not be the best tool. The government can also ban or regulate certain activities (like advertising junk food to children), adjudicate competition (for example between established firms and start-ups) and make direct investments (such as in science facilities or lending to new businesses).

Broadly, taxes are a good tool when changing prices (such as making the creation of pollution more expensive or R&D investments cheaper) or rates of return (such as making the post-tax rate of return higher if income is taken in capital gains rather than in earned income) leads to more (or less) of the activity that the market is currently under-(over-) producing. For example, R&D tax credits reduce the price of investing in research and thereby give companies an incentive to do more. If we want very specific outcomes (like investment in malaria drugs), more direct intervention (like funding research or providing prizes) can be better targeted. And since we usually operate tax and direct measures simultaneously (for example the UK spends around £3bn on R&D tax credits and about the same on direct support for business R&D) we should consider how they interact and what purpose different policy levers serve.



3

Third, can we design tax solutions where benefits outweigh costs?

There may be a clear rationale for a policy and a reason why tax is, in principle, a good tool to use. But we still need to go to the effort of designing a policy that works and that doesn't cause more problems than it solves. Consider entrepreneurship. One can justify considering policies that reduce the cost of trying a new business venture. But, that absolutely does not mean that a set of large, across the board tax breaks to all small business owners is a well targeted policy. Sure, it might help boost some of the activities that have externalities, but it's created a whole bunch of other unintended side effects (like tax motivated incorporation) along the way. In policy discussion, there's a disappointing tendency to overestimate the ability to fine tune outcomes with tax, and dramatically underestimate the set of unintended ways in which people respond to tax incentives. Also, having identified that the market may under produce entrepreneurs, it doesn't mean that more is always good – we can have too many people starting new ventures. Finally, if the actual concern about start-ups relates to access to credit, then we should address that problem directly – offering juicy tax breaks for activities that generate capital gains doesn't help a business which can't get a loan today.



Removing distortions may be less sexy but better policy

While building industrial strategy into tax design might sound quite exciting, we shouldn't get carried away. The bar for deviations from a neutral tax system (i.e. one that doesn't affect our industrial structure) should be high. This is not because a neutral tax system is perfect but because attempts to use tax to help some groups too often create more problems than they are worth.

When we find problems or outcomes we'd like to change, we should first look at current policy. Removing current distortions is a seriously underrated policy option and often much more sensible than layering another distortion on top. For example, there has been much concern about the effect of business rates on the high street, with proposed policy solutions including reliefs for pubs, retailers and small business and new taxes on online sellers. Instead, we could consider moving the tax away from business buildings to land values and thereby remove all distortions to competition. This approach would not only make the system simpler rather than more complicated but it would actually work – the quick fixes may offer some short term relief but leave the structural issues in place.

If we were more willing to remove policies that weren't working, we'd not only get a fairer, simpler and more efficient tax system but we could be more confident in experimenting with new policy options. If every new tax break or relief is destined to be a permanent fixture, we need to be much more mindful of how it will help shape the long term structure of the economy.



Spillovers can mean that the market will produce too much of some things (like pollution) and not enough of others (like R&D) and this can be the basis for possible government intervention.





Article 2

Tax and the Industrial Strategy – a ready reckoner

Stella Amiss

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Reputation

We know all too well that there are several challenges when using tax to support particular activities, behaviour and outcomes.

But that shouldn't stop us looking at the positive role that tax policy can play in making a difference. The UK Government has set out its industrial strategy for the future with a view to boosting productivity by backing businesses to create jobs, and invest in skills, industries and infrastructure. Tax policy can play a vital part in all of that – to ignore the role of tax is akin to arguing that the world is flat.

The conference we sponsored with the IFS last year met this challenge head on and asked 'what role tax should play in the industrial strategy?' If the Industrial Strategy is really going to make a difference, and if we are serious about looking at the positive role that tax can play in delivering this change, then this ready reckoner coming out of everything we heard may be of some use.

1

It's not just about tax

Tax alone cannot shape an Industrial Strategy, and whilst it can make a difference, tax alone should not dictate the direction of travel. What is important is collaboration. Solutions need to involve different areas, different specialisms, skills and inputs. No one discipline can do it alone. We need a holistic approach bringing together ideas and expertise in skills, infrastructure, education, innovation and in tax to name just a few. This calls for collaboration and cooperation on a scale never seen before.

2

It's about the people

A recent PwC report¹ suggests that the UK could boost GDP by around £40 billion a year in the long run if it reduces the number of young people not in education, employment or training (NEET), to match the levels we see in Germany, the best performing EU country. Despite making improvements in recent years, the UK only ranks 19th out of 35 countries across the OECD in the index. Add to this the fact that we know that the future of work is changing with the advent of technology, so that the market will demand different skills whether we like it or not. This underlines the fact that there is a need for more focus on skills, security and access to work. We need to start thinking about what skills we need, and where we need them. There needs to be a focus on finding ways to upskill, re-skill, train and retrain. Tax could play a key part in how we mobilise this, and how we encourage more education and training. Re-imagining things like the apprenticeship levy to directly respond to this challenge is something that should be explored.

3

Getting with the programme

Digitalisation and technology enablement is continuing at a pace. Already we are seeing changes proposed to the tax system that look to change the way we impose tax on digital activities. But the real question to be answered is whether the tax system we have now is sufficient to meet the needs of a digital world, and whether it is indeed fit for the future. This is explored further in Julian Sansum's article below. Here, we need to at least look at what tax measures should be introduced to encourage the development and adoption of technology, and where new taxes are imposed to what extent might they act as a potential and significant restraint. We need to harness technology not penalise it.

4

Place your bets – on innovation

It's clear that the UK needs to attract, encourage and support innovation so it follows that we also need a tax system that does just that. The UK Government has established a good track record in supporting research and development activities to date but the time is ripe for a closer examination of the current system to see whether this goes far enough. To do this effectively we need some real focus on the types of innovation we want to encourage and reward – what about broadening incentives to boost productivity through the development of new technologies. Let's take the principles that Helen Miller sets out to get a real spotlight on innovation and the behaviours we want to encourage and test whether tax could have a greater role to play.

5

"If you build it... they will come"

It's not just a quote from an 80's movie, it's a truism that works well here. Infrastructure is key to delivering on any industrial strategy and key to supporting economic growth. So we need to look hard at whether tax has a part to play in encouraging development of transport, housing, digital networks and energy supplies. Here, tax has a dual role. On one hand as a way to incentivise investment, partnerships and development, and on the other hand being a means to helping raise further funds to finance ongoing government spend – a dynamic we often miss when evaluating the cost of our investments. This could also be an area where it's worth looking harder at whether there is a role for hypothecated taxes to help prioritise and ring fence investment into this critical area.

¹ www.pwc.co.uk/services/economics-policy/insights/youth-employment-index.html

6

'D' is for Devolution

Whilst we are busy working out our approach to the Industrial Strategy we run the risk of forgetting about the different needs of our regions and the momentum that has already built up for greater tax devolution. Devolution has taken a back seat of late, but when building an Industrial Strategy that can work, we must look at how it will operate on the ground. It would be foolish to overlook the impact increased devolution of the tax system could have in delivering the Industrial Strategy. It is important to have a strong dose of realism here, too. We need to assess the potential benefits of tax devolution in relation to a wide range of criteria which should include, improvements to accountability, the distortionary impact between regions, the benefit or not of providing incentives, inequality, volatility risk as regards the tax base, and finally the additional administration and complexity that devolution would require.

7

Rome wasn't built in a day

And nor can an Industrial Strategy be delivered overnight. To make this a real success we need to embrace finding a way to build and deliver a longer term approach. We cannot build a multi-disciplinary Industrial Strategy with short term solutions. Whilst there are some short term measures that can make a real difference, and should be taken, it's not the way to deliver long term sustainable change. There needs to be a long term plan to see the longer term ambition through. This is not radical, it's practical. We need a clear road map for those tax measures which are part of the Industrial Strategy setting out clear objectives which embrace enduring principles and are transparent in approach. This allows us to gain more buy in, more commitment and a greater appetite for change.

8

We need to talk about... tax

We have seen that tax can make a difference across a raft of different areas. We have also heard that tax may not always be the answer. To me, this is another stark reminder that we all need a better understanding of the tax system with more engagement to help make better choices. We can start with better education and communication. But we also need to up our game on being clear as regards any tax measures introduced and their objectives. The Industrial Strategy is a great opportunity to really demonstrate the relevance, impact and costs of tax – let's make the most of it.

9

...and finally!

Defining the role for tax to help support an effective Industrial Strategy is all well and good. Finding tangible ways that tax measures can make a positive difference to effect real change and to deliver that strategy is even better. BUT can any new tax policy make a big enough difference if it is another bolt on to a tax system that is outdated and overly complex? If our future is one that needs us to deliver an Industrial Strategy then it could be just the excuse we need to reform our tax system so it is fit for the future too.





Article 3

The impact of digitalisation and AI on the economy and the tax system – a look forward

Julian Sansum

UK Partner at PwC
– Employment and
equity lead

Technology is evolving at an unprecedented rate, fundamentally changing the way our society and economy operates. Here we consider how this could impact taxes levied and the way in which they are collected.

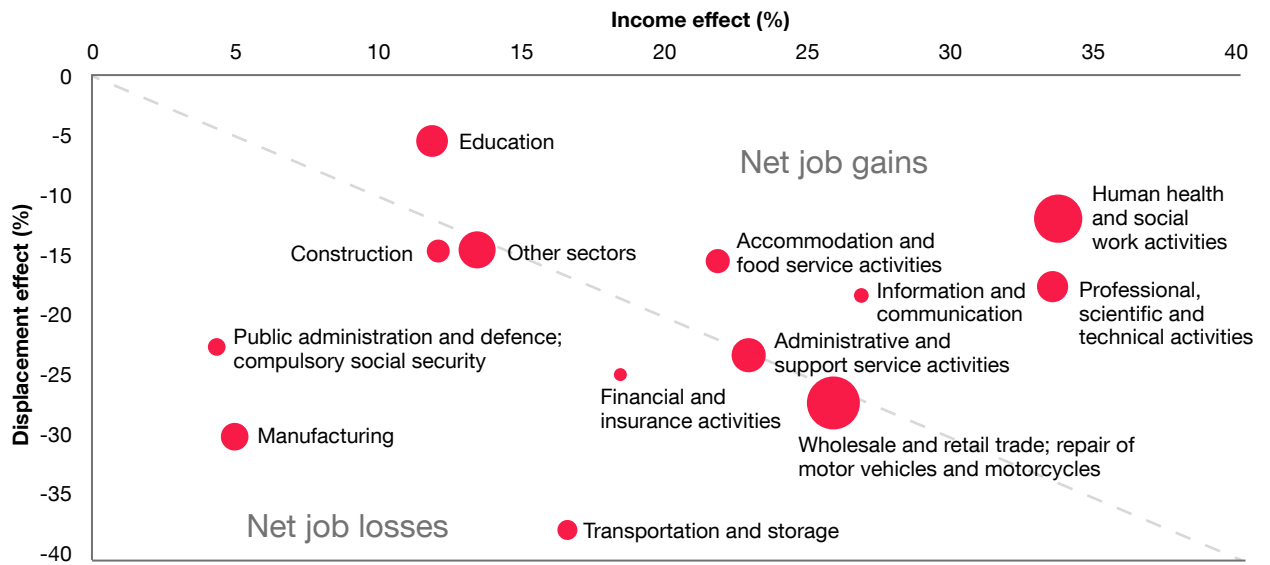
The taxes that government collects are currently skewed in favour of taxing labour rather than capital. Personal Income tax and National Insurance Contributions (NICs) amount to around 45% of total UK tax receipts and underlying labour driven activities are taxed at a much higher rate than corporate income tax that collects around 8% of total UK tax receipts. As the deployment and uptake of AI increases, the expectation is that capital could become a relatively more important production factor than labour bringing with it the potential for a significant change in the mix of revenues collected from different taxes.

Initial studies undertaken by our economists at PwC in their report **on the impact of AI on the UK economy**² using conservative assumptions suggest that AI will drive an increase in UK GDP of just over 10% by 2030. This growth is predicted to be generated through productivity gains – for example the work force performs tasks more efficiently – but as time goes by to be generated increasingly by consumption driven gains as the ability to collect and analyse data accelerates increasing demand through improving quality of products, tailoring them more specifically to consumers, and reduced costs of consumption.

Alongside this impact on GDP growth, the other major effect that AI will likely have is on jobs. The expectation is that between 20-30% of UK jobs will be impacted by new technologies by 2030. Some will be altered, and some displaced, but there will also be new jobs created. Our economic models suggest that overall the effect on UK jobs will be broadly neutral but that there will be winners and losers by industry sector, importantly the mix of jobs will likely change. There is evidence which suggests an emerging polarisation of the workforce with job creation heavily weighted towards non routine, manual low-skill at one extreme and cognitive high skill at the other, and a consequential so called ‘hollowing out’ of middle-income jobs.

Technology doesn't just affect jobs, but can also affect the taxes raised. We have already seen various challenges to the existing international tax rules and questions raised as to whether they are fit for purpose in a modern economy. The challenge posed by technology to the tax base is another issue that needs a better understanding and response.

Figure 1: The impact of AI – Winners and losers by industry sector



Sources: PwC analysis

From a corporate tax perspective, this is something already featuring in the debating halls and on the legislative books of many countries but the current international debate is heavily focused on defining taxable presence thresholds for highly digitised businesses and the potential for re-allocation of existing profits between countries. In the UK this potential has now become all the more real with the Chancellor's proposals for a Digital Services Tax as announced in the October 2018 budget. In the main these are short term approaches where we are seeing some countries proceed with unilateral action focused on a new allocation of taxing rights for some types of digital activity. This is disappointing. It brings with it all the risks of double or multiple taxation and the potential for cross border disputes to arise. But more fundamentally, it misses the point. We need to turn our attention to developing a sustainable tax base that is fit for the future and can respond to the disruption caused by technology. This requires more efforts towards international consensus, a greater understanding of the potential impact of technology on our tax base, some bravery and a good dose of longer term focus.

If we look more closely at the potential medium term impacts of the increasing digitalisation of the economy and AI (as mentioned above), in the period up to 2030 we would see that whilst the UK's flexible labour market might help to ensure many of the GDP gains of technology accrue to labour, the type of jobs that are created to replace those lost, and the nature of our personal income tax system could combine to provide an additional risk to our tax base.

This risk is rooted in the profile of taxpayers within the UK income tax system. Specifically whilst the top 1.4% of income tax payers earning over £150,000 account for a large amount of income tax revenues (c.31%), it is the middle range of earners (those earning between £30,000 and £150,000) who account for over half of those revenues (c.54%). As a result, any displacement of jobs within that middle range of earnings could have a disproportionate effect on the UK tax take.

One might theorize that employees on middle incomes who are displaced as a result of developments in AI are more likely to take a job at a lower level of income, as they are unlikely to have the fiscal security to wait for a job with similar earning potential. This would have the effect of "hollowing out" the middle of the UK tax base and would need to be addressed if tax receipts were to be protected. One solution might be to implement strategies to continually upskill the workforce, enabling employees to keep moving up the earnings ladder rather than dropping down. Employers clearly have a role to play here, but government interventions such as the Apprenticeship Levy are also important.

Another impact of the advancements in AI and technology more broadly on the UK jobs market could be that more workers will look to the gig economy to supplement their earnings. This brings with it its own set of challenges from a tax perspective. The UK is currently wrestling with how to address the perceived tax gap in relation to workers who source their income via digital platforms, for example with the sale of goods or increasingly the provision of services. The Government has consulted on the options around how platform providers might support these gig workers with their tax filing/payment requirements. Whilst some of the solutions consulted on have merit, there is a question as to whether they make full use of the developments in technology. For example, one solution which would use digital advancements to collect tax in cleverer ways could be for gig workers to be paid gross into a central account which then operated the tax and franked the money as 'taxed' before moving it to a bank account of taxed money for the worker to use. New solutions such as these will need to be considered if the UK is to continue supporting its flexible workforce whilst still protecting tax receipts.

At a corporate level, without protection we could see the tax base being eroded as the deployment of AI could well alter the relative importance and contribution of the production factors driving economic growth – with a shift from labour to capital. There are two key factors that could well affect AI's impact on the UK economy and tax base, the ownership of capital and the level of investment in AI.

At present, the return on capital will likely be taxed in a territory that owns the capital, so if it is not owned and retained in the UK that poses a potential risk to the future of the UK tax base. The extent to which the returns are attributable to the UK will depend on the level of control that capital owners will want to exert through the deployment and control of that capital in the UK. Despite the potential risk to the UK tax base sustained foreign investment is vitally important. The PwC studies 'Sizing the Prize'³ and 'The macroeconomic impact of artificial intelligence'⁴ show an increase of 10% in the level of real GDP in the UK by 2030. In order to achieve this our models suggest that there would need to be an incremental investment in AI of 15% of GDP⁵. The tax take may increase as a consequence of the growth in the economy which results from the investment in AI.

As one of 'The Grand Challenges'⁶, the UK Industrial Strategy is seeking to encourage businesses to embrace technological development and AI, to put the UK at the forefront of the artificial intelligence and data revolution. This will also create a challenge for the current UK tax policy to provide incentives to develop and utilise this technology, and also to modernise the tax system so that it continues to generate the necessary tax receipts to fund our public services. Reforms are needed to anticipate the changes that we are expecting the digital economy and AI to bring and, as necessary, to bring sensible alignment with changes made at a global level.

3 www.pwc.com/gx/en/issues/analytics/assets/pwc-ai-analysis-sizing-the-prize-report.pdf

4 www.pwc.co.uk/economic-services/assets/macro-economic-impact-of-ai-technical-report-feb-18.pdf

5 This is an average figure for the whole economy. Some businesses will need to invest more than this figure, others less. It depends on the extent of a businesses engagement with AI led technology.

6 www.gov.uk/government/publications/industrial-strategy-the-grand-challenges/industrial-strategy-the-grand-challenges





Article 4

How do we balance fairness in the tax system with desire to attract big companies?

Neville Howlett

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PwC – External and
Government relations
for tax

The UK Government has set out an industrial strategy for the future with a view to boosting productivity by encouraging businesses to invest in skills, industries and infrastructure. Changing ways of working and doing business, as discussed in other articles in this publication, highlight the need for the tax system to be reviewed and reformed.

Measures to ensure the UK remains an attractive location for investment needs to be part of this reform. It also needs to manage the perceived tension between looking to use tax to attract multinational activities while meeting calls for multinationals to pay their 'fair share'. And if it is accepted that this tension exists, there is a need to think through how government can set its priorities to manage the necessary trade-off.

This break out session at the conference attracted a wide range of stakeholders to discuss these issues, including continuing claims in the media that businesses are not paying their 'fair amount' of taxes. Three main themes emerged from the discussions; how do you define fairness?; the need for better education and understanding of the tax system; and can the tax system be used to attract business to the UK and if so is tax the most appropriate policy too?



Defining fairness

The basic question of whether a tax system is fair is at the heart of much of our public debate and we regularly see discussions around whether 'the rich', or companies are paying their 'fair share'. Defining fairness was seen as difficult by our break-out session participants as it means different things to different people. In particular what is seen as 'fair' in one country can be regarded very differently in another; if it can't be defined it's simply not a useful term. A progressive tax system was seen by some as a guiding principle, but clearly the discussion is often concerned with closing perceived loopholes in the tax code.

In assessing fairness, is that a question of process or of outcome? The former is clearly much easier to assess than the latter. While taxpayers have a key role in ensuring they comply with their obligations, some felt that it's not for taxpayers to assess fairness of outcome. But we might ponder that by expressing collective views and influencing change through the ballot box, fairness of outcome is indeed addressed.

The difficulties with defining fairness in the tax arena are unlikely to go away, so we can expect this to be a continued point for discussion and for it to be part and parcel of future political debate.



A need for education and understanding

If we are to have a fruitful debate about what a fair tax system looks like, we need to start from a base of good factual understanding, to generate well-formed questions and for them to be supported by the best available information.

The sense from our participants was that the public debate is not currently well informed, but that there is an appetite for more information on how taxes are raised and spent, and the inherent trade-offs in the system. It was thought that people are more likely to buy into the tax system if they have a better understanding of how it works.

The challenge then is how to improve the level of education, encourage a constructive conversation and overcome polarised positions, to inform the public debate and encourage a sense of community. Tax is not an easy subject, and it was recognised that conveying complex measures in a simple way without being simplistic is difficult. What information does the public expect and how does this information provide transparency about the tax system? It was felt that there is a need to be transparent both about new tax measures and how business complies with the tax system. That transparency will hopefully contribute to balanced media reporting which in turn will facilitate a more constructive public debate, and clearly the simpler the system the easier it is to understand it.

As regards the public perception that large companies are not paying their 'fair share' of tax, there was some recognition by participants that tax can be complex and that along with some recently introduced mandatory rules, some companies are also making voluntary disclosures to provide a better understanding of their tax affairs.



Can the tax system be used to attract business?

What business do we want to attract to the UK and is it 'fair' or effective to use the tax system to do this?

There was consensus in the room that the UK has some major economic and social challenges ahead and that underlying all of this is a need to help improve the competitiveness of the UK economy. Using the tax system to help address these issues was seen by many as essential. The reductions in corporate tax rates under the current government, the coalition government and the previous Labour administration have improved UK competitiveness and provided a stable policy framework. However changes designed to boost competitiveness must be sustainable over the long-term, and not based on providing tax breaks which cannot be sustained.

There is concern that tax competition can be harmful but checks and balances such as measures recommended by the OECD through its BEPS program (Action 5) for peer reviews to identify potentially harmful features and commitments to transparency should help to allay these concerns.

Businesses in the room also underlined the need for certainty. Having a stable system is key, as is clarity on changes in law. Changes in law or ambiguity in approach undermine trust in the system. Equally important for business however is where the talent is, and an environment where the skills needed for the future will be secured. It was thought that the tax system could be helpful in making sure they are available.

So this was a thought-provoking exchange of ideas and issues, recognising the necessary trade offs and challenges, and a useful addition to the list of things for Government to consider in setting its Industrial Strategy for the future.

Tax and business ownership – the tax ‘tail’ should not wag the business ‘dog’

Paul Morton

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Should the tax system provide encouragement for people thinking about starting a business? Should it encourage individuals to hold on to their business or should it provide an incentive when a business is sold or passed on? Which tax policies would best stimulate entrepreneurship and provide the most efficient allocation of resources? How can tax policy address the long tail of low productivity firms?

The review of the Business Life Cycle, published by the Office of Tax Simplification in April 2018, identified that the number of tax reliefs available tends to increase over the life cycle of a business:

There are no reliefs for start-up capital but a variety of reliefs available on disposal.

The Conference break-out group felt that tax incentives were not the right kind of instrument to encourage investors to provide start-up capital. “Friends and family” tax relief would be much too easy to abuse, probably give rise to huge “deadweight” cost and perhaps encourage some people to start poor quality businesses. Instead, advice, support and help with seeking finance were the right approaches.

The reliefs available to an existing business for raising further capital, such as the Enterprise Investment Scheme, seemed to work well, however. In particular, there was a strong feeling that these reliefs enabled some businesses to raise additional funds which would not have been available from banks or other lenders.

There was some debate about the merits of reliefs on disposal of a business. In particular many commentators feel that Entrepreneurs Relief (ER), which provides a lower rate of capital gains tax on disposal of a business, rewards those who have grown successful businesses but does not provide an incentive to set one up. The Resolution Foundation noted that “it has a good claim to being the worst of Britain’s main tax reliefs”. On the other hand, some participants worried that there would be even fewer transactions such as sales of businesses, and more incentive to hold on to a business, without the relief. Although some members of the discussion group had anticipated a negative conclusion on ER the outcome of the debate was somewhat ambiguous.

Figure 2: Taxes and tax reliefs over the life cycle of a business

| Event | Start-up | Incorporation | Finance | Succession | Disposal |
|-------------|----------|---------------|---------|-------------|-----------------|
| Tax Charges | None | CGT | None | CGT / HT | CGT |
| Tax Reliefs | None | CGT Rollover | SEIS | EOT relief | SEIS |
| | | | EIS | Gift relief | EIS |
| | | | VCT | BPR | VCT |
| | | | | APR | Investor relief |
| | | | | ER | ER |
| | | | | PETs | EMI shares |

There was some concern that inheritance tax reliefs on passing a business on to the next generation might encourage some business owners to hold on to their business for “too long” in order to pass on a business tax free but there was a strong feeling that they would do this anyway, so the problem was not with the tax relief but with a general reluctance of successful business owners to pass on their life’s work! The view that multi-generational businesses would be adversely affected without inheritance tax reliefs was widely supported although some questioned whether multi-generational businesses (i.e. those owned by consecutive generations of the same family) were as successful as other businesses.

The reasons why some business owners choose to hold their business within a company were discussed. Although tax can be a motivation (as incorporated businesses can give rise to a lower level of taxation, overall, than unincorporated) there was a strong feeling that other reasons for incorporation, such as the presentational impact, legal protection and custom and practice in some professions and industries, were also important reasons. It would be difficult to address tax motivated incorporation without impacting on commercial arrangements.

A recurring theme throughout the conference was that tax should play a small part in an industrial strategy and that seemed underlie much of the discussion of the impact of the tax system on the ownership of businesses. While disappointing perhaps for tax aficionados it reinforced the general approach that the tax ‘tail’ should not wag the business ‘dog’.



About the authors

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