
Government Borrowing: deeper into debt
Budget 2003
IoD Policy Paper

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1 Introduction

“Annual income twenty pounds, annual expenditure nineteen nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery.”

Charles Dickens: Mr Micawber from “David Copperfield” (1850)

1.1 Introduction: the global economic background

This year’s budget decisions are being made against a background of great economic uncertainty and difficulty. The world economy seems to have deteriorated further since last November’s Pre-Budget Report¹. The US continues to struggle with substantial economic imbalances – though the weaker dollar should help with the yawning trade gap. The Eurozone, in general, and Germany, in particular, seem to be facing a “double-dip” recession and the stronger euro will almost certainly not help. And Japan remains stuck in the doldrums with little sign that any significant recovery is imminent. The stock markets continue to weaken and, in the US at least, corporate scandals continue to damage business confidence.

Hanging over this generally gloomy background there is the high probability of war in Iraq. We in the IoD have done considerable research in this area² and outline our main results in chapter 3. Whilst not advocating war, we conclude that prospects for the world economy would improve if there is a quick resolution to the current tensions.

1.2 The domestic economic background

The British economy is not immune to the fraught global environment and growth seems to be faltering. GDP grew by only 0.4% in the fourth quarter of last year and growth was just 1.7% in 2002 as a whole, compared with 2% in 2001. We expect it to be little higher for this year, as shown in the table overleaf, and down on the Chancellor’s Pre-Budget and Budget forecasts.

Table 1.1 GDP growth forecasts (year-on-year % growth rates)

	2001 (out-turn)	2002 (out-turn)	2003	2004
IoD forecasts (2003)	2.0	1.7	1.9	2.4
Pre-Budget Report (November 2002)		1.6	2 ½ to 3	3 to 3 ½
Budget Report (April 2002)		2 to 2 ½	3 to 3 ½	2 ½ to 3

But even these, rather gloomy, forecasts assume that there will not be a major bust in the housing market (as some analysts are expecting) and, if there were to be a bust our figures could then look too optimistic. For more on our economic forecasts, see chapter 3.

1.3 Government borrowing: deeper into debt...

One of the consequences of the deteriorating economic circumstances is the deteriorating fiscal situation. And this to our minds is one of the biggest problems now facing the Chancellor – and that is why we have chosen the theme of “government borrowing: deeper into debt” as the main theme for this year’s Budget Representations.

As we have written on several occasions we regarded the last Budget’s huge increases in spending on, in particular, health and education as a huge gamble³. And there were, more specifically, two gambles that we feared would not pay off:

- The first Budget gamble was that the large increases in spending on health and education without radical reform would not “deliver” the better public services this country needs⁴. The evidence so far seems to bear this out^{5, 6}. But, alas, the Chancellor seems to have ruled out any radical reform in these crucial services⁷.
- The second Budget gamble was that the fiscal outlook crucially depended on a buoyant economy. The Chancellor has already had to downgrade his fiscal projections since the Budget and it now looks very likely that even these (the Pre-Budget) forecasts will turn out to be too optimistic.

The following table (overleaf) shows just how the finances are deteriorating and are expected to deteriorate. (Please note that the public sector current surplus was over £20bn in FY2000 (2000/01) and public sector borrowing was over -£15bn.) We show the Budget and the Pre-Budget forecasts and also include the latest projections from the Institute of Fiscal Studies, who are far from being the most pessimistic forecasters.

Table 1.2 Public Sector Current Balance and Net Borrowing (£bn, financial years)

	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007
Public Sector Current Balance:							
Budget 2002	10.6	3	7	9	7	9	
Pre-Budget 2002	7.7	-5.7	-5	3	5	8	10
IFS January 2003		-8.8	-5.1	-2.4	-4.0	-4	-5
Public Sector Net Borrowing:							
Budget 2002	1.3	11	13	13	17	18	
Pre-Budget 2002	1.2	20.1	24	19	19	19	20
IFS January 2003	0.1	22.1	25.2	24.8	28.1	31	35

Source: The IFS Green Budget: January 2003.

The government is indeed getting deeper into debt - more red ink. No wonder the European Commission has been uttering disapproving noises! We discuss the public finances further in chapter 3.

1.4 ...but no to higher taxes

The next question, therefore, is whether taxes should go up again. Well, even with the bloated government spending plans, we do not see any need for higher taxes for FY2003 (2003/04) but further out, if the Chancellor is to meet his "Golden Rule"⁸ and if he sticks to current spending plans, it is very likely that taxes will have to rise.

We take the view that this is exactly what shouldn't happen as it threatens the economy's competitiveness further, especially as we are so sceptical that the huge increases in spending on health and education without reform to these services is unlikely to deliver the goods. As we have written on many occasions, the current government has already damaged the country's competitiveness by increasing the tax and regulatory burden on business⁹. And, as we discuss further in chapter 3, we believe that rather than having higher public spending and higher taxes, the economy would benefit from lower public spending and lower taxes¹⁰. We believe that there is much complacency about the damage that high taxes can do to an economy and much complacency about the dangers of having an ever-larger public sector "squeezing out" the more competitive private sector.

So rather than taxes rising, the priority should be on lowering public spending to more affordable levels and aiming for tax cuts. Ideally, we would like to see cut-backs in spending for FY2003 and a reversal of the increases in National Insurance Contributions (NICs), which were announced in the last Budget. The increases in employers' NICs are little more than a tax on jobs and the extra £4bn cost is particularly unwelcome at this stage of the economic cycle when margins are being squeezed and the business climate is so difficult.

1.5 The tax system is too complex

We are not just concerned about the (seemingly) ever-higher tax burden, we continue to express our dismay at the increasing complexity of the tax system. We fear there will be further complications in the next Budget as, for example, there may be measures to “help investment”. Even though they may be welcome in some quarters, they are very likely to add to the current complexities and are unlikely to be very effective in “helping investment”. Investment will recover when the business sector recovers.

In chapter 4 we discuss our tax representations in detail (and they are summarised in chapter 2), but underlying them is the need to simplify. And no new taxes – please.

References

1. See Lea and Brownlee: *Pre-Budget Report 2002* (IoD, 2002).
2. Leach: *War and the world economy* (IoD, January 2003).
3. See, for example, Lea and Brownlee: *Pre-Budget Report 2002* (IoD, 2002).
4. We have written at length on the need for reform. See Lea, Baron and Leach: *Tax and spend: gambling on better public services* (IoD, 2002); Lea: *Healthcare in the UK: the need for reform* (IoD, 2000) and Lea: *Education and training a business blueprint for reform* (IoD, 2002).
5. See Hawkes: *Ignore what Gordon says, listen to what he doesn't say* (Times, 27 November 2002), who wrote “more ominous is the evidence from England, where funding has been rising fast without corresponding increases in activity”.
6. Moreover, it seems that much of the extra public spending is going on PC public sector jobs, as advertised in the Guardian (“Guardian jobs”), that will add little to the productiveness of the country or to people’s well-being.
7. See the FT leader: *The Treasury knows best: in Gordon Brown's mind at least* (FT, 4 February 2003).
8. The current fiscal rules are: (1) the Golden Rule which states that, on average over the cycle, the government will borrow only to invest and not to fund current spending and (2) the Sustainable Investment Rule which states that public sector debt as a proportion of GDP will be held over the cycle at a stable and prudent level. The government believes that, other things being equal, it is desirable that public sector net debt be below 40% of GDP over the cycle.
9. See, for example, Lea: *Keeping Britain competitive Manifesto for business* (IoD, 2001).
10. Leach: *We're going the wrong way – Tax and Spend Fiscal Policy* (IoD, 2002).

2 Executive summary

2.1 The economic and fiscal outlook

The main conclusions are:

- Our forecast of UK GDP growth is less optimistic than the Chancellor's Pre-Budget Report forecast. We expect growth of 1.9% in 2003 (compared with the Chancellor's 2 ½ - 3%) and 2.4% in 2004 (compared with 3 - 3 ½%) (3.2).
- There are many uncertainties overhanging this forecast not least of all the high probability of war in Iraq and the possibility that the housing market will turn from boom to bust (3.2).
- If there is to be war in Iraq (and we are not advocating war), then the best option for the global economy (and hence the UK economy) is a short war. We regard this as the most likely outcome – but far more economically damaging options cannot be ruled out (3.2.1).
- Whilst we do not rule out a full-scale boom and bust in the housing market, we do not regard this as likely. We do, however, believe that affordability constraints will exert a constraint on house prices and along with the record levels of personal debt will drag on the economy (3.2.2).
- The fiscal balances are already deteriorating as revenues stagnate and public expenditure expands. A worsening economic climate can only lead to a further deterioration (3.3). Whilst we do not see any immediate need for higher taxes, there is a real danger of higher taxes over the next 4 years (up to FY2006) if current spending plans are adhered to.
- We have expressed our deep scepticism on many occasions that rapid increases in spending on health and education will deliver significantly better services without reform. We have also expressed our concern that higher taxes act as a drag on growth as the more competitive private sector is squeezed by the less competitive public sector. Under these circumstances, we believe that business and the economy would benefit from a downgrading in public spending plans and a reversal of last April's National Insurance Contributions (3.3 and 3.4).
- A recent IoD Business Opinion Survey suggested considerable dissatisfaction with the performance of fiscal policy and, in particular, overall government policy towards business (3.4).

2.2 Taxation

The main recommendations of our tax representations are as follows:

- The tax burden is too high and the tax system is too complicated. There should be no new taxes and no extension of existing taxes. In extremis, we would recommend a moratorium on budgets with tax changes – not least of all so businesses and individuals can get to grips with all the changes to date (4.1).
- Personal Allowances and personal tax bands should be uprated and the personal tax system needs to be simplified. The removal of the upper earnings limit of employees' National Insurance Contributions (NICs) has effectively conceded that NICs are, in all but name, income taxes. Consideration should be given to merging the two taxes, providing there are not major distributional effects (4.2).
- Consideration should be given to scrapping the increases in National Insurance Contributions (announced in the budget of April 2002) – though there would have to be equivalent reduction in public spending (4.3).
- The administrative costs of the PAYE system are a major burden for business and we urge moves towards reducing the costs. Concerning tax credits, we continue to oppose the delivery of state benefits through the payroll (4.3).
- Concerning share schemes, we welcomed the PBR announcement of the statutory deduction for the cost of providing shares for employees, but we would urge the government to review whether the current state of the law following the *Mansworth v Jelley* case is credible (4.3).
- We have welcomed recent changes to the Capital Gains Tax regime, but we are concerned that the gap between business and non-business assets is now too wide (4.4).
- Inheritance tax should be abolished (4.4).
- On the taxation of business profits, we reiterate our opposition to taxation on unrealised gains. And, concerning Quarterly Instalment Payments (QIPs), we urge government to address the unnecessary burden in requiring payments to be based on an estimate of the current year's tax liability (4.5).
- We welcomed the government's decision to introduce the exemption for disposals of substantial shareholdings – but we suggest the reduction (or abolition) of the minimum holding requirement. On rollover relief, we would like to see the extension of rollover relief to all capitalised business expenditure (4.5).
- Concerning North Sea Taxation, we are concerned about the damaging impact of the supplementary range of Corporation Tax levied on Ring-Fence profits (4.5).
- We strongly support the introduction of DAVIS and would urge business-friendly implementation of the scheme. Concerning the Cash Accounting Scheme for VAT, we urge an increase in the turnover limit to at least £2m (4.6).
- There should be no further increases in fuel duties – indeed they should be reduced when “affordable”. Whilst recognising there is a role for environmental taxes for achieving certain environmental policy aims, we prefer policies which incentivise environmentally “friendly” behaviour (4.6).
- We continue to believe the abolition of Stamp Duty and Stamp Duty Reserve Tax (SDRT) would be beneficial to the City and to the beleaguered pension funds (4.7).
- We continue to oppose EU-wide “tax harmonisation” (4.8).
- We oppose the Customs and Excise's introduction of a “Gold, Silver and Blue” accreditation system for taxpayers (4.9).

-
- A simpler tax system is one that is less likely to encourage avoidance. Therefore, as the government is keen to reduce avoidance it should simplify the tax system (4.9).
 - Tax law is far too complex – simplification is a priority. More specifically, we would like to see more resources available to the Tax Law Rewrite Committee (TLRC) that is dealing with the very welcome Tax Law Rewrite Project (4.10).

3 The economic and fiscal outlook

3.1 Introduction

This chapter is divided into the economic outlook (3.2), the fiscal outlook (3.3) and, finally, a discussion of a recent IoD survey results on whether the economy is well run or not (3.4).

3.2 The economic outlook for the British economy

Across a range of economic indicators the performance of the British economy still appears to be quite impressive, with record levels of employment and historically low mortgage rates, unemployment and inflation. However, the UK economy is also characterised by deep division between the performance of equity versus housing markets, manufacturing versus services, domestic versus overseas and public versus private sectors.

In the November 2002 Pre-Budget Report, HM Treasury forecast GDP growth of 2.5% to 3% in the UK in 2003, followed by 3% to 3.5% growth in 2004. The latest Consensus Forecasts (*A Digest of International Economic Forecasts* Consensus Forecasts, 13 January 2003) for the UK shows a mean of 2.3% in 2003 and 2.6% in 2004. The Financial Times (*Brown faces more pressure over forecasts* Financial Times, 31 January 2003) has recently stated that of 42 independent forecasts for 2003 compiled by HM Treasury, 23 suggest growth will be less than the lower end of the Treasury's range¹.

The IoD's latest GDP and inflation forecasts (shown in Table 3.1, overleaf) are more cautious than the Treasury's projections. We have forecast GDP growth of 1.9% in 2003 – well below HM Treasury's 2.5% growth assumption used in estimating the public finances. Our forecasts have been revised down to reflect a weaker outlook for the world economy and corporate investment in the UK. As a result, GDP growth in 2003 is likely to be very similar to the 1.7% rate recorded in 2002 (*GDP Preliminary estimate – 4th quarter 2002*, National Statistics First Release, 24 January 2003).

If the IoD's GDP forecasts prove to be correct there will be a further significant deterioration in net public borrowing. Alternatively, if GDP growth can be maintained at 2.5% or higher over the 2003-2004 period, the immediate pressure on the public finances will be less. However, (as discussed below in section 3.3) a significant increase in public borrowing has already been projected by HM Treasury and this figure appears to be rising with the publication of each successive Budget and Pre-Budget Report.

Table 3.1 IoD Economic Forecasts for 2003 and 2004

Indicator	2003	2004
GDP % change (year-on-year)	1.9%	2.4%
RPIX % change (Q4 year-on-year)	2.4%	2.3%
Base rate – end Q4	3.5%	3.25%

There are many uncertainties overhanging this forecast – not least of all the high probability of war in Iraq and the dangers of a serious bust in the housing market, but we are of the view that worst-case scenarios for both are unlikely. Our reasons for cautious optimism regarding the external threat and internal debt are explained below.

3.2.1 The global economy

The IoD has recently published a major study on the potential impact of war in Iraq on the US and world economy in 2003.² The report highlighted the uncertainty surrounding the nature of any potential conflict (duration, intensity and degree of escalation) and the resulting wide range of oil market and macroeconomic scenarios that could result.

Amongst the key conclusions of the study were (and see Table 3.2 overleaf):

- A short war, with regime change, would produce faster US GDP growth in 2003, than no war or no regime change, because of the removal of uncertainty.
- The fastest US GDP growth scenario (2.9% GDP growth in 2003) was found to have the highest probability.
- The lowest US GDP growth scenario (2% GDP contraction in 2003) was found to have the lowest probability.
- Both the Euro-zone and Japanese economies could be more adversely affected by escalation scenarios because of their lack of flexibility in the use of monetary and fiscal policy.

Table 3.2: The US economy in 2003 – War Scenarios

Scenario	GDP % change	Probability	Explanation
Stand-off – no war	2.2%	LOW to MEDIUM	Oil price higher than under capitulation scenarios. Direct defence spending less than under war scenario. Fiscal stimulus delayed on Capitol Hill by Democrats.
Capitulation – no war	2.5%	MEDIUM	Oil price higher than capitulation short war scenario due to uncertainty of no regime change
Capitulation – short war	2.9%	HIGH	Oil price falls back quickly to \$20pb due to removal of war premium and potential long-term supply boost from Iraqi production Fiscal stimulus swiftly driven through in full on Capitol Hill. Stock market rises 5% in 2003.
Escalation Scenario 1	1.0%	LOW to MEDIUM	Oil price spikes to \$45pb. Fiscal stimulus delayed by Democrats – sensing ‘damaged’ President. Stock market falls 10% in 2003.
Escalation Scenario 2	- 0.5%	VERY LOW	Oil price spikes to \$60pb. Yield curve steeper. Stock market falls 20% in 2003.
Escalation Scenario 3	- 2.0%	VERY LOW	Oil price spikes to \$80pb. Steep yield curve. Stock market falls 30% in 2003. Negative housing wealth effects.

Our fear is that if escalation scenarios begin to unfold, the world and UK economic outlook could deteriorate rapidly. Economic forecasting is never easy and at times such as now is all the more uncertain.

3.2.2 The UK housing market

One widely expressed concern at present is the risk of a negative demand shock emanating from asset markets – the risk that changes in asset prices will impact adversely on the economy. The FTSE 100 has fallen heavily in early 2003, following on from significant falls over the 2001-2002 period. What impact is this likely to have on consumption and the savings ratio in the UK?

Research suggests that in the UK, the wealth effect – for a given rate of change - stemming from the housing market is likely to exceed that associated with equity holdings (**Comparing wealth effects: the stock market versus the housing market**, K. Case and R. Shiller, NBER Working Paper No. 8606, 2001). The NIESR has estimated that (**The UK Economy**, National Institute Economic Review No. 183, January 2003) personal sector housing wealth rose by 25% in the UK in 2002, thereby offsetting the effect of falling equity prices on household sector net worth. Providing equity markets now stabilise and moderate UK house price growth continues (this might include small house price falls in the South-east) the impact on consumption is likely to be small. The danger is that continued stock market falls will be followed by a significant fall in house prices. If there were, in addition, a hard labour market shake-out (especially in debt constrained households), then there could well be a significant jump in precautionary behaviour.

Much therefore depends on the housing market and here there is further reason for reassurance because of:

- The potential for further reductions in interest rates.
- Continued real income growth.

As already suggested, the danger is of continued equity market falls, running in parallel with falls in house prices and a rise in precautionary behaviour by consumers. Model simulations by the NIESR suggest that even if house prices fall progressively in 2003, to the extent that they are 20% lower (year-on-year) in the fourth quarter, the savings ratio would still remain below the levels seen in the early and mid-1990s. The effect of a 20% reduction in house prices in the NIESR model appears to be moderate. We tend to be of the view that any fallback in house prices is unlikely to reach 20%, but that if it did, the impact on the savings ratio would, however, be greater than suggested by the NIESR model.

How does the current UK situation compare with the late 1980s and early 1990s?

- The house price to average earnings ratio is considerably above the historic average, but below the levels seen in the late 1980s (albeit only slightly).
- The ratio of house prices to household disposable income is above the historic average but considerably below the levels seen in the late 1980s – due to the fact that this measure allows for the growth in double-income households (to some extent).
- In London, house prices are well above the historic average regardless of the measure used.
- Mortgage service costs, both nationally and in London, are well below the historic average. Nationally the figure is just over 8% of disposable income compared with almost 15% in 1990.
- Overall debt burdens, and the mortgage burden – as a proportion of disposable income – are both higher than the previous peak in 1990.

The contrast between debt burdens and debt servicing costs suggests that the housing market is unlikely to repeat the experience of the early 1990s when it moved from boom to bust. Back of the envelope calculations suggest that for the costs of debt servicing to return to the early 1990s peak, either (1) and (2) below, or a combination of both, would need to occur:

1. Debt would have to double at current interest rates.
2. At the current level of debt, interest rates would need to move into double digits.

House price growth at the beginning of 2003 is still running at around 25% (year-on-year) and on balance we believe affordability constraints will slowly exert a constraint on house price growth – working as a dragging anchor. We recognise that a number of external or internal ‘wild cards’ could potentially undermine this scenario – and create a more serious reduction in house prices and/or rise in unemployment – but one must also consider that any future downturn in GDP growth could be met by an easing in monetary policy.

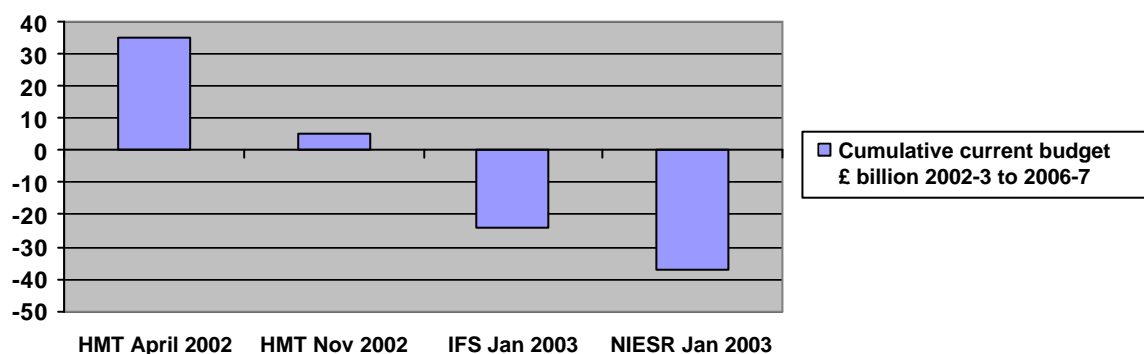
3.3 Fiscal forecasts

In the IoD's November 2002 Pre-Budget report submission to the Treasury Select Committee we strongly argued that there was "no slack left in the public finances". And we still take this view.

Over the FY2002 (financial year 2002/03) to FY2006 (financial year 2006/07) period, the cumulative surplus on the current budget has deteriorated from £35.2 billion in the April 2002 Budget to £5 billion in the November 2002 Pre-Budget report. The latest IFS Green Budget (*The IFS Green Budget*, Commentary 92, The Institute for Fiscal Studies, January 2003) suggests there will be a cumulative deficit of £24.3 billion over the FY2002 to FY2006 period. NIESR project an even greater cumulative deficit of £37.3 billion over the same period (NIESR National Institute Economic Review, 1/2003).

Over the FY2002 to FY2006 period, the November 2002 Pre-Budget Report forecast net borrowing of £101 billion – compared with an expectation of £72 billion in the April 2002 Budget. The latest IFS Green Budget suggests this figure may now rise to £131 billion. NIESR project net borrowing at £137.3 billion over the same period.

Chart 1 Cumulative current budget surplus/deficit FY2002 to FY2006

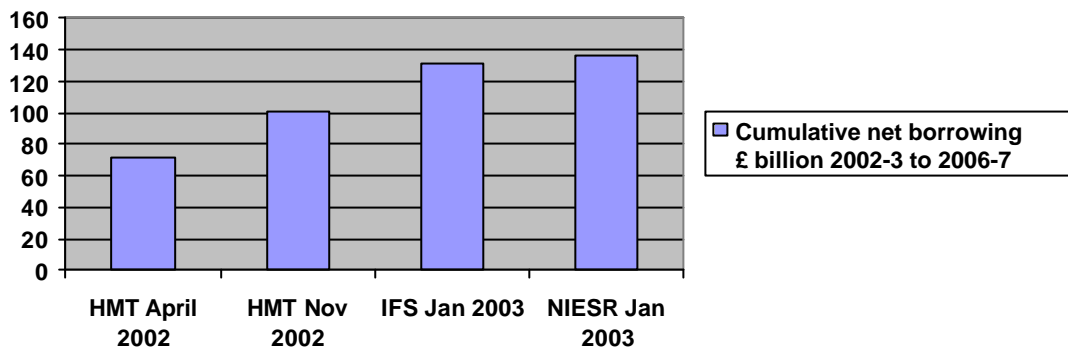


The IFS has pointed out that whilst the move from surplus to deficit in the current budget over the FY2002 to FY2003 period is consistent with cyclically adjusted surpluses in these years, but only just. They estimate that the cyclically adjusted surpluses are only 0.2% and 0.3% of GDP respectively.

Forecast errors in either projected GDP growth, and/or levels of public spending and taxation suggest the golden rule³ may come under pressure. HMT figures show the average error in public sector net borrowing is £12.5 billion one year ahead, £20.9 billion two years ahead, £31 billion three years ahead and £43 billion four years ahead. After allowing for the 'correct GDP', the absolute errors are still £10 billion, £15 billion, £21 billion and £25 billion respectively. In other words, even if the government is making the correct GDP forecast, public sector net borrowing could still be 1% of GDP higher this year, 1.4% of GDP higher

next year, 2% of GDP higher the following year and 2.4% of GDP higher than forecast four years from now. If HM Treasury is wrong about the GDP outlook, public sector net borrowing could be 4% of GDP higher than currently projected, four years from now. Clearly the forecast error is an average figure and so potentially net borrowing could be far less than projected. However, most commentators would agree that the forecast risks are mainly on the downside as a result of weaker GDP growth.

Chart 2 Cumulative net borrowing FY2002 to FY2006



Source: Pre Budget Report 2002, IFS Green Budget January 2003, National Institute Economic Review 1/2003.

Despite the obvious deterioration in the public finances the IoD calls on the Chancellor to cancel the proposed increases in employer and employee National Insurance Contributions, to be financed by a reduction in the proposed increases in public spending.

Such a policy shift could provide significant macroeconomic and microeconomic benefits:

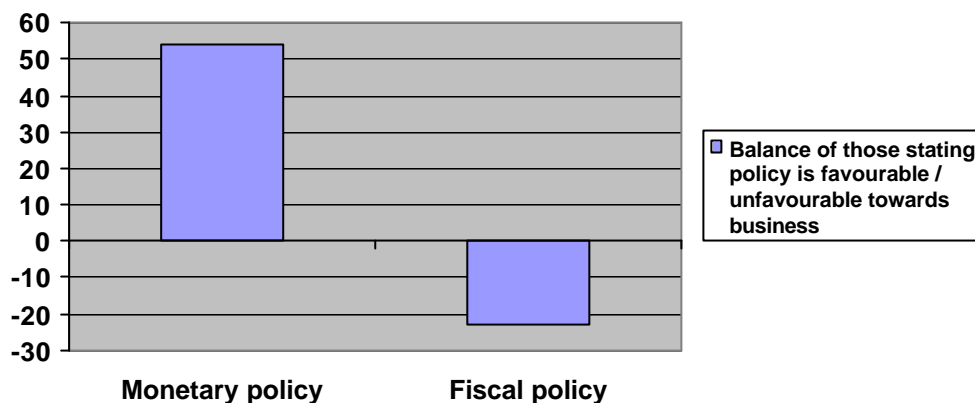
- Macroeconomic – By providing a ‘surprise’ boost to consumer and corporate confidence at a time of great economic uncertainty at home and overseas.
- Microeconomic – By recognising that without fundamental reform to the provision of public services such as health and education, rapidly rising public spending is producing very little improvement in services, in return for the huge increases in public spending.

3.4 Is the UK economy well run?

We have a duty to communicate the concerns of our members to the government. As part of the quarterly Business Opinion Survey⁴ the IoD asks members their views on the conduct of monetary and fiscal policy in the UK. The latest December 2002 survey results show strong dissatisfaction with the conduct of fiscal policy. When asked whether fiscal policy was favourable or unfavourable towards business, the survey revealed a negative balance of -23%. This compared with a positive balance of 54% when IoD members were asked the same

question about the MPC's conduct of monetary policy. When asked their view of overall government policy towards business there was a negative balance of -31%.

Chart 3 How favourable or unfavourable is economic policy towards business?



Source: IoD Business Opinion Survey, December 2002.

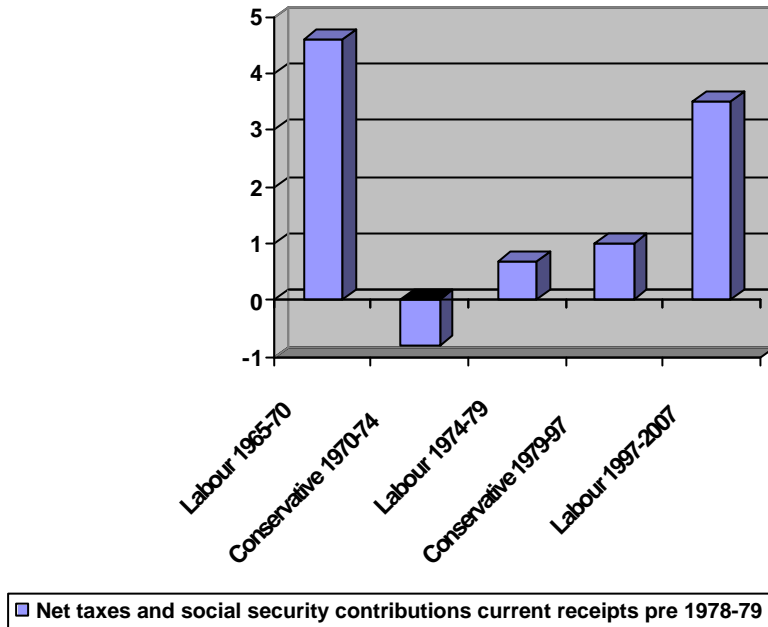
The IoD is very concerned that the tax burden could rise even higher than currently forecast by HM Treasury. The economy is nourished and strengthened by a low tax burden. Take away that nourishment and it will get progressively weaker.

A recent report from the IoD (*We're going the wrong way – Tax and Spend Fiscal Policy*, Graeme leach, IoD Policy Paper, 2002) argues that the priority should be to reduce the share of public spending and taxation as a proportion of GDP. The IoD produced this report in order to challenge widespread complacency regarding the negative impact of higher public spending and taxation on economic performance. The report shows how a smaller public expenditure and tax share will ultimately benefit everyone.

OECD research suggests that a 5% point increase in the tax to GDP ratio reduces GDP growth by 0.25% points per annum. This means that the underlying rate of growth may fall as a result of recent tax and spend fiscal policy – see Chart 4 below.

The argument that some well performing economies have high tax to GDP ratios and some badly performing economies have low tax to GDP ratios, ignores the counterfactual i.e. the well performing economies might have performed even better with a lower tax ratio, whilst some badly performing economies could have performed even worse with a higher tax ratio

Chart 4 Changes in the tax burden - % of GDP



The IoD has strong concerns that tax and spend fiscal policy may deliver negative macroeconomic consequences with little/no microeconomic improvement in public services. The concern of the IoD is that:

- Higher taxes will impose an increasing burden of deadweight losses on the economy as the size of the public sector expands.
- As the public sector grows relative to the private sector, diminishing returns will reduce the rate of return derived from the public sector.
- The political process is much less dynamic than the market with less incentive for increased productivity.
- As the public sector expands it has a tendency to further engage in the re-distribution of income and regulatory activism.

References

1. Press reports (*EU rap for Chancellor's forecasts*, The Times, 29 January 2003) suggest that the European Commission believes the Treasury's 2.75% GDP growth forecast for this year is "optimistic".
2. Graeme Leach: *War and the world economy* (IoD, January 2003).
3. The current fiscal rules are: (1) the Golden Rule which states that, on average over the cycle, the government will borrow only to invest and not to fund current spending and (2) the Sustainable Investment Rule which states that public sector debt as a proportion of GDP will be held over the cycle at a stable and prudent level. The government believes that, other things being equal, it is desirable that public sector net debt be below 40% of GDP over the cycle.
4. Survey question introduced in 2003.

4 Taxation

4.1 Introduction and overview

As highlighted in the economic analysis, taxation is too high and is damaging competitiveness. Our budget submissions highlight a number of possible improvements to the taxation system; some are “technical” in nature, others more straightforward. For example, we reiterate that the proposed increases in National Insurance should be scrapped.

However, the government should go further and rule out introducing any new taxes, or extending the scope of existing taxes, whether by increasing rates or reducing reliefs. Furthermore, it should do so for the medium to long term.

But what if the government decides not to take our advice? It would be presumptuous to write the Chancellor’s 2003 Budget Speech for him, so here is another suggestion: don’t have one – or at least, don’t have one with tax changes in it. Even better, don’t have another Budget with tax changes in it until after the next election. Just let businesses and individuals get to grips with all the changes to date. It might not get headlines – but it would do a power of good for business.

4.2 Personal tax

We welcome the progress being made by the Inland Revenue towards short form returns. And we recognise that there is only so much which the Inland Revenue can do while the tax system remains so complex. But we have several concerns and comments about the way personal taxes are operating and we discuss them below.

Bracket creep is dragging more and more people into tax.

The decision not to index the Personal Allowance for 2003/4 was an unwelcome and “regressive” measure. In recent years many more people have started paying higher rate income tax because earnings growth was faster than the rate of increase in the higher rate threshold.

The Personal Allowance and all tax bands should at least be updated in line with inflation (if not the growth in the economy, which would allow individuals to retain the fruits of their labours). Government does not generate wealth and should not claim a “free ride” in this way.

We continue to oppose the increases in National Insurance Contributions which are due to take effect in April. We believe that these should be scrapped.

Stop tinkering, start simplifying

In the long term, we urge the government to pursue the radical simplification of the tax system. A single, low, flat rate of tax above a reasonable personal allowance would be a much more straightforward, and economically efficient, system than the current regime with a plethora of rates, allowances, reliefs, “tax credits” etc. But there are strong distributive arguments against this and we would not consider the introduction of a flat rate of tax as a priority.

Many measures which would simplify the tax system are opposed because, on their own, they lead to an increased burden of taxation (e.g. the removal of Married Couples’ Allowance). If the additional revenue from such measures was focussed on increasing the personal allowance and reducing the tiered rates of taxation then a “pincer” movement towards a simpler tax regime would emerge.

Aligning tax and national insurance

The removal of the upper earnings limit effectively concedes that Employee National Insurance is, in all but name, Income Tax. It would obviously be simpler to amalgamate the two but we would have serious reservations about the impact on incentives.

However, it would be beneficial to demonstrate to the public how little the contributory principle (which we continue to support) remains in the benefits system today, and to show just how high the real rate of Income Tax is. On balance, if the two systems can be merged without altering the distributional burden of the two taxes, it would merit consideration.

“Customers” and choice

Many commentators condemn the Inland Revenue for referring to “customers” as opposed to “tax payers” (or, also these days, “Benefit Recipients”). We support the use of the term, not merely because it underpins a notion of service by the tax authorities, but also because it recognises that customers can move elsewhere. Excessive taxation will eventually drive people (and companies) out of the country.

It is often said that many people would be prepared to pay additional tax – so why not introduce a box on the tax return to allow them to? It would be relatively simple to adjust an employee’s tax code to allow them to pay more tax on a voluntary basis (say in £500 increments), or indeed to introduce a “socialist” option to enable employees who want to pay more tax to have all their earnings above the national average taken in tax.

Pensions and long term saving

We welcome the publication of the HM Treasury/Inland Revenue Green Paper ***Simplifying the Taxation of Pensions: Increasing Choice and Flexibility for all*** and will be responding to it separately.

However, if the government wishes people to save for their long-term future it must ensure that the tax burden (amongst other things) is not preventing them from doing so. Higher taxes will, in general, lead to lower saving, which in turn will lead to greater dependence on the state, higher long term public spending, lower growth and a spiral into a dependency culture which will do great harm.

It is also crucial to ensure that every individual has an incentive to save for his/her retirement. The Minimum Income Guarantee currently provides a huge disincentive to save for those on middle to low incomes.

4.3 Employers and employees

In this section we discuss our comments and concerns relating to the taxation of employers and employees.

Employers' National Insurance Contributions – an unwelcome tax on jobs

We continue to oppose the increase in National Insurance Contributions set to take effect in April. However, of particular concern to us is the increase in Employers' NICs, which will cost jobs and impose additional costs on employers at a difficult time. Competitiveness is often finely balanced, and increasing the cost of employing staff by £4 billion a year will push some firms over the edge.

Payroll procedures

The successful operation of the PAYE system significantly reduces the cost of tax collection to government and reduces the burden on individuals in terms of tax administration. We recognise the potential benefits of electronic filing of payroll returns and, whilst at best sceptical about compulsion, particularly on small firms, we do recognise the potential to reduce the administrative burden on employers and the Inland Revenue.

However, the operation of PAYE is one of the single greatest administrative burdens on business and a significant outsourcing industry has grown up around its operation. We urge the government to recognise the costs to business of administering PAYE and work to reduce this.

Tax Credits

We welcome the consultation which has been carried out with regard to the implementation of the new Tax Credits which come into force in April. However, we remain opposed to the

delivery of state benefits via the payroll and we are concerned about the impact of extending means tested benefits up the income scale to the extent that families on incomes of £66,000 can qualify for them.

Share schemes

We welcome the announcement in the Pre-Budget Report of the statutory deduction for the cost of providing shares to employees, as recommended in our representations in July 2003.

Despite the turbulence in the Stock Market, we continue to believe that encouraging employee share ownership is a laudable aim.

We are uneasy at the outcome of the *Mansworth v Jelley* case, and the consequent unexpected tax liability which has arisen for some taxpayers. We urge the government to review whether the current state of the law following this case is satisfactory.

4.4 Capital taxes

Capital Gains Tax taper relief

The application of full taper relief for business assets held for two years or more is welcome and represents an all too rare move away from increasing taxation in recent years.

However, we believe that the gap between business and non-business assets is now much too wide. The simplest solution would of course be to reduce the non-business asset taper to the same level as the business asset taper; however, as a staging post to this, the tapering period could be reduced to 5 years from the current 10.

We would also welcome the removal of the anomalies that exist because of the changing definition of business assets. It would be much simpler if assets which now qualify as business assets were deemed to have been business assets from the time of acquisition, or the time from which they would have met the current definition, whichever is later.

Inheritance Tax (IHT)

Inheritance Tax should be abolished. Abolition would lead to welcome simplification of the tax system and remove hundreds of pages of legislation from the Statute Book at a stroke. Abolition would also increase the incentives to work and save, reducing the burdens on the state in terms of welfare costs.

If Inheritance Tax is not abolished then a number of major changes to the regime are necessary. In particular, the nil rate band is now relatively low. House price inflation has led to the situation where many individuals own houses worth more than the annual exemption. Unless there is a crash in the housing market, this problem is only going to get worse.

We are also concerned at the increasing problems encountered by farmers in relation to Agricultural Property Relief (APR) where they attempt to diversify in order to protect their

livelihoods. A widening of the scope of APR, in the light of a wider scope of the “farm business” would be welcome.

4.5 The taxation of business profits

We have responded in detail to the consultation on *Reform of Corporation Tax* and urge that any changes proposed simplify the taxation system without imposing additional burdens on business. We reiterate our opposition to introducing taxation on unrealised gains, a proposal which would devastate many businesses.

Quarterly Instalment Payments (QIPs)

The pragmatic approach adopted by the Inland Revenue has meant that the basing of QIPs on current rather than prior year profits has been less problematic than feared. Nonetheless, there remains an additional, and unnecessary, administrative burden in requiring payments to be based on an estimate of the current year’s tax liability.

We note with concern the downturn in corporate profitability. This downturn will feed into lower Corporation Tax liabilities and hence increasing numbers of companies reducing their instalment payments. We hope that the Inland Revenue will continue to adopt a pragmatic approach as companies do this.

The substantial shareholdings exemption

We welcomed the government’s decision to introduce the exemption for disposals of substantial shareholdings, and its decision to lower the qualifying shareholding to 10%. However, we would suggest that this minimum holding requirement is reduced, or indeed abolished, in order to enhance the attractiveness of the UK as a place in which to do business.

In addition, a welcome simplification would be the removal of the requirement for both investor and investee companies to be trading.

Rollover relief

We would encourage the widening of the range of assets which qualify for rollover relief in order to encourage investment in the UK. In principle, we would like to see the extension of rollover relief to all capitalised business expenditure.

North Sea taxation

We welcome the removal of the Government Royalty from 1 January 2003. Royalty was a regressive tax which also imposed significant administrative burdens. However, we are concerned at the damaging impact of the supplementary rate of Corporation Tax levied on ring-fence profits. Last year’s Capital Allowance changes do not compensate for this additional tax. Fiscal stability is welcome; fiscal stability within a regime of excessive taxation is not, and will damage the competitiveness of the UK oil and gas industry.

4.6 Indirect taxation

Delayed Accounting for VAT at Import Scheme (DAVIS)

We welcome the government's decision to consult on the introduction of DAVIS. We believe this scheme will be beneficial to a number of UK businesses and strongly support its introduction.

However, we are concerned that the good intentions behind the scheme may be thwarted if the implementation is unduly onerous and restrictive. We believe that many of the advantages of the scheme would be erased if companies with good VAT compliance records were forced to go through a cumbersome approval process, and/or provide additional guarantees.

Cash accounting for VAT

The Cash Accounting Scheme for VAT removes a major source of cash flow difficulty for many businesses. In the increasingly uncertain economic conditions this is more and more important. We urge an increase in the turnover limit to at least £2m in order to allow more small businesses to benefit.

Custom duties

The high differential between the rates of duty on alcohol and tobacco in the UK and the rest of the EU has led to an increase in the "black market" for these products. As a result, UK Customs revenues are depressed and criminals find a lucrative source of income. The only long-term solution would be an alignment of the rates of duty, or at least a very substantial reduction in UK duty rates to match those in the rest of the EU.

However, we recognise the difficulties in reducing duty rates, particularly from a public health perspective in relation to tobacco. Accordingly, we urge the government to study whether a reduction in levels of duty on alcohol would actually increase UK tax revenues.

We also note with concern the discriminatory taxation levels applied to spirits in the UK as opposed to other alcoholic drinks. In principle, alcohol should be taxed at a rate dependent on its strength, rather than its type. Given the pressures noted above, the best way to achieve this is to reduce spirits duty.

Any further increases in fuel duties should be resisted – indeed, they should be reduced when fiscally possible to do so.

Environmental taxation

We recognise the increasing trend towards using the tax system to achieve environmental policy aims. We welcome the publication of ***Tax and the Environment: Using Economic Instruments*** as a basis for debate.

In general, we do not support the introduction of new taxes to discourage certain forms of activity. Rather, we prefer a model which incentivises behaviour that is considered to be less harmful for the environment.

4.7 Stamp Duty and Stamp Duty Reserve Tax (SDRT)

We will be responding separately to the consultation paper *Modernising Stamp Duty on Land and Buildings*

We cautiously welcomed the extension of the Stamp Duty exemption for disadvantaged areas. We do not, in general, support tinkering with the tax system and, in itself, this measure will not lead to urban regeneration. However, it is a welcome signal that the government realises that is entrepreneurial activity in the private sector which regenerates deprived communities and should thus be encouraged, not government “task forces” or “outreach teams”.

In relation to Stamp Duty and SDRT on shares, we continue to believe that abolition would have a beneficial effect on UK competitiveness. In the medium to long term, the UK will lose business to overseas registrars if duties remain. For this reason, the amount of revenue currently raised by the operation of Stamp Duty and SDRT on shares is no excuse for inaction, as it will fall away as business is transferred.

Further, the National Association of Pension Funds estimates that abolition of Stamp Duty would add £4,500 in today’s money to the average pension fund. While this may not sound a lot, in the context of the value of the current average pension fund it is significant.

4.8 The European dimension

Recent tax cases suggest an ever-greater influence on UK tax law emerging from the European Community. Some of the possible changes are far reaching in the extreme and we would urge the government to undertake a comprehensive review of current tax law to ensure that it is consistent with European law in order to give business certainty.

In addition, if the government must introduce new legislation, it should first of all ensure that it is wholly consistent with European law. It is difficult enough for most businesses to administer and apply tax law, without having to take a view on whether it is overridden by European law.

We remain firmly opposed to “Tax Harmonisation” in principle. The UK must aspire to be a competitive place in which to do business, within the European Union and in the wider world. Tax harmonisation would blunt our competitive edge and would be unwelcome both for business and consumers.

4.9 Tax avoidance

We urge the government to continue to crack down on tax evasion in order to ensure that individuals and businesses complying with the law are not unfairly disadvantaged. However, we note with increasing concern the growing tendency for those involved in administering the tax system to confuse legal tax avoidance with illegal tax evasion.

For example, Customs and Excise are introducing a “Gold, Silver and Blue” accreditation system for taxpayers, with “Gold” taxpayers receiving preferential treatment. A taxpayer may be downgraded to “Blue” status because he, perfectly legally, pays less tax than Customs would like him to do so. The answer to this is, of course, to persuade Parliament to change the law, not to exercise discretion given by Parliament in a capricious manner.

It is unacceptable to treat certain taxpayers less favourably on the grounds of a perception of their attitude by civil servants. Taxpayers should be equal under the law, and any departure, however slight, from that principle is insidious.

A simpler tax system is one which is less likely to involve avoidance. The current system is so complex that some organisations may unwittingly avoid tax.

4.10 Tax legislation

Everyone concedes that tax law has become much too complex. It devours too much time and energy from business and individuals. It diverts people (sometimes our best and brightest, often not) from creating economic wealth into tax administration, in the civil service and the accounting and legal professions. It clogs up our Courts.

Never in history has a country prospered by devoting additional resources to administering its tax system and the UK will be no exception. It is time to move from conceding that there is a problem to dealing with it.

Tax law rewrite project

We continue to support the work of the Tax Law Rewrite Committee (TLRC). However, we are concerned that the levels of resource supplied to the TLRC may be insufficient. We do not believe that an entirely rewritten body of tax law will be enacted in this decade, which will mean that the Rewrite project will have taken at least three times as long as originally envisaged.

Obviously, we do not wish to see legislation rushed through Parliament, and indeed the detailed scrutiny of rewritten legislation may well serve as a model for future tax legislation. However, we believe that careful consideration should be given to increasing the resources available to the TLRC, both in terms of staffing, and in terms of Parliamentary time available, in order to accelerate the timescale.

Simplification generally

While we welcome the work of the TLRC, there is only so much which can be achieved by rewriting the legislation; the underlying cause of much of the complexity of tax law is the complexity of the concepts and rules which the law is based on. Equally, a huge amount of complex legislation is enacted primarily as “anti-avoidance”.

Enacting such provisions is one way to tackle tax avoidance; however, we prefer an alternative approach – lowering tax rates and simplifying the system to make avoidance less attractive and compliance simpler.

It will be interesting in this regard to evaluate the impact of the changes to business asset taper relief. Anecdotal evidence suggests that a 10% rate on gains after two years has significantly reduced “avoidance”.

The cost of administering the tax system is shared by Inland Revenue and businesses and individuals (although, ultimately, it all falls on individuals). The recent trend is to shift more and more of this burden to the taxpayer. Every pound spent on complying with an increasingly Byzantine tax system is a pound which cannot be spent on developing business, creating wealth or investing for the future.

In recent years, each Finance Act has been lengthy. If the government is not minded to reduce the burden of taxation then we would welcome a Budget which merely uprated allowances etc, and which did not introduce any substantive changes in the tax regime. Indeed, a government which replaced the annual budget with one for the life of the Parliament, forsaking the constant tinkering with the tax system, would generate significant goodwill from business.

Finally, in view of the government’s relish in developing targets, we suggest a targeted year on year reduction in the volume of tax legislation.

Improving the quality of legislation

We have already commented on the model adopted by the TLRC for scrutinising the rewritten legislation. We welcome the increasing trend to publish legislation in draft prior to the Budget in order to allow for increased scrutiny.

However, we believe that the quality of tax legislation would be improved if greater scrutiny were to be allowed for all tax legislation. The quality of legislation is not helped by legislation being rushed through Parliament with little effective scrutiny. We believe there may be merit in taking the bulk of technical tax changes (i.e. those changes which do not introduce significant additional burdens in tax or administrative terms) into a separate Bill, separate from the inevitably hasty Finance Bill process.