How to tackle the corporate savings glut

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Martin Wolf has an article in the FT this morning on the corporate savings glut. What he explores is the trend that has developed over the last decade or so (and which preceded the financial crisis) of the world's largest companies making substantial profits, being little taxed upon them, paying out somewhat less than the sum earned to their members in dividends, and also investing somewhat less than the total amount they have retained, all of which means that they have, in effect, been saving very large piles of cash for a long period of time.

The scale of the problem is huge, especially in the context of sectoral balances. If governments really want to reduce their deficits then they are, in effect, going to save. The trouble is, that in pure cash terms, for every saver there must be a borrower: that's a simple requirement of double entry bookkeeping. If, however, the business sector is also insisting on saving whilst the government wishes to do so and the only people who can borrow more to permit the change in government behaviour are then either the public, where borrowing rates are already high and if increased would exceed the level seen in 2008, or the overseas sector, who currently insist on saving the UK in very large amount as well.

Since I cannot see the overseas sector changing its behaviour in a big way at present, because the UK remains a safe haven for overseas savings, and because I also want to see the scale of household debt reduced, because I think it is at dangerous levels for the well-being of the economy as a whole as well as particular borrowers, then if the government is going to in any way reduce the scale of its borrowing it has to find ways to change large corporate behaviour so that these companies stop saving.

There are two ways in which they could do this. First, these companies could distribute a lot more of their profits to their members. I think there are strong economic arguments for them being expected to do so: it is only perverse tax incentives that have created low tax rates in companies coupled with low capital gains tax rates on the holding of shares that have encouraged this savings glut. The overall tax rate of those saving has been reduced by tacit agreement that the companies should retain their profits with the underlying increase in net asset value being reflected in increased share prices which are then taxed at lower rates as capital gains than would be the case if dividends were paid. This is the first problem to be tackled.

The second is the fact that businesses are simply not investing anything like enough. When business investment is of enormous significance to growth and the overall rate of investment by business in the UK has fallen from about 14% of GDP in 1998 (which rate was, it must be said, exceptional) to less than 10% now this is macro-economically important. The simple fact is that we invest too little and save too much: no wonder we are in the economic doldrums.

Tax is a mechanism to change this, although I have to say that, as is quite common when it comes to tax, Martin Wolf gets much of his prescription wrong. The answers are, in truth, fourfold.

First, the standard rate of corporation tax has to be increased significantly in the case of larger companies. I am quite happy to consider rates of 30%, or even more.

Second, when dividends are paid reduced rates of tax should be applied to the part of profit used to settle these payments. The obvious rate to apply is the basic rate of income tax at the time of payment, or 20% at present. This then gives the business an incentive to pay and this tax charge then settles the basic rate tax liability arising on the shareholder.

Third, capital gains tax rates on shares need to increase: there is no reason at present to use the tax system to encourage corporate saving when we need the opposite behaviour in the economy. Low capital gains tax rates encourage that saving and so they should be changed.

Fourth, we need to encourage more corporate investment. If higher capital allowance rates were given (especially in non-financial companies) on investment then, in combination with the higher rate of corporation tax on non-distributed profits, there would be a significant cash flow advantage for companies that invest.

Put these factors together, in combination, and you have a policy that firstly might raise more revenue, secondly encourages appropriate behaviour and thirdly delivers the investment we need whilst fourthly reducing corporate saving which, fifthly, is a precondition of the government reducing its deficit. That is joined up thinking. But I don't expect to see it in the Spending Review.