

Not so taxing: spurring private investment to tackle inflation

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Summary

This briefing makes the case for using the tax system to better tackle the causes of inflation:

- Every pound from the public purse should advance the government's objectives for a strong and sustainable economy. The government is currently reviewing how the tax system can support businesses to invest. This review should incentivise green and productive capital, not outdated technologies.
- The government should provide the most backing for investments that will do the most to alleviate current challenges. Super-deduction level rewards should only be for increasing green energy and reducing energy waste. Investments that will make the problem worse should be penalised.
- The government should take a similar approach to personal taxes. Adjusting taxes on electric vehicles, energy efficient homes and energy bills should make it easier for the public to switch away from inflationary fossil fuels.

Unleash the power of business

Businesses and private capital will do the heavy lifting to reach a net zero carbon economy. Government policy should create a supportive environment to allow them to do so. In an environment with heavy fiscal pressure, concentrating on the tax treatment for businesses could achieve the best result for public funds.

There has been a focus on cutting the headline rate of corporation tax to boost economic growth. But adjusting capital allowances is a more targeted intervention to increase business investment by reducing the cost of capital. This was deployed with success in the 2021 budget through the super-deduction, allowing businesses to claim 130 per cent capital allowances on qualifying investments.

Tax credits should be used to accelerate the government's wider objectives. The free market research organisation [Rhodium Group](#) shows that they are

one of the least expensive ways to reduce carbon emissions, offering benefits three to four times their cost in the US. The Milton Friedman chair at the University of Chicago has called them a policy “slam dunk”.

Making existing allowances work harder, while expanding them across technologies, can lower costs now and could lower inflation by speeding up the transition away from the main driver of price rises, which is gas. Tax credits are especially effective for building new green industries in the UK where technologies often have lower operational costs but significant upfront costs, like green steel.

Better value from existing business allowances

Rewards and incentives based on outcomes

Tax credits and allowances are not currently doing enough to support government policy. The government recognises this and is committed to designing a new system of allowances that drives growth, but it should not stop there. A new system should also target private investment where it is most needed, ie in addressing the causes of inflation and decarbonising the economy.

Crucially, focusing on a future net zero economy is better for growth: green capital lasts longer and is more productive. As the government’s net zero review sets out, economic multipliers for green investments are two and a half times those in fossil fuels (see paragraph 1.16). Allowances should reflect that.

Businesses that invest in green technologies will shield themselves from increasingly volatile global prices. Those investing in carbon intensive machinery will be left behind as technologies become obsolete. This is poor value for taxpayers’ money and should be penalised, not rewarded. The 91 per cent investment allowance on the Temporary Energy Profits Levy is one such perverse reward.

A better allowances programme should increase the level of tax incentive based on the outcome of the investment. The US system of tax credits, in the new Inflation Reduction Act, does a version of this, with increasing levels of expensing based on green criteria, alongside others including labour standards and the level of manufacturing done inside the US.

The US example is tied to technologies, like hydrogen. Similarly, Sweden for sustainable biofuels. This is similar to the previous UK offering of enhanced capital allowances for limited private investments on the Energy Technology List, which were often complicated to access. The Netherlands updates a list annually of environmentally improving assets that qualify for additional allowances, of varying amounts depending on the outcome.

UK allowances should apply to any environmentally improving or low carbon technology, with the focus on what role it plays in decarbonisation. Like R&D tax credits, they would be claimed by business based on alignment with our framework in the table below. It is not about picking winners but getting greater value from the public purse.

This focus on outcomes claimed by business alleviates the problem of definitions. Although over time this will be solved by the [UK green taxonomy](#), it is unclear whether this will include transitional technology. The example of a new gas grid (see the table below) expected to be used for hydrogen clarifies this. In this case, once there was proof from the investor that there were adequate plans to move to hydrogen, the investment could receive the allowance. If these plans did not materialise, the government could, in turn, impose a tax penalty, holding a company to its commitments.

Reward innovation and skills

Allowances should cover not just physical capital but support intangible capital, which is often lower cost.

[Italy](#) offers sizeable allowances for both skills and other intangible allowances. Skills and innovation are vital to a productive economy and would also fall into the tiers below.

R&D tax credits cost the exchequer £7.4 billion in 2019-20, including R&D carried out overseas. This is reported directly by industry, but is increasingly used for research that would have been carried out anyway, or for activities that the Office for National Statistics (ONS) would not classify as R&D. In 2019-20, R&D tax credits claimed were [over £20 billion](#) more than the ONS estimate for business R&D.

Given the need to use the innovation system to accelerate the [productivity gains](#) of net zero carbon focused business activity, R&D tax credits should also be put to more productive use, driving more [socially useful research](#).

An alternative allowance system explained

Tier	Explanation	Level of expensing	Examples
1 Brown tech	Investments that impede growth by relying on outdated technology, including those that cause direct harm to the environment	-10 per cent	Incinerators, oil and gas infrastructure, fracking

2 Neutral and transition tech	Those investments that are aligned with sector specific transition pathways but are not directly contributing to decarbonisation.	100 per cent	Machinery and office equipment, combined heat and power systems
3 Green tech	Investments that accelerate decarbonisation, preparing the economy for the future. Likely aligned with the imminent UK green taxonomy.	120 per cent	Green steel scrap collectors and sorters, electric arc furnaces, electric space and water heating, external solar shading, smart systems that lower energy consumption
4 Urgent priorities	Reserved for the most pressing investment needs facing the country, currently energy security.	130 per cent	Energy efficiency, low carbon energy and storage, electric vehicle charging, training for green jobs

Unleashing the power of the individual

The government is rightly looking at ways to lighten the burden of rising costs on individuals. Tax cuts can help when they are targeted. But tax cuts without direction could exacerbate inflation. As with allowances, cuts should help to meet government objectives to shield households and move them away from the causes of inflation, ie skyrocketing oil and gas prices.

Low carbon technologies [will save people money](#), tax cuts can help bring those technologies within their reach. Cutting VAT rates for home energy efficiency measures at the last budget was a good start but there is real potential to lower the tax burden in other important areas.

Target tax cuts where inflation bites

Homes

Recent cuts to VAT on energy efficiency will help consumers. Changes to

property taxes can further stimulate energy efficiency improvements by rewarding homeowners who upgrade their properties.

Stamp duty land tax should reflect energy efficiency to encourage homeowners to invest in upgrading their homes. An effective but small tweak to the tax, as described by the [UK Green Building Council](#), could introduce a price differential whilst remaining revenue neutral to Treasury. Stamp duty would be calculated in the usual way and then adjusted up, by a maximum of three per cent, for the least efficient homes, or down by a maximum of three per cent for the most efficient. The final tax payment would be finalised two years after purchase to enable home buyers to install upgrades and reduce their liability. This small adjustment would not be enough to prevent a sale going through but would reward investment.

Homes in the private rental sector are poorly insulated: only 42 per cent are in EPC bands A to C. Energy efficiency upgrades are currently considered as capital expenditure and can be offset against capital gains tax when a property is sold. Treating energy efficiency measures as allowable expenses would enable landlords to deduct the cost of upgrades from their taxable rental income. This would enhance the short-term incentive to make improvements, benefiting tenants through lower bills, prior to the introduction of minimum EPC standards.

Transport

VAT for charging an electric vehicle (EV) at home is five per cent, but electricity from a public charger is VAT rated at 20 per cent, punishing those without off street parking. Equalising public charging to five per cent will save lower earners money and speed up the switch to EVs, which are cheaper to run overall and reduce reliance on Russian oil.

Energy

Legacy costs of policies such as the Renewables Obligation and feed-in tariffs are currently paid through a levy on electricity, making it more expensive than gas. Shifting these costs to gas would be revenue neutral for the government and consumers, while offering a greater incentive for consumers to move from gas to electricity, which is better for homes and the environment. However, given the current high prices, the government should first take around £160 per household into public spending, helping to cut bills in the short term. Switching just the Renewables Obligation onto gas would lower electricity bills by around [£75 per year](#), and would reduce the unit price of electricity by nine per cent. Gas would rise to 8p per kWh in its place. Including other policy costs could reduce electricity to 24p per kWh.

Tackle the cost of living with consumer tax credits

It is not just businesses that can benefit from tax credits. As well as tax cuts, individual tax credits can lower the costs for individuals of upfront

investments, leading to longer run savings. These could be claimed by individuals or households and could be easier to administer than direct grants.

The US has just approved a technology agnostic [ten year programme](#), providing \$4,000 for those on lower and middle incomes to access used electric cars, and \$7,500 for new EVs. There are also credits for home energy and home energy efficiency. Former US treasury officials on both sides of the House agreed this was [deflationary](#). Similarly, the Netherlands has provided tax relief for heat pumps and electric hobs, accelerating [sales](#) of both.

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