

Rebuilding the bias to equity

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I was re-reading a speech by [George Osborne the other day](#). He said in March:

Our corporate sector's excessive dependence on debt is deep rooted in the structure of our economy. In particular, economists have long pointed out that our corporate tax system favours debt financing over equity.

Interest costs are fully deductible with very limited restrictions, while the returns on equity receive little or no tax relief.

Gordon Brown's decision in 1997 to abolish the dividend tax credit for pension funds made an existing imbalance worse. The result is that the UK is widely regarded as having the most generous tax treatment of debt interest of any major economy. That's economically inefficient at the best of times, but it makes even less sense now that we understand more about the dangers of excessive leverage. There are several ways that we could begin to undo this imbalance by reducing the costs of equity financing relative to debt.

I have long argued that there is a powerful case for looking at stamp duty on shares, which raises the costs of capital and reduces investment. But I believe the time has come to look again at the generosity of interest deductibility in our corporate tax system.

Interesting idea George — as he went on to say he might abolish tax relief on interest paid.

He did not say where this is leading of course — to the Flat Tax idea of no tax charge on interest received — which undermines any prospect of progressive taxation — which I am sure is a Tory goal — but let's leave that aside for now.

The reality is Osborne does hit a relevant target. I have seen estimates that suggest 80% of bank lending is offshore i.e. in the Euro-dollar and other markets which float pretty much outside regulation and get recorded largely in tax havens. How else is Cayman the fifth biggest financial centre in the world?

Private equity exploits this to the full. They load their UK companies with debt and pay the interest offshore where it is not taxed on receipt. In effect for every £1 of interest paid a 28p tax subsidy is given by the UK taxpayer — an extraordinary mechanism for shifting wealth from the poorest to best off in our society.

This is ludicrous — but has Osborne got the right answer? I'm not sure. Why not tax at source instead? That way give relief in the UK by all means — but at least capture the tax revenues due here as well.

This then creates a bias to equity — a bias we need in banking and in business if appropriate incentives for risk taking, for building up buffers of capital reserves and if incentives for profit making rather than bank management are to dominate in our economy — where the reverse has been true for far too long.

I suspect I'll have more to say about this — as this is a key tax issue of the future — but if Osborne is serious think how equity is brought back into vogue using the tax system and how to capture the tax yield on low risk capital at the same time — rather than use a supposed swipe at gearing as the prelude for a wider, and seriously retrograde swipe at the whole tax base on which society depends — which is what I fear he is doing.