



INSTITUTE OF DIRECTORS

IoD budget representations

MARCH 2004

IoD POLICY PAPER



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George Cox

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This policy paper was written by Graeme Leach, Chief Economist and Derek Brownlee, Taxation Executive, with an introduction by George Cox, Director General.

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1: Introduction by the Director General

The IoD continues to be relatively optimistic about the outlook for the UK and world economy over the coming year.

In our Pre-Budget Report the IoD acknowledged the Chancellor's two fiscal rules (the Golden Rule and the Sustainable Investment Rule) represented a real improvement in the conduct of economic policy. There is clearly no crisis in fiscal policy at present. However, there is a problem.

Over recent months, the IMF, OECD, Institute for Fiscal Studies (IFS), National Institute of Economic & Social Research (NIESR) and Oxford Economic Forecasting (OEF) have voiced doubts over whether the Government will be able to satisfy the Golden Rule – the commitment to balance the current budget over the economic cycle.

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. Even a small productivity improvement in the public sector could remove the need for billions in extra taxation. The IoD welcomes the Atkinson Review on the future measurement of government output and productivity and hopes that it will prove a catalyst for further public sector reform.

In an increasingly competitive world, economic success is going to have to be hard won. Beyond the immediate economic recovery, if the tax and regulatory burden on business continues to rise, long-term GDP growth will suffer. Alternatively, if the tax and regulatory burden can be reduced, long-term prospects could be very good.

Over the coming years the tax burden is projected to rise by a further 2% of GDP. The IoD does not wish to see any Budget measures to increase further the tax burden beyond that already projected.



George Cox
DIRECTOR GENERAL

2: Summary

2.1 Economic outlook

- Government figures suggest that over the 1997-2006 period public sector employment will rise by 650,000. If current growth rates are maintained, public sector employment (excluding nationalised industries) will exceed 1979 levels before the end of the decade.
- IoD forecasts show UK GDP growth of 3% in 2004 and 2.6% in 2005, with interest rates peaking at 4.5%. These forecasts are based on a progressive decline in quarter-on-quarter growth from 0.8% to 0.5% through 2004. HM Treasury forecasts of 3% to 3.5% GDP growth, this year and next, appear optimistic. If the UK economy manages to grow by 3.5% this year, the Bank of England will almost certainly have to raise interest rates well beyond 4.5% and it is difficult to believe that GDP growth could be as strong next year as a result.
- The IoD's UK GDP forecasts are less optimistic than those of HM Treasury for two reasons:
 1. They assume a smaller output gap (because of slower underlying GDP growth).
 2. They assume weaker growth in household consumption (greater consumer sensitivity to past/future interest rate rises, because total debt servicing costs – including interest costs and repayment of principal – are actually very high by historic standards).ⁱ
- Underlying trend GDP growth (potential output growth) may have declined towards 2.25% over recent years. HM Treasury assume that trend growth is 2.75% per annum and as a result, estimate a negative output gap of around 1.5% of GDP in 2003Q3 (the output gap is defined as actual output less trend output as a per cent of trend output). A larger output gap would permit the economy to grow faster over 2004-05, as slack in the economy is taken up. If the output gap is smaller (because trend growth is slower) there is less slack in the economy and GDP growth may not be as fast.
- Over recent months, the IMF, OECD, Institute for Fiscal Studies (IFS), National Institute of Economic & Social Research (NIESR) and Oxford Economic Forecasting (OEF) have voiced doubts that the Government will be able to satisfy the Golden Rule. Future satisfaction of the Golden Rule looks wafer thin.
- 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.
- HM Treasury projections show a 3% of GDP rise in the tax burden over the 1996-97 to 2007-08 period. Only 1% of GDP of this increase will have been recorded by the end of the 2003-04 tax year. The IoD does not wish to see any further increase in the tax burden beyond that already projected.
- 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 Golden Rule could still mean that taxation and public expenditure rise as a proportion of GDP.ⁱⁱ

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.
- Full consultation on any changes to the tax system for small companies following the Pre-Budget Report announcement, and no legislation on this prior to 2005.
- 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 without.
- 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.
- 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

3.1 HM Treasury growth projections

Short term

Following the release of provisional fourth quarter GDP figures at the end of January, the IoD has marginally revised its 2004 UK GDP forecast. The IoD now forecasts UK GDP growth of 3% in 2004 and 2.6% in 2005.

The IoD's analysisⁱⁱⁱ shows the UK economy is set to re-balance in 2004, but not in a dramatic way. Household consumption is expected to slow without crashing, whilst business investment is set to accelerate, but more slowly than in previous upturns.

The November 2002 Pre-Budget Report forecast 2% to 2.5% GDP growth in the UK in 2003. This compared with an outturn of 2.1%. The December 2003 Pre-Budget Report forecasts 3% to 3.5% GDP growth in 2004 and 2005.

How realistic are these forecasts? HM Treasury can justifiably claim to have been more optimistic than the consensus about 2003 growth prospects and to have then been proven correct. This has understandably led to many commentators being cautious about criticising the latest HM Treasury forecasts.

However, there are significant differences between 2003 and 2004. Attaining 2.1% growth is a lot easier than attaining 3% to 3.5% growth. Moreover, HM Treasury is projecting 3% to 3.5% growth both this year and next.

HM Treasury employ GDP growth assumptions of 3.25% in 2004-05 and 2.75% in 2005-06 for their public finance projections. These GDP growth assumptions are closer to those of the IoD.

If the UK economy manages to grow by 3.5% this year, the Bank of England will almost certainly have to raise interest rates above 4.5% by year-end. If interest rates were to move toward 5%, it is difficult to believe that GDP growth could be as strong next year.

If household consumption continues to rise as a proportion of GDP and at the same time business investment accelerates, interest rates will need to rise further than projected by the IoD. If house price growth remains strong throughout 2004, the risk of a subsequent crash and negative knock-on effects also becomes more likely. Household spending and house prices need to slow to sustainable growth rates.

The IoD's latest UK Economic Outlook highlights research showing that total debt servicing costs are actually very high at present, when interest costs and repayments of principal are included in the calculation.

Recent UK house price modelling by the OECD has highlighted the potential threat to macroeconomic stability. The OECD model simulation shows how changes in housing wealth have a relatively large short run impact on consumption, so that short run changes in consumption are better correlated with contemporaneous changes in house prices than disposable income. The clear implication of this result is that if there were to be a future sharp slowdown in house prices, it could have an abrupt impact on consumption.

OECD model simulations show the effect of a continued 20% house price inflation through 2004, followed by an abrupt subsequent fall in house prices of 20%. The model simulations suggest GDP growth would be lowered by 1% point in 2005 (compared with what it otherwise would have been).

The IoD argues that these negative effects can be avoided, providing interest rates don't rise much beyond 4.5%. The problem is believing GDP growth can be maintained at 3% plus if interest rates hit 5% or more. In other words, HM Treasury may prove to be correct this year, but the knock-on effect of stronger growth this year will almost certainly be weaker growth next year.

Long-term trend growth

Table A2, Contributions to trend output growth, in the December 2003 Pre-Budget Report, shows HM Treasury estimates of trend output over the recent past, together with future projections. Future trend growth is estimated at 2.75% until 2006. HM Treasury employ a more conservative 2.5% assumption for estimating the public finances. The underlying growth rate has huge economic significance and so it is very important to try and understand whether it is moving higher or lower.

Trend growth is estimated from changes in:

- the population of working age,
- the employment rate
- average hours worked
- output per hour worked

Table 3.1 shows HM Treasury estimates of the contributions to trend output growth, together with alternative City estimates.

TABLE 3.1 CONTRIBUTIONS TO TREND OUTPUT GROWTH CONTRIBUTION

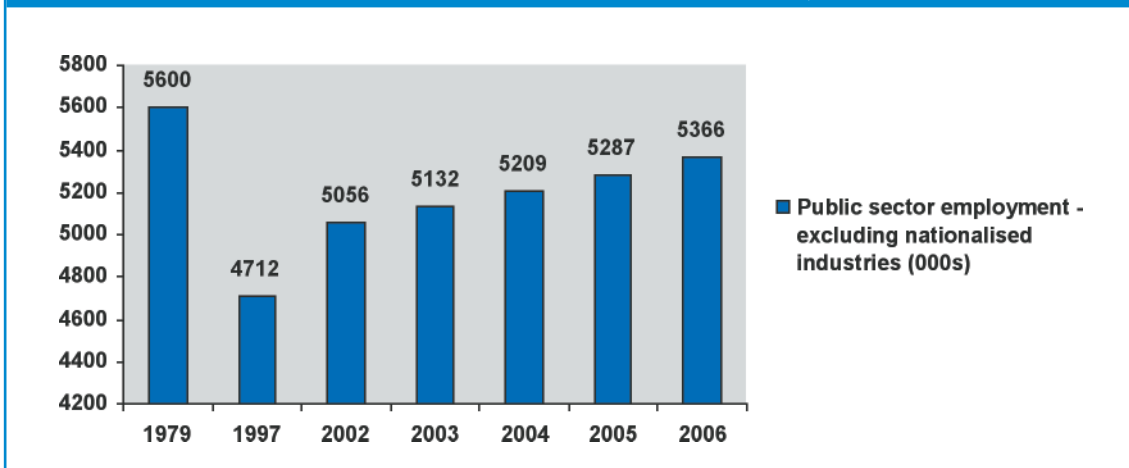
Contribution	HM Treasury	City estimate
Trend output per Hour	2.25%	2%
Trend average hours worked	-0.1%	-0.5%
Trend employment rate	0.2%	(zero/possibly 0.2%)
Population of working age	0.5%	0.5%
Trend GDP growth rate	2.75%	2% to 2.2%

City estimate by Richard Jeffrey, A View from the Bridge, Issue No. 62, Bridgewell Securities, February 2004.
HM Treasury figures from Table A2, Pre-Budget Report, December 2003.

The more cautious City estimate is based on 2% trend growth in output per hour worked, given that it has averaged 1.75% per annum over the past 5 years. Moreover, recent data suggests that average hours worked has been falling by 0.5% per annum over recent years.

HM Treasury have acknowledged that growth in output per hour in recent years has been below 2%, but state this may reflect cyclical factors. The IoD is less confident and would argue that it may instead (or at least in part) reflect structural influences and the increasing share of public sector employment. HM Treasury figures suggest that public sector employment could rise to 5.37 million (excluding nationalised industries) by 2006 – an increase of 650,000 since 1997. Latest data show that public sector employment rose by almost 350,000 over the 1997-2002 period^{iv}.

CHART 1.1 PUBLIC SECTOR EMPLOYMENT PROJECTIONS



(Source: IoD projections based on HM Treasury estimates of 1.5% per annum growth in public sector employment over 2003-06 period)

HM Treasury also acknowledge (page 176, para A23, Pre-Budget Report, December 2003) that the trend fall in average hours worked could be more than assumed in the Pre-Budget Report.

This is not an arcane debate. HM Treasury estimate that the negative output gap was around 1.5% of GDP in 2003Q3, on the assumption of trend growth of 2.75% per annum. The output gap is defined as actual output less trend output as a per cent of trend output.

This means that a larger output gap can permit the economy to grow faster during an upturn, as slack in the economy is taken up. If the output gap is smaller (because trend growth is slower) there is less slack and GDP growth may not be as fast. This is the risk at present.

3.2 Public finances

The IoD stated in its Pre-Budget Report:

"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 and many other economic commentators are concerned at just how little slack there now is in the public finances. Future satisfaction of the Golden Rule looks wafer thin.

Over recent months a wide range of economic commentators have expressed concern about the likelihood of satisfying the Golden Rule. These include the OECD, IMF, IFS, NIESR and OEF.

The OECD has stated that:

"On the one hand the Golden Rule is expected to be met over this cycle, projected to end in 2005-06 ... on the other hand, the more pessimistic OECD projections suggest that, although the Golden Rule would just be met in the current cycle, a sizeable structural deficit would persist. In this case, meeting the fiscal rules in the future would imply revenue or spending adjustments".

The IMF has stated that:

“The Pre-Budget Report projections imply that the fiscal accounts will have underperformed budget targets for a third consecutive year. In cyclically adjusted terms, the extent of the fiscal underperformance has been particularly marked this fiscal year, with the deficit revised up almost 1% of GDP only six months after the Budget ... The PBR does project a steady turnaround in public finances starting in FY 2004-05, with the deficit declining to 1.75% by FY 2008-09 ... [primarily reflecting the cyclical upturn] ... we are more pessimistic. In our view, in the absence of actions, the deficit would decline only modestly over the medium term – to about 2.75% of GDP in FY 2008-09. In this scenario, the risk of breaching the Golden Rule in the current cycle is not trivial”.

The NIESR has stated that:

“the Pre-Budget Report indicates that the cumulated current budget surplus will be £14 billion ... given the average absolute forecast error ... there has to be a significant risk that ... the Golden Rule will be broken”.

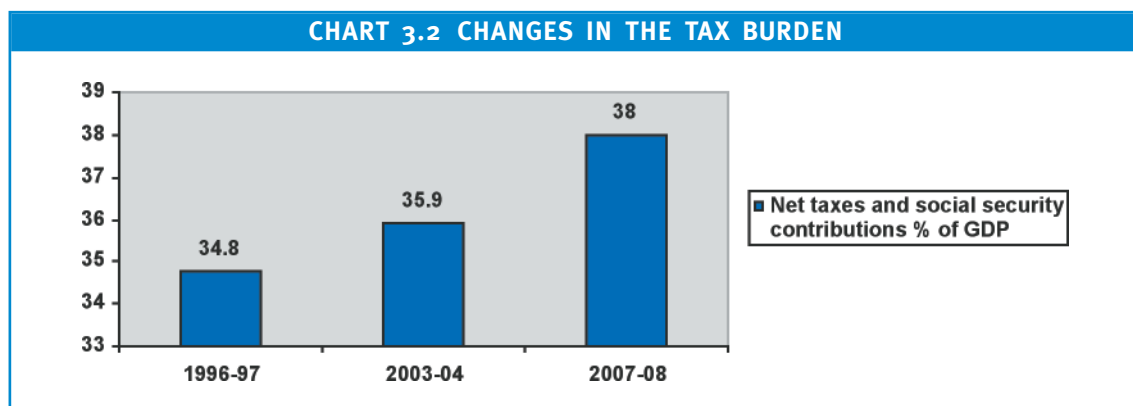
The IFS has stated that:

“In the December 2003 Pre-Budget Report, the Treasury estimated that the average surplus would be positive and that the Golden Rule would therefore be met. But the amount by which the Treasury expects to overachieve the Golden Rule has fallen substantially over the past three years, reflecting policy decisions and forecast revisions ... the Chancellor may have used up too much room for manoeuvre too quickly. Given the size and direction of recent forecasting errors, even on the Treasury’s own figures it is touch and go whether the Golden Rule can be met over the current cycle without reducing existing spending plans or raising more revenue”.

OEF have stated that:

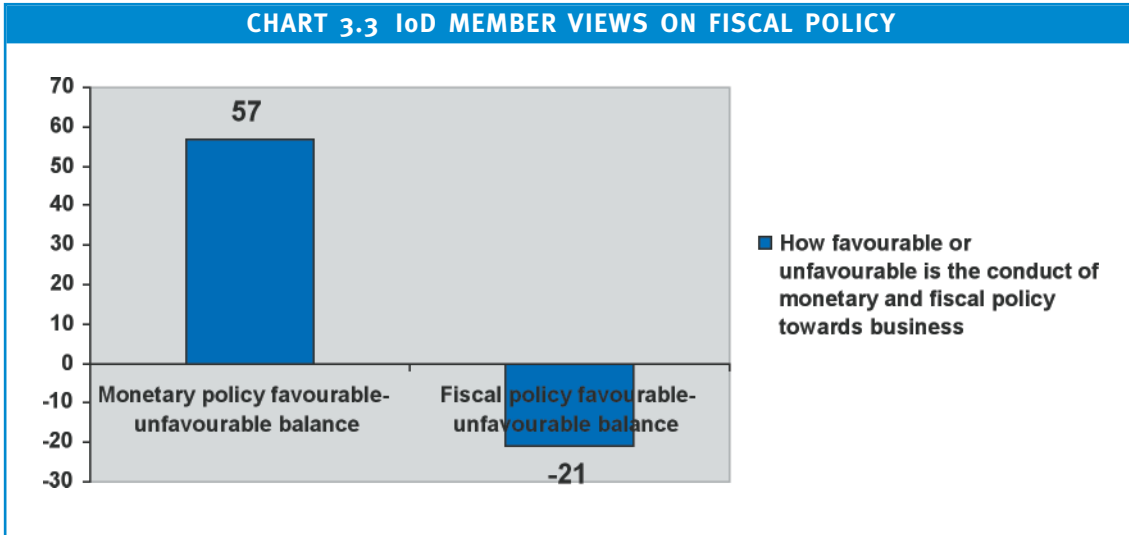
“While the recovery has so far matched the Chancellor’s hopes, government tax receipts have not. As a result, he had to revise his forecasts for public sector borrowing sharply higher in December’s Pre-Budget Report ... On our calculations, the Golden Rule will be breached, but the Chancellor should be able to delay any significant tax increases until after the next election”.

Chart 3.2 is taken from the December 2003 Pre-Budget report and shows HM Treasury projections of the change in the tax burden over the 1996-97 to 2007-08 period. Of the 3% of GDP rise in the tax burden over the projected period, only 1% of GDP will have been recorded by the end of the 2003-04 tax year. The IoD does not wish to see any further increase in the tax burden beyond that already projected.



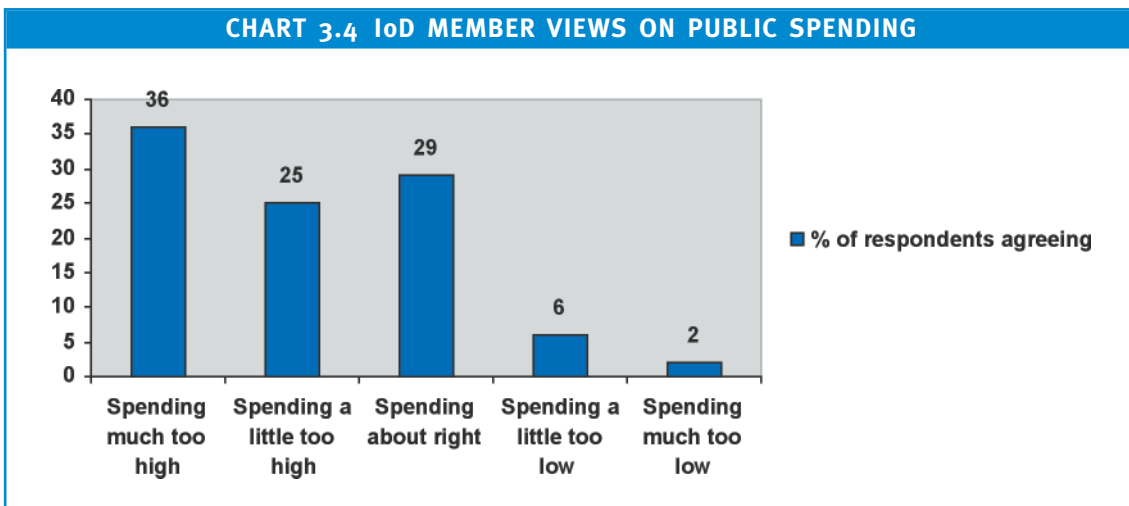
(Source: Pre-Budget Report, HM Treasury, December 2003)

IoD members are concerned regarding the direction of fiscal policy. When asked whether the conduct of fiscal policy was favourable or unfavourable towards business, a negative balance of -21% stated it was unfavourable. This compared with a positive balance of 57% towards the conduct of monetary policy.



(Source: IoD Business Opinion survey)

Chart 3.4 shows that a majority of IoD members believe the Government's spending plans are too high. In other words, the IoD strongly urges the Government to overcome the deterioration in the public finances by making future growth in spending conditional on both reforms and affordability.

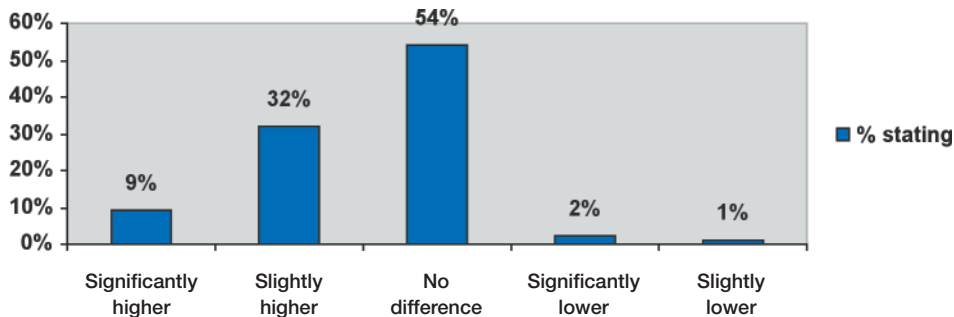


(Source: IoD Business Opinion Survey)

IoD members also assert that the rise in the tax and regulatory burden since 1997 has damaged employment. Four out of ten companies state that current employment levels would be higher if the tax and regulatory burden had not increased.

CHART 3.5 TAX AND REGULATORY BURDEN

If taxes and regulations had remained unchanged since 1997, would the present number of employees in your company be:



(Source: IoD Business Opinion Survey)

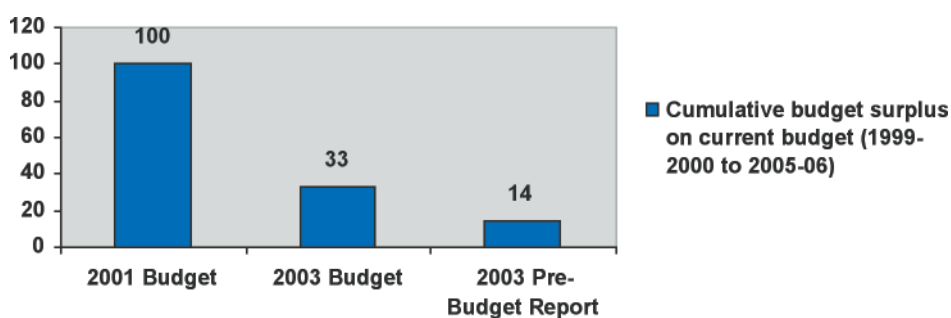
The IoD's fiscal concern centres on the Golden Rule and the performance of public services. There is no crisis in the public finances, but there is now a problem adhering to the Golden Rule.

The Golden Rule

The Chancellor is constrained by the Golden Rule – the commitment to balance the current budget over the course of the economic cycle and only borrow for investment. Chart 3.6 shows that the cumulative surplus on the current budget has fallen sharply in recent years. In the 2001 Budget the Chancellor projected the cumulative budget surplus over the economic cycle at £100 billion. By the time of the 2003 Budget the projected cumulative surplus had fallen by two-thirds. In the 2003 Pre-Budget Report it fell further to just £14 billion.

The Chancellor has little or no slack left in the public finances. If GDP growth underperforms his assumptions, or the tax yield is less than expected for a given rate of GDP growth, he will have little choice but to raise taxes or moderate spending.

CHART 3.6 THE EVOLUTION OF THE GOLDEN RULE (£ BILLION)



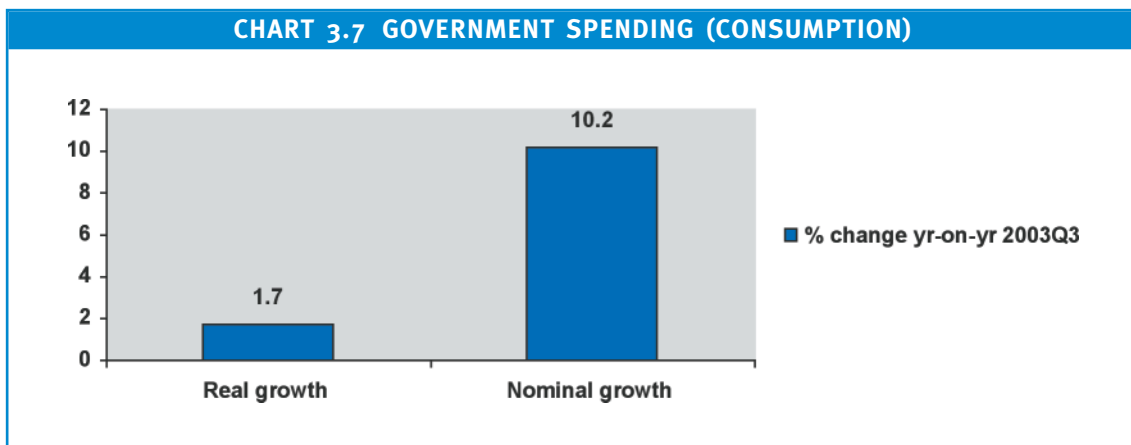
(Source: HM Treasury)

The fiscal difficulty is accentuated when one considers the error factor in the public finance projections. One simple rule of thumb indicator of the Chancellor's lack of room for manoeuvre is the average forecast error for public borrowing, which is £10 billion one year ahead, £20 billion two years ahead, £30 billion three years ahead etc. One important issue at present is highlighted by the Chancellor hitting his GDP growth target for 2003 (2.1% actual versus the 2% to 2.5% range

forecast by HM Treasury) but not raising the tax revenue he envisaged – in other words the rise in borrowing has been in large part structural rather than cyclical.

The public services

Latest GDP figures show a large differential between the growth in government consumption at current versus constant (chained volume) prices. In 2003Q3 general government consumption rose by 10.2% (yr-on-yr) at current prices, but only 1.7% (yr-on-yr) at constant prices. The implied deflator shows the huge contrast in inflation performance between the public and private sectors.



(Source: ONS)

The public sector is experiencing large increases in expenditure at the same time that costs are increasing sharply as well. In this environment of negligible or negative productivity growth, output growth is very poor in comparison. Obviously the public sector is labour intensive and so more resources inevitably mean more staff, but the problem we now have is that higher staffing levels are only achieving minimal improvements in output. One recent experimental series of public sector productivity, produced by the government, showed that over the 1996-2001 period cumulative public sector productivity declined by 3%^v.

Boosting spending by 10% to achieve a 1.7% increase in output is not efficient. We are therefore in the strange position of having a very large increases in public expenditure which is also weakening real GDP growth below its trend rate. If public sector inflation declines and productivity rises, underlying GDP growth could improve even against the background of a lower overall growth in public spending. Unfortunately, this almost certainly requires more radical structural reform of the public services than is in place or on offer.

References

- i *Re-balancing the UK Economy*, IoD Economic Comment, December 2003.
- ii See: IoD *UK Economic Outlook*, February 2004.
- ii See: *It's Time for a Third Rule*, IoD Pre-Budget Report, November 2003.
- iii See: IoD *UK Economic Outlook*, First quarter 2004.
- iv Mid-year, June 2002 estimate. 2003 data not yet published.
- v Measuring public sector productivity is complicated. For example, increasing the number of teachers to reduce class sizes would reduce productivity on a pupils per teacher measure, but may increase the overall quality of teaching as measured by results.

4: Taxation

4.1 Introduction

The IoD's Budget Surveyⁱ last 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.ⁱⁱ 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.

While we welcome the uprating of the Personal Allowance for 2004/5 announced in the Pre-Budget Report, it should go further, uprating by inflation since the last uprating. 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 do not wish to see any increase in the higher rate of income tax, or an additional band introduced on top of it. The increase in National Insurance Contributions last year effectively leaves a 41% upper rate for taxpayers.ⁱⁱⁱ 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,^{iv} 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. 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% FYA on ICT expenditure by small businesses is effective in stimulating new investment rather than altering its timing.^{viii} 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.

The announcement in the Pre-Budget Report of measures to tackle perceived tax avoidance in small owner managed companies is worrying. Many of the tax measures introduced in recent years have promoted incorporation and it would be unfair to hit these newly incorporated businesses with additional extra taxation. The measures announced in the Budget must be properly consulted upon and the law in this area should not be changed before 2005/6 at the earliest. The vague wording in the Pre-Budget report has caused great uncertainty to small businesses.

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. We welcome the return to a Budget date prior to the start of the tax year, however, 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.^{ix}

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. 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.

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.^x 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

- 1 The CBI has voiced similar concerns. See Focus on investment: The impact of pension deficits, CBI Economic Brief, July 2003.
- 2 Available from the British Household Panel Survey.
- 3 See: Government borrowing: deeper into debt, IoD, February 2003. Pre-Budget Report, Economic Comment, IoD, November 2002.
- 4 IFS Director, Robert Chote, in public statements.
 - i *Budget Survey*, IoD, March 2003
 - ii *Budget 2003*, IoD, March 2003, Chapter 4, Para 4.2
 - iii 51% for taxpayers earning less than the upper earnings limit for National Insurance but more than the threshold for higher rate tax
 - iv *Budget Survey*, IoD, March 2003
 - v Much would depend on what would happen to provisions in the Capital Gains Tax legislation which currently interact with Inheritance Tax.
 - vi See, for example, *Government Borrowing: Deeper into debt*, IoD, 2003, Chapter 4.4; *Tax and Spend: Gambling on Better Public Services*, IoD, 2002, Chapter 4.5;
 - vii For example, *Housing, Equality and Choice*, IPPR, August 2003
 - viii Presumably it is effective, given its extension in Finance Act 2003
 - ix Admittedly this assumes that businesses are able to understand the UK Tax System – given its complexity this is probably somewhat naïve.
 - x *Budget 2003*, IoD, March 2003, Chapter 4.8

