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# It's time for a third rule

PRE-BUDGET REPORT 2003

IoD POLICY PAPER



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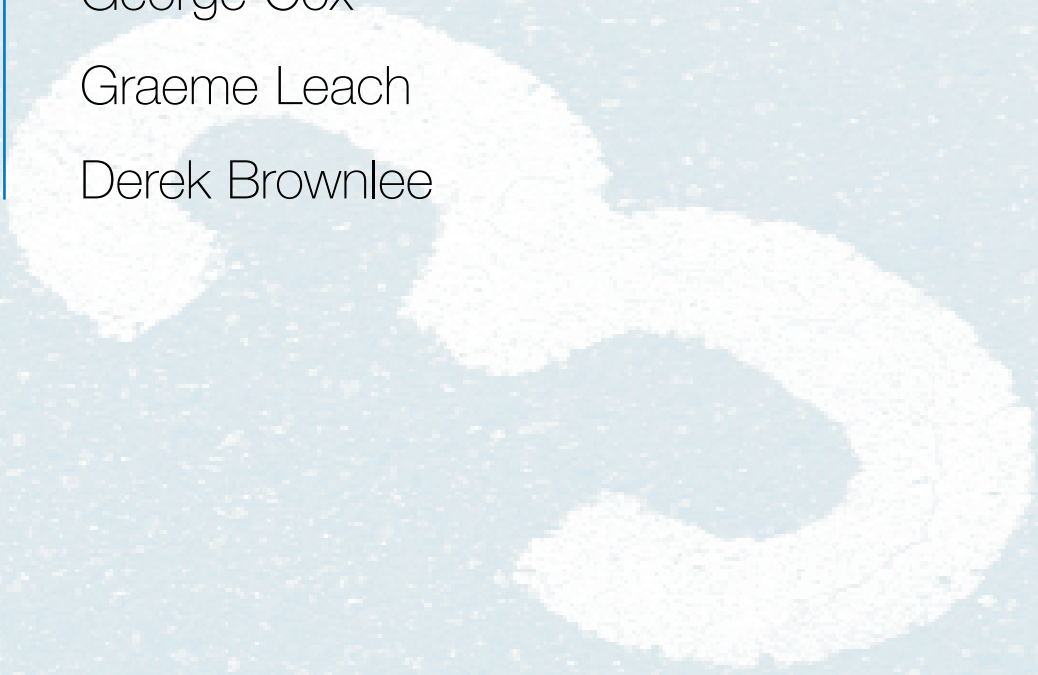
PRE-BUDGET REPORT 2003

IoD POLICY PAPER

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This policy paper was written by George Cox, Director General, Graeme Leach, Chief Economist & Derek Brownlee, Taxation Executive. It was produced by Lisa Tilsed, Policy Unit Manager.

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# 1: Introduction by the Director-General

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The IoD celebrates its centenary year in 2003 and as we look ahead to our next century, one thing is clear: in an increasingly competitive world, economic success is going to have to be hard won.

Economic growth can only come about as the result of enterprise: business creation and business growth. To facilitate this we need to reduce the tax and regulatory burden. We are increasingly shackling British business, not so much compared with Europe where we focus so much of our intention, but with the rest of the world which represents the real competitive threat.

The Chancellor's two fiscal rules (the Golden Rule and the Sustainable Investment Rule) are important components of macroeconomic stability and together with the introduction of the independent MPC, represent a real improvement in the conduct of economic policy. However, the current fiscal rules are, on their own, insufficient. In this Pre-Budget Report the IoD proposes the creation of a new Third Rule – a commitment to reduce the tax burden as a proportion of GDP, over the course of the economic cycle.

Our proposal for a new Third Rule reflects the concerns of IoD members. A recent survey which asked whether the conduct of fiscal policy was favourable or unfavourable towards business, showed a net balance of 30 per cent stating it was unfavourable.

As our detailed tax proposals show, we want to see a simpler tax system and not just a simpler style of legislative drafting. What we would really like to see is a moratorium on new tax legislation - if legislation does not contribute to reducing the tax burden or simplifying the tax system, it should not be enacted.

Too much tinkering with the taxation rules – albeit, often with good intention – has led to fifty years of progressively over-complicating the system. The cumulative effect, as any business or self-assessing tax payer will tell you, is horrendous.

Looking ahead at the world and the UK economy over the coming year, there are strong grounds for optimism, at least for the short term. We believe that 2004 will be better than 2003. However, beyond the immediate economic recovery, if the tax and regulatory burden on business continues to rise, the long-term GDP growth will inevitably falter. Alternatively, if the tax and regulatory burden can be reduced, the long-term prospects could be very good.

**George Cox**  
**Director-General**

## 2: Executive summary

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### 2.1 The economic and fiscal outlook

- The IoD calls for the introduction of a New Third Rule, a commitment to reduce the tax burden – over the course of the economic cycle – as a proportion of GDP. The IoD believes that the Chancellor's two existing fiscal rules are insufficient to keep future growth in public spending in line with what can be afforded. Satisfying the existing Golden Rule could still mean that taxation and public expenditure rise as a proportion of GDP.
- At the present time the public sector is characterised by strong growth in costs per employee and weak growth in productivity. The IoD calls on the Government to introduce real reforms in the delivery of public services, particularly education and health, so that parents and patients can exercise the choice available to them in almost every other area of consumption. Future generations will think it bizarre, that at the beginning of the 21<sup>st</sup> century, the two most important areas of our lives - our children's future and our health - were dominated by monopoly provision, with no say by the parents or patients.
- A new IoD survey shows our members have strong concern about the conduct of UK fiscal policy. When asked whether the conduct of fiscal policy was favourable or unfavourable towards business, a net balance of 30% stated that it was unfavourable. This compared with a favourable balance of 59% for the Bank of England's conduct of monetary policy towards business.
- The condition of the public finances poses an increasing problem for the Government. Our central scenario is that the Golden Rule will continue to be passed, albeit with only a small cumulative surplus. Even if the Golden Rule were to be broken, the Government would still have a choice between lower spending and/or higher taxation.
- The IoD strongly urges the Government to overcome the deterioration in the public finances by making future growth in public spending conditional on both reforms and affordability. The IoD believes that lower public spending growth and greater efficiency, not higher taxation, will best promote long-term GDP growth. Even a small productivity improvement in the public sector could remove the need for billions in extra taxation.
- The IoD is relatively optimistic about the UK and global economic outlook in 2004. The IoD forecasts UK GDP growth will rise to 2.6% in 2003 from 2.0% this year. The UK economy will experience a re-balancing in 2004 as business investment accelerates and household consumption slows.

## 2.2 Taxation: key recommendations

The main recommendations of our tax representations are as follows:

- A moratorium on all new tax legislation which does not either simplify the tax system, or reduce the tax burden.
- Automatic indexation of all allowances and thresholds by the inflation rate.
- An explicit rejection of new taxes or levies and of higher tax rates or expansion in the tax base, across all taxes.
- A recognition that high levels of Council Tax have the same negative effects on prosperity and growth as other taxes.
- An explicit policy decision from HM Government on whether the tax system should be broadly neutral on the choice of business medium or not.
- Budget date to be announced in the Pre-Budget Report and to take place before the start of the tax year.
- Greater time for scrutiny of all new tax legislation, both within Parliament and outside.
- All new tax legislation to be accompanied by an analysis of its interaction with EU law.
- Greater encouragement and availability of e-filing of tax returns, but no compulsion.
- Delay in the introduction of Stamp Duty Land Tax until 1 April 2004.
- An increase in the discount rate for lease duty for Stamp Duty Land Tax.
- The abolition of Stamp Duty and Stamp Duty Reserve Tax on Share Transactions.

## 3: Economic outlook

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### 3.1 The global economy

The IoD is optimistic about the global economic outlook in 2004 as it is very clear that the US economy will remain the driving force of global GDP growth. US GDP growth surged in 2003(Q3) at an annualised rate of more than 7% - the highest rate of growth in two decades. The sources of US economic growth are not difficult to identify:

- **Monetary policy** – Low interest rates and mortgage refinancing have supported household cash flow, together with housing and vehicle markets in particular.
- **Fiscal policy** – Significant tax cuts have further supported disposable income and investment spending. Defence spending is surging also.
- **Replacement cycle** – Globally, capacity excesses in IT sectors are being worked off as the replacement cycle kicks-in. Across the globe, key IT sectors such as semi-conductor sales, have notably improved in 2003.
- **Robust productivity growth** – Strong productivity growth has improved corporate profits. Output per man-hour grew by 6.8% (year-on-year) in 2003(Q3). Over the past five years the US has experienced the fastest productivity growth in any such period since World War 2. Moreover, productivity growth continued to increase beyond the peak in the economic cycle in 2000 and at a time when IT investment was falling. This bodes well for the future, because it indicates companies are becoming more effective in their use of IT.

Although the stimulus from monetary and fiscal policy is likely to fade over the coming year other cyclical influences should act to sustain the US recovery:

- **Employment** - US employment growth is expected to accelerate – so far rising output has been manifested almost entirely in higher productivity, encouraged by the continued fall in the price of IT capital goods relative to the cost of labour. However, employment is now expected to respond to the economic upturn.
- **Inventories** - The inventory sales ratio has slipped to an all-time low, with the result that stock building should support industrial production and output growth in coming quarters.
- **The output gap** - Weak GDP growth over the 2001-2002 period widened the US output gap with the result that above trend GDP growth over the coming year is unlikely to result in a serious pick-up in inflationary pressures – thereby reducing upward pressure on interest rates.

- **Business confidence and investment** - Rising business confidence will combine with the IT replacement cycle to boost business investment. Business investment in equipment and software rose by 15% at an annualised rate in 2003(Q3).
- **The dollar** - Dollar weakness, in the wake of the US current account deficit (above 5% of GDP), should provide an additional stimulus to exports as the world economy recovers.
- **The Fed** – The Federal Reserve is unlikely to begin a tightening in US monetary policy until payroll employment is rising at a sustained rate of 200,000 per month. Even allowing for a significant acceleration in employment growth, this point is unlikely to be reached for some time yet.

Whilst the IoD is confident about the US economic outlook in 2004, there are serious questions as to the sustainability of strong GDP growth in 2005. The performance of the US current account in 2003 is sharply different to previous recoveries in the early 1980s and 1990s. In the wake of previous US economic downturns the current account deficit moved towards balance, before economic recovery began. In the latest economic cycle the historic experience has not been repeated and recovery has started from a position of current account deficit above 5% of GDP. Consequently, as US domestic demand growth moves further ahead of that in other countries, the current account deficit could well deteriorate further - although any deterioration may be tempered by the export stimulus and import substitution arising from a weaker dollar.

A second US concern is the size of the budget deficit. Multiple tax cuts, two wars and one economic slowdown have together resulted in a significant deterioration in the US budget deficit. There are times - if consumer and business confidence is particularly weak, such as in the 1930s or in the wake of the recent stock market boom and bust – when a strong fiscal stimulus is the best medicine for an ailing economy. However, the strong fiscal stimulus does not need to be maintained once recovery becomes self-sustaining. If large budget deficits continue throughout the next decade, long-term interest rates are likely to be higher, than otherwise would have been the case. Thus far, there appears to have been little upward pressure on bond market yields owing to strong demand for US Treasuries from Asian central banks.

Although Japan remains the second largest economy in the world, it is the pace of economic activity in China, which appears to be the strongest driving force behind Asian growth at present. Shipping rates are at record levels owing to the lack of space on cargo vessels moving commodities and goods into and out of China.

Over the past decade the Japanese economy has done little more than move sideways, plagued by deflation. Zero interest rates failed to revive economic confidence and spending, owing to the enormous level of bad debts in the banking system. In the absence of structural reforms and adequate bad debt provisioning, fiscal stimulus became the primary instrument of economic policy. There are now tentative signs that GDP growth in Japan may be about to become self-sustaining for the first time in more than a decade. The quality of growth has improved, with less reliance on public spending projects and a greater role for business investment.

Japanese GDP has grown above potential output for five successive quarters. However, to some degree the jury is still out as to the future implications, since recent strength in recorded GDP growth may be overstated due to the difficulties in accurately measuring GDP deflators in a deflationary environment. In addition, whilst confidence in the banking system has improved - as

uncertainty regarding the scale of non-performing loans has receded - it would be foolish to be complacent. With regard to export performance, it is clear that this sector has been propped up by massive foreign exchange intervention aimed at keeping the yen weak. On a positive note, consumption growth should be maintained over the coming months by rising real incomes – nominal wages are rising whilst there is still deflation in general prices. Our interpretation of events in Japan is that the situation is not as bad as perceived at the beginning of 2003, but not as good as some overtly optimistic views at present.

In both Japan and the Euro-zone, a weaker dollar is expected to take the edge off GDP growth in 2004. The IoD expects a weak recovery in the Euro-zone in the final quarter of 2003 and into 2004. In the short-term, continued breaches of the Stability & Growth Pact by Germany and France provide some underpinning to growth. More positively, recent improvements in business confidence have been displayed across a broad range of surveys covering orders and output. However, so far there has been a contrast between improving business surveys and official data, which has remained weak.

TABLE 1.1 IoD GLOBAL GDP FORECASTS		
Country/grouping	2003	2004
US	3.1%	3.7%
Euro-zone	0.5%	1.4%
Japan	2.4%	1.5%

Euro-zone recovery is unlikely to be strong due to:

- **Monetary policy** – The German economy requires much lower interest rates and on current policy may experience deflation in 2004. German consumer prices are rising by just 1.1% compared with 2.1% across the Euro-zone. There are two important aspects to monetary policy in Germany at present. First, the one size fits all Euro-zone interest rate policy is a real constraint on cyclical recovery in Germany. Second, problems of under-capitalisation in the German banking system are dampening already weak credit and broad money growth.
- **Structural policy** – The unemployment rate in the Euro-zone remains high, at almost 9%. Moreover, despite limited reforms in recent years, structural rigidities in labour and product markets mean that there is likely to be a weak employment response to any pick-up in GDP growth. We remain doubtful that recent reforms will have made EU GDP growth substantially more 'jobs intensive'.

### **3.2** The UK economy

Consumption has risen sharply as a proportion of GDP in the UK over recent years and cannot realistically be expected to continue to rise at current rates. Between 1997 and 2003 household consumption increased from 61% to 65% of GDP. This increase is measured at constant prices, which is slightly misleading, because over the period falling import prices for PCs and other items

has meant that at current prices the consumption share has only risen from 62% to 63% over the same period. Despite this caveat, it is clear that the Bank of England wants to bring about a re-balancing of the economy. The MPC is obviously worried that if left unchecked, household borrowing and consumption will continue apace and de-stabilise the economy.

**TABLE 1.2 IOD UK ECONOMIC FORECASTS**

Indicator	2003	2004
GDP	2.0%	2.6%
Consumption	2.6%	1.8%
Business investment	1.0%	3.5%
Interest rates (end Q4)	3.75%	4.25%
Inflation	2.8%	2.4%

Note: Inflation measured using RPIX not HICP.

So how is the re-balancing process expected to work? There are two dimensions to this process. First, the UK economy needs to experience a reduction in the growth rate of household consumption and an increase in the growth rate of business investment. Household consumption growth needs to fall back in line with overall GDP growth while business investment needs to accelerate and take-up an increasing share of GDP.

Second, there needs to be a re-distribution of growth between the domestic and overseas sectors – we need to see an improvement in net exports. What are the prospects for achieving a successful re-balancing? The improvement in corporate finances over the 2002-03 period, together with rising business confidence, suggests that business investment will accelerate in 2004, although we have some concerns<sup>1</sup> over the impact of pension fund deficits on the availability of finance. As a result, we are not forecasting a strong cyclical recovery in business investment.

With regard to net exports, the surge in US economic growth in the second half of 2003 is likely to be sustained into 2004 as a result of rising employment and the re-building of inventories. However, as discussed above, 2004 is also likely to see further dollar weakness, and this could take the edge off the recovery in export markets in the EU and Japan.

In the UK, the uncertainty is whether consumption will slow too quickly, thereby undermining business confidence and investment. This is why the MPC needs to proceed with caution as it tightens monetary policy.

The IoD believes that a successful re-balancing of the economy can be achieved, because the large build-up in household debt over recent years does not as yet pose a fundamental threat to the economy.

Total household debt has increased from just under 100% to more than 120% of disposable income over the 1997-2003 period. Whilst this debt mountain is dominated by secured debt on

<sup>1</sup> The CBI has voiced similar concerns. See Focus on investment: The impact of pension deficits, CBI Economic Brief, July 2003.

properties, unsecured borrowing has increased over recent years - attributable to a combination of easier availability of credit and/or falling unsecured borrowing costs.

The secured debt income ratio was flat during the 1970s (below 40% of disposable income) and then rose rapidly during the 1980s (towards 80% of disposable income). The ratio then stabilised before beginning to rise again in the late 1990s (above 95% of disposable income).

The increase in the secured debt ratio is probably due to a combination of cyclical and structural influences. The primary structural explanation is long-term growth in owner occupation. Cyclical factors relate to the low interest rate environment, the boom in house prices and the associated explosion in mortgage equity release which reached 8% of disposable income in the first half of 2003.

Despite the surge in debt levels to date, there is good reason to believe that this process will not necessarily end in tears:

- **Measurement issues** – The debt ratio is misleading as a measure of economic exposure. The numerator is the sum of total debt, whilst the denominator is the sum of all incomes i.e. those with and without debt. A better measure would show the ratio of total debt to the total incomes of those in debt. Such a measure<sup>2</sup> is only available up until 2001, but does show that over the 1995-2001 period the secured debt to income ratio for mortgage holders increased from 1.24 to 1.25 – at a time when the standard debt income ratio rose much faster. There can be little doubt that the adjusted debt income ratio will have increased since 2001, at the very least because of the growth in mortgage equity release in recent years.
- **Undrawn housing equity** - The growth in equity release has not been alarming when measured against retained housing wealth. Bank of England estimates show that because of the growth in house prices over recent years, undrawn housing equity has actually increased from 65% to 77% of housing wealth over the 1996-2003 period.
- **Debt wealth ratios** – The ratio of total debt to total assets is relatively close to the average of the past two decades.
- **Debt servicing costs** – Despite the upturn in the UK interest rate cycle, the tightening in monetary policy will be a world apart from that seen at the beginning of the 1990s. However, we do acknowledge that debt servicing measures which incorporate capital repayments are less favourable on a historic comparison, simply because lower interest rates are being paid on a higher stock of debt.
- **Net acquisition of financial assets** – Net acquisition of financial assets actually rose from 0.2% to 1.2% of household income between 1998 and 2003(Q1). In aggregate, households have been expanding both the liability and asset sides of their balance sheet. What is unclear from the data is the extent of any mismatch i.e. debt accumulation concentrated in certain households and asset accumulation in others.

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<sup>2</sup> Available from the British Household Panel Survey.

- **Savings ratio** – The household savings ratio has been relatively stable over recent years, ranging from 6.7% in 2001 to 4.8% in 2003(Q2). At current levels the savings ratio does not suggest a sudden upward shift as a result of a swing towards precautionary behaviour on the part of consumers.

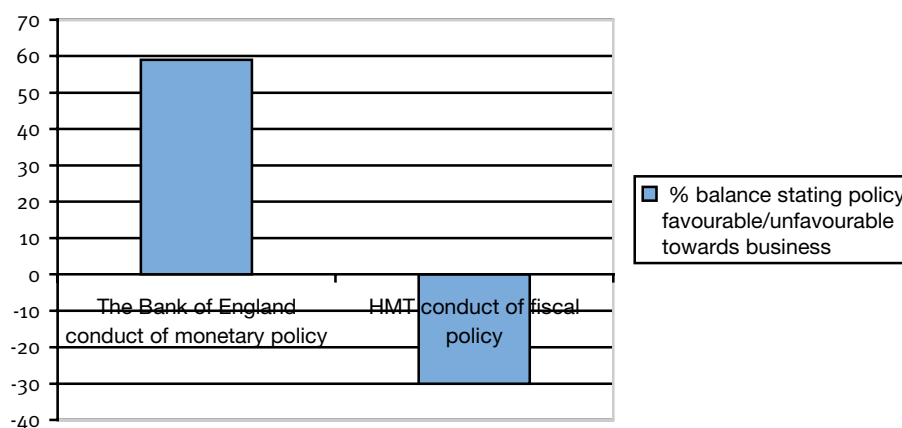
Despite this relatively optimistic assessment, it would be foolish to ignore potential downside risks to our UK forecast. Two potential risks stand out:

- **Economic shocks** – Such shocks could take various forms and might include an act of mega-terrorism. Danger would arise if a future economic shock triggered a sharp adjustment in employment levels as a result of an anticipated and/or realised deterioration in corporate finances. In such an environment of rising unemployment, debt income ratios would also begin to rise, even if total outstanding debt remained constant. This in turn could result in a swift upward movement in the savings ratio.
- **Real house prices** – Throughout the post-war period the peak in the house price cycle has been followed subsequently by a fall in real house prices. If this tendency were to be repeated there would be a clear risk of falls in nominal house prices – given that general inflation is so low.

### 3.3 UK public services

Over recent years the IoD has consistently voiced concern<sup>3</sup> over the growth in public spending and higher taxation to finance it. IoD members are polled each quarter on their view of the effectiveness of monetary and fiscal policy towards business. Chart 1.1 shows significant unease on the part of IoD members towards the conduct of fiscal policy – in contrast to attitudes on the conduct of monetary policy.

Chart 1.1 IoD member's views on the conduct of monetary and fiscal policy

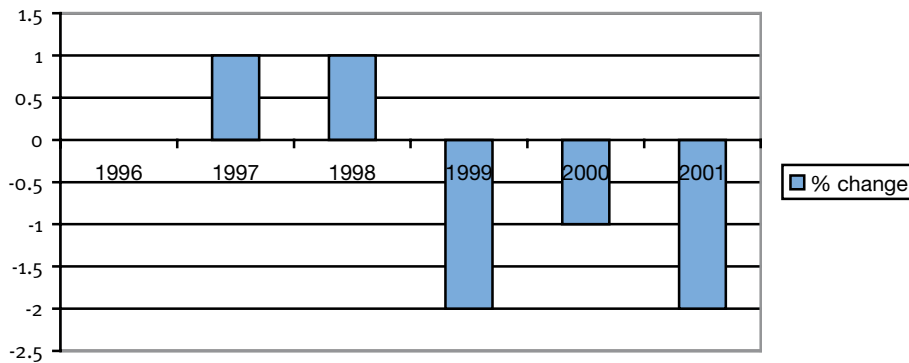


(Source: IoD Business Opinion Survey, September 2003)

<sup>3</sup> See: Government borrowing: deeper into debt, IoD, February 2003. Pre-Budget Report, Economic Comment, IoD, November 2002.

The IoD's concerns have increased over the past year. Latest figures show that pay awards in the public sector are running at almost twice the level in the private sector – 5.6% versus 3.1% growth. However, recent Government data on public sector productivity performance (admittedly a new series with no data beyond 2001) shows a very poor performance. In other words, a lot of money is going into the public sector but as yet the return is very poor. Over the six-year period shown in chart 1.2, public sector productivity has fallen by a cumulative 3%. Even allowing for the fact that the data is based on an experimental series, the statistics surely reinforce the IoD's central argument that fundamental reforms in public service delivery should have preceded the huge increases in expenditure.

Chart 1.2 General Government productivity



(Source: ONS)

The IoD calls on the Government to institute real competitive reforms in key public services, so that parents and patients can be freed to exercise the choice freely available to them in almost every other area of consumption. It seems bizarre, at the beginning of the 21<sup>st</sup> century, that the two most important areas of our lives, our children's future and our health, remain dominated by public sector monopoly provision.

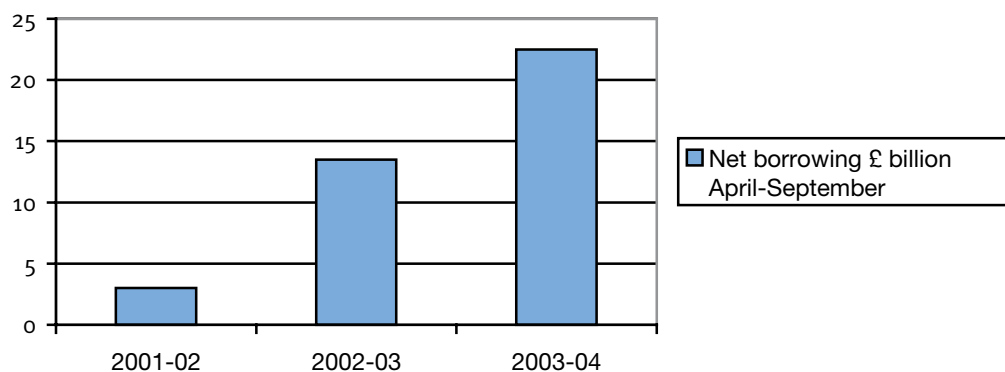
The IoD's call for change reflects a broad consensus in the UK. An ICM opinion poll in June 2003 found that 79% of those surveyed believed that public services had stayed the same or got worse since 1997 (48% stated they had stayed the same, 31% stated they had got worse). The same ICM poll also found that 71% of those surveyed felt public services would stay the same or get worse before the next election (49% stated they would stay the same, 22% stated they would get worse).

An ICM poll undertaken in July 2003 showed significant cross party support for a fundamental change in public services, along the lines proposed by the IoD. For example, when asked if parents should be allowed to use the money currently spent per pupil, to send their child to any school they chose, there was a net positive response across all voters and all voter groups, whether Labour, Conservative, Liberal Democrat or those with no party affiliation. Indeed, amongst those who failed to identify with any political party, there was a positive balance of 35% stating it was a good idea. There needs to be more choice and competition in the delivery of publicly funded health and education.

### 3.4 UK public finances

The condition of the public finances poses an increasing problem for the Government, but there is still no need to raise taxation. Chart 1.3 shows net borrowing for the April-September period over recent financial years. In the 2003-04 financial year net borrowing has already reached £22.5 bn against a full-year projection of £27 bn in the April 2003 Budget Red Book. A very significant overshoot is now certain, but the Golden Rule can still be met, even though the cumulative current surplus has fallen sharply over recent years.

Chart 1.3 The deterioration in net public borrowing



(Source: ONS)

The Golden Rule requires that the current budget is balanced over the course of the economic cycle and so a deterioration in one year does not necessarily require a cut back in public spending and/or increase in taxation in response. In the 2001 Budget the projected cumulative current budget surplus over the economic cycle stood at just over £100 bn. The projected current budget surplus had fallen by two thirds to £33 bn in the April 2003 Budget and latest data suggest the surplus could be down to £20 billion or less.

Satisfaction of the Golden Rule clearly provides a welcome constraint on the public finances, but this does not mean that taxes now have to rise. Even if the Golden Rule position deteriorates further, the Government will still have a choice between higher taxes and /or lower growth in public spending. The IoD, in common with other business organisations, would urge that the Government squeeze far greater efficiency out of the public sector.

In the actual Pre-Budget Report we expect HM Treasury to show there is no need to further increase the tax burden on top of existing plans, by a combination of:

- Adjusting future UK GDP growth forecasts and/or the period of the economic cycle.
- Adjust future estimates of tax revenues i.e. tax GDP elasticities.
- Place an increasing emphasis on the cyclically adjusted current budget surplus.
- Place an increasing emphasis on the Sustainable Investment Rule.

Clearly HM Treasury's credibility would be stretched if it were to push very strong GDP growth into the out-years. There are problems with option two also, since organisations such as the Institute for Fiscal Studies (IFS) have already voiced concerns that future revenue estimates may be optimistic. The IFS has questioned whether projected corporate tax revenues will be achieved<sup>4</sup>.

The IoD strongly urges the Government to overcome the recent deterioration in the public finances by cutting the future growth in public spending. The IoD believes that lower public spending, not higher taxation, is the best solution to current difficulties.

### 3.5 The need for a new Third Rule

The IoD calls for the introduction of a new Third Rule, a commitment to reduce the tax burden - over the course of the economic cycle - as a proportion of GDP.

The IoD believes that the Chancellor's two fiscal rules are insufficient to restrain growth in public expenditure in the long term. It is possible to argue that satisfaction of the Golden Rule should alleviate this upward pressure, but the IoD is less confident.

Satisfying the Golden Rule could still mean that taxation and public expenditure rise significantly. This propensity for tax and spend is a matter of great concern. There needs to be a more binding constraint on expenditure if upward pressures on taxation are to be avoided.

The new Third Rule can still be reconciled with improved public services, by providing people with the incentive to make a greater private contribution towards the cost of health and education. Moreover, lower public spending growth, if tied to real competitive reforms, should result in an improved quality of health and education services.

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<sup>4</sup> IFS Director, Robert Chote, in public statements.

## 4: Taxation

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### 4.1 Introduction

The IoD's Budget Survey<sup>j</sup> this year showed widespread discontent with the direction of tax policy in the UK. Our members want to see a lower tax burden, on individuals and on business. They also want to see a simpler tax system, not just a simpler style of legislative drafting. As a result, we are calling for a moratorium on new tax legislation – if legislation does not contribute to reducing the tax burden or simplifying the tax system, it should not be enacted.

The IoD's tax representations for the 2004 Budget are summarised below:

### 4.2 Income Tax

#### *The Personal Allowance*

We condemned the failure to increase the Personal Allowance for 2003/4 by the rate of inflation.<sup>ii</sup> Such “bracket creep” may well be a useful means of raising additional tax revenues with the minimum of political difficulty but it is wrong – and, of course, has a disproportionately burdensome effect on those low earners earning just above the threshold.

At the very least, the Personal Allowance for 2004/5 should be uprated for inflation since the last uprating, *not* merely by inflation in 2003/4. This will still mean that tax revenues have been artificially boosted due to the lack of indexation in 2003/4, but will ensure that this unfair additional tax is not levied again, year after year.

#### *All tax thresholds should be indexed*

In addition, the current thresholds for basic and higher rate tax should be indexed by inflation. Failure to index by inflation leads to a real terms tax increase.

In order to ensure that the Personal Allowance and all tax thresholds are properly adjusted for inflation, their uprating should be automatic and taken out of the Budget process, although uprating beyond inflation should still be allowed in the Finance Bill.

#### *Higher tax rates must be rejected*

We are alarmed at the suggestion by a senior Government Minister that the higher rate of income tax should be increased, or an even higher additional rate be introduced for upper earners. The increase in National Insurance Contributions this year effectively leaves a 41% upper rate for taxpayers.<sup>iii</sup> The debate should be about how to reduce the current high rates of tax, not how to penalise success.

To increase tax rates would further damage incentives to work and send a signal to the wider world that Britain is a less attractive place in which to conduct business, and deter global executives from working here.

### 4.3 National Insurance contributions

The damaging effect of the increases in National Insurance for 2003/4 was highlighted by the results of our 2003 Budget Survey,<sup>iv</sup> which revealed widespread anger at their impact, with one member, for example, stating “The more we are taxed for employing people the less people we will employ”. Higher employees’ National Insurance creates a further disincentive to work and higher employers’ National Insurance contributions prevent employers contributing more to employee pensions, for example.

We continue to call for a reversal of the increase in National Insurance Contributions, in particular the increased levy on employers and the 1% charge on employee earnings above the upper earnings limit.

### 4.4 Tax credits

We have consistently criticised the concept of state benefits being delivered via the payroll, and the fiendish complexity of the tax credit system. Constant change has, inevitably, caused real problems in the administration of tax credits.

The IoD has a number of fundamental concerns with regard to tax credits:

#### *Extending the dependency culture up the income scale*

First of all, they reach too far up the income scale. The notion that a family earning £66,000 per annum can be in receipt of state benefit (the baby element of the child tax credit) is ludicrous. Either this is an attempt to widen a culture of dependency on the State, or a signal that the tax burden has become so onerous that even those on significantly higher earnings than is the norm are paying so much in tax that they cannot afford to raise a family without state benefits.

#### *Time limits are too short*

We are also very concerned about the three month claim window for tax credits. At the very least, claimants should be able to make valid claims for tax credits up to and including the deadline for filing their tax return for the relevant year, since at least by that point they ought to know their income for the period.

#### *Too much bureaucracy*

In a system which already shows signs of strain due to the volume of claims, it is lunacy to force people to make “protective claims” in order that, should their income fall below that which they expect, they will not lose out on any tax credits due. Such a system would be unnecessary if a claim could be made in the tax return.

In addition, it is bizarre that at the same time as the Inland Revenue is testing a four-page self assessment return with 16 pages of guidance notes, the tax credits form and guidance notes run to 58 pages.

#### 4.5 Inheritance Tax

The nil rate band for Inheritance Tax is much too low, and as a result many families with relatively modest means are being caught by this pernicious tax. It is important that incentives to generate and pass on wealth are present in the tax system.

Since abolition is not on the agenda in the short term, the nil rate band should be increased significantly, perhaps to £500,000. This would take many smaller estates out of the scope of the tax. An alternative to increasing the threshold would of course be to lower the rate to 20% or so, but this would still mean that those with modest wealth would continue to be taxed.

#### 4.6 Residence and domicile

We note the current review on the rules relating to the residence and domicile of individuals for tax purposes. We see no compelling reason to amend the current rules and will strongly oppose any measures which damage the UK's international competitiveness.

#### 4.7 Council Tax

Whilst not strictly a Business Tax issue, the high and ever increasing levels of Council Tax have the same negative impact on prosperity and growth as do other taxes. The Government must ensure that it does not force higher levels of Council Tax by underfunding centrally mandated services.

#### 4.8 Corporation Tax

We have responded separately to the further consultation on Reform of Corporation Tax. This submission will not repeat the points made in our response to that consultation, or indeed those points which will be developed in response to the 2002 consultation, but instead outlines the general themes for Corporation Tax which we believe are appropriate regardless of whether reform proceeds or not.

Business has borne the brunt of the significant increase in taxation in the UK in recent years. Too often raising Corporation Tax is the easy option (particularly when it can be masked by a corresponding reduction in the rate, or the introduction of a new gimmick).

Our members strongly oppose any attempt to widen the tax base further, or to increase the applicable rate of Corporation Tax. The UK must strive to remain competitive internationally in terms of its tax system.

#### 4.9 Encouraging investment

Generally speaking, whilst supporting the underlying aims, we are sceptical of the value of limited tax breaks. In particular, we are sceptical of the approach of targeting “market failure” via the tax system. We will watch with interest the impact of the Stamp Duty/Stamp Duty Land Tax exemption for “disadvantaged areas”. We would hope that it would stimulate new investment rather than merely displace planned investment.

Similarly, we would like evidence of whether the 100% first year allowance on ICT expenditure by small businesses is effective in stimulating new investment rather than altering its timing.<sup>v</sup> If it is effective, we would urge that it be made permanent and extended to all businesses, not merely small businesses.

#### 4.10 Choice of business medium

In principle, we believe that the tax system should be as neutral as possible, and that businesses should select the form in which they choose to operate for commercial reasons, with the tax system barely featuring in the decision.

It is true that the distinction between the taxation of incorporated and unincorporated business is not new, but the scale of the difference has grown markedly in recent years. We would welcome a clear statement of policy direction in this area to ensure that future policy announcements are shaped in the context of an agreed direction, be it a move towards greater neutrality, or an explicit decision to create distinctions.

#### 4.11 Capital Gains Tax

We have strongly welcomed the speed of taper relief on business assets for Capital Gains Tax purposes in the past. However, the gap between the treatment of business and non-business assets remains too wide. If the distinction must be retained at all it would be very beneficial to business to have either a broader definition of “business asset”, or a faster accrual of taper relief for non business assets, or, preferably, both.

#### 4.12 Budget timing

We believe that Budget measures should be announced prior to the Financial Year in which they are to take effect. If we must continue to have annual Budgets, we see no reason why the date of the Budget should not be fixed in advance, ideally at the time of the Pre-Budget Report. This would allow business to take decisions in the knowledge of the tax consequences of doing so.<sup>vi</sup>

#### 4.13 A stable tax system

Taxation is highly complex, as can be seen by the large number of advisers required to advise on the detail of tax law and practice. It may be tempting to try to find “market failure” and then introduce new tax rules which hold the illusory promise of dealing with the problem. However the volume of tax legislation and its complexity is a sign that the system is breaking down.

The 2003 Finance Act was one of the longest on record. Finance Act 2004 (if there must be a Finance Act 2004) needs to be one of the shortest in order to allow business to get to grips with the many changes of recent years.

#### 4.14 Finance Bill scrutiny

We remain concerned that tax legislation, including delegated legislation, should be scrutinised carefully. For example, we do not believe that sufficient Parliamentary time was given to the 2003 Finance Bill.

Schedule 22 was a very good example of the problems. Not only did this complex piece of legislation replace legislation which had been in force for only a few days, but it did so in an overly complex manner, destroying the drafting style employed in the Income Tax (Earnings and Pensions) Act 2003.

So widely drawn was this legislation that weeks later non-statutory clarification was published by the Inland Revenue. Non statutory clarifications or interpretations are better than nothing, but remain wholly unacceptable. Schedule 22 FA 2003 must be replaced by narrower legislation which does not need such clarification.

We believe that the exposure of draft legislation for comment is the best way to ensure that legislation is well drafted and achieves the desired policy effect. There have been some very good examples of this in recent years, but also too much legislation where such scrutiny has not been possible. We believe that all tax legislation should be consulted upon prior to its inclusion in the Finance Bill, except in highly exceptional circumstances.

#### 4.15 Tax avoidance and tax evasion

Much has been said about evasion and avoidance in recent years. We reiterate our objection to the wilful blurring of the distinction between the two by the Tax Authorities. There is no moral case for paying more tax than that laid down in law, and if those responsible for tax administration take a different view taxpayers may lose confidence in their impartiality.

Legislation which has not been scrutinised properly is more likely to create “loopholes” or unintended consequences, both in favour and against the Exchequer. “Anti-avoidance” legislation is often introduced retrospectively, with the date of implementation backdated to the date of issue of the press release announcing the legislation. We recognise that this practice is not new, and we understand the motivation behind it, but the practice does mean that there is less incentive to get the legislation “right first time.” It would be interesting to see the impact on the quality of legislation if anti-avoidance legislation could only be introduced prospectively.

We repeat our opposition to the concept of a legislative “General Anti-Avoidance Rule”, although the Government might well take account of the General Anti-Avoidance Rule which applies in practice – the lower the tax burden, the simpler the tax system, the less likely avoidance is. We would welcome confirmation from Ministers that no General Anti-Avoidance Rule will be introduced.

#### 4.16 E-filing etc

We recognise the potential benefits of e-filing of tax returns across the whole range of taxes, but we remain firmly opposed to compulsion as a means of achieving these benefits, at least for the medium term future. If it is quicker, cheaper and easier to file returns electronically, most businesses and individuals will do so.

We much prefer the use of incentives to encourage greater e-filing. The extension of the deadline for the filing of self assessment returns for which underpayments could be collected through PAYE to December 2002 was a good example of the use of incentives to the mutual benefit of taxpayer and the Inland Revenue.

A simple innovation which would also be of benefit would be the availability of all Revenue forms on the Inland Revenue website in .pdf format, with the ability to e-file added as soon as possible.

#### 4.17 Simpler forms

We welcome the progress made on the 4 page short Income Tax Return. We would welcome the extension of the pilot to other tax returns. Perhaps if a tax return cannot collect all the necessary information in four pages, the system is too complex.

#### 4.18 Stamp Duty Land Tax

We are not averse in principle to the “modernisation” of Stamp Duty (although increasingly to “modernise” seems to mean to “increase” or “make more burdensome”). We do welcome some aspects of reform, such as the move to a transaction basis rather than the current documentary form, and the ability to recover Stamp Duty Land Tax in some circumstances where future contingencies do not occur. However, we have concerns about Stamp Duty Land Tax, some of which are outlined below.

##### *Implementation date*

Stamp Duty Land Tax has a number of major differences from Stamp Duty. It is a major legislative change and business needs time to absorb the impact of the changes and to plan for implementation. We do not believe that implementation on 1 December 2003 is necessary and would prefer implementation to be delayed at least until the beginning of the next tax year.

### *Lease duty*

There is a logic in taxing the discounted value of the lease payments but the consequences of this measure will significantly increase the costs of entering into leases. We question whether the discount rate is too low at 3.5%. The aim should surely be to ensure that Stamp Duty Land Tax is as neutral as possible in consideration of whether a business enters into a lease or an acquisition of property.

### *The “Slab Rate” system*

Though we appreciate that the “slab rate” feature of Stamp Duty Land Tax is not new, it is onerous and is more likely to encourage avoidance at the margins. Ideally, we would prefer to see one rate of Stamp Duty Land Tax applied above a reasonable threshold. However, if this is not possible it would at least be preferable to apply the current rates only to the extent that consideration exceeds the relevant band.

## 4.19 Stamp Duty and Stamp Duty Reserve Tax

The stated rationale for the introduction of Stamp Duty Land Tax was “modernisation” although in reality its introduction is more to do with increasing the yield from property transactions. If modernisation is genuinely desired, abolition of Stamp Duty and Stamp Duty Reserve Tax on share transactions would be a huge step forward, as well as reducing the transaction costs which affect business and savers, and being a welcome boost to pension funds. Both taxes raise the cost of capital and are an impediment to market efficiency.

## 4.20 The European dimension

The influence of EU law on UK Tax Law is becoming increasingly apparent and the IoD has urged the Government to review the influence of EU law.<sup>vii</sup> The logic of recent decisions from the European Court of Justice have the potential to turn many aspects of the UK Tax System on their head. The IoD continues to oppose tax harmonisation, but the European Court of Justice is forcing it upon the UK. This must be resisted – and reversed.

The IoD will be participating fully in the debate on the impact of EU law on the UK tax system over the next year, (including, but not limited to, the consultation in *Corporation Tax Reform*) but in the meantime we would like to see all new tax legislation (if we really must have any new tax legislation at all) published with an analysis of its compliance with EU law to ensure that pertinent issues may be debated prior to enactment. It is important that an analysis, rather than a mere statement of compliance, is published, in order that proper scrutiny can be conducted. In the long term, the clear solution is an amendment to the Treaties to exclude direct taxes from the scrutiny of the ECJ.

## References

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<sup>i</sup> *Budget Survey*, IoD, March 2003

<sup>ii</sup> *Budget 2003*, IoD, March 2003, Chapter 4, Para 4.2

<sup>iii</sup> 51% for taxpayers earning less than the upper earnings limit for National Insurance but more than the threshold for higher rate tax

<sup>iv</sup> *Budget Survey*, IoD, March 2003

<sup>v</sup> Presumably it is effective, given its extension in Finance Act 2003

<sup>vi</sup> Admittedly this assumes that businesses are able to understand the UK Tax System – given its complexity this is probably somewhat naïve.

<sup>vii</sup> *Budget 2003*, IoD, March 2003, Chapter 4.8