



Fiscal policy — the fork in the road

IoD POLICY PAPER



now

tomorrow

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IoD – Emergency Budget Representations

A Fork in the Road

1. Introduction

The emergency Budget in June 2010 represents a *fork in the road* for fiscal policy in the UK. With the right decisions, prospects for economic recovery in the short term and potential output in the long term could be enhanced. But there is also a risk that the wrong decisions could hasten a double-dip recession and damage the supply-side potential of the UK economy. There is much to play for. We can either shrink the state, or the state will shrink the life out of the economy.

Among the IoD's key Budget Representations are:

- **Economic recovery in the UK is more likely to be L than V shaped** – This does not mean quarter-on-quarter GDP growth will be zero. By L shaped we mean there will be weak average quarter-on-quarter growth with intermittent periods of acceleration and deceleration.
- **The possibility of a square root recovery** – If we are wrong and the economy does achieve accelerating above-trend GDP growth in 2010-11 the Bank of England is likely to become very concerned about the inflationary implications of quantitative easing and rapidly change tack from gilt purchases to gilt sales. This economic cycle would then look more like a square root symbol, with strong growth which then levels off.
- **The need to recognize the possibility of an expansionary fiscal contraction** – With a negative fiscal multiplier from lower public spending at times of grave fiscal crisis.
- **The opportunity from the fiscal-monetary policy trade-off** – If the fiscal policy multiplier is slightly negative, or positive, deficit reduction should permit the continuation of near-zero interest rates.
- **The need for a nominal freeze in public spending** – A real freeze in public spending, combined with trend GDP growth and no increase in the tax burden, could still leave public sector net borrowing (PSNB) of at least 5 per cent of GDP in 2015-16. In contrast, a nominal freeze in spending – a cash squeeze – combined with the same trend GDP and constant tax share projections almost eliminates the headline PSNB deficit over the same period.
- **The significance of not just the scale of deficit reduction, but the manner in which it is done as well** – Deficit reduction needs to be overwhelmingly based on lower public spending not higher taxation. The IoD has consistently argued for a 4:1 ratio of spending reductions to tax rises. Any tax rises should be on indirect not direct taxation.
- **The need to reduce the deficit further and faster than financial markets expect** – The need for decisive action not gradualism, thereby helping to

transform private sector expectations. This could also provide an insurance policy against speculation about the UK 'going Greek'.

- **The need to transform expectations of the future tax burden** – Whilst the scale of the deficit and the £10K personal allowance commitment limit the options for lower taxation elsewhere, the Chancellor could announce specific long-term commitments to, for example, reverse the 50 per cent top rate, providing certain milestones are reached – the deficit falling below £X billion in 2013 etc. Pre-announcing tax reductions, as part of a credible fiscal consolidation, should help transform expectations about the future tax burden, which are currently very pessimistic.
- **The need to ring-fence key transport, energy and ITC infrastructure spending** – As opposed to the March 2010 Budget which projects a halving in public sector investment over the 2009-10 to 2012-13 period.¹
- **The need to broaden the focus of deficit measures** – To include the primary budget balance before debt interest payments.
- **The need to think in terms of the double-deficit** – The UK has 2 fiscal challenges: the short-term deficit and the long-term pressures on public spending, principally from an ageing population, debt servicing costs and infrastructure needs. There is potentially over £100 billion a year of longer-term pressure on public spending – and the deficit.
- **The need to recognize the long-term implications of decisions taken in the emergency Budget** – Shrinking the size of the state significantly could raise potential output growth to 3 per cent per annum. Increasing the tax burden significantly and failing to shrink the size of the state risks trend growth falling towards 1.5 per cent per annum.
- **The need to ensure that changes are made that fully reverse the effect of the national insurance increase.**
- **The need to reduce the main corporation tax rate** – We also support business-friendly reform of the controlled foreign companies regime, but wider reform of the corporation tax system must be subject to consultation between now and next March.
- **The need to ensure that any increase in capital gains tax rates is accompanied by generous reliefs** – It is vital to protect long-term investment and those who invest in businesses where they work.
- **The need to take care with any shift in the balance of taxation in favour of environmental taxes** – Such a shift must not be used to increase the overall tax burden.
- **The need to take care with tax relief for pension contributions** – Any changes should only be made as part of a well thought-out reform to all incentives to save.

¹ The March 2010 Budget projection included public sector investment in schools and hospitals. The IoD's ring-fenced definition is therefore a narrower measure of public investment.

This report is a summary document.

For more information on the keys to fiscal policy success and the supporting analysis please see: *Facing up to the perfect fiscal storm*, IoD Pulse – Economic Outlook, June 2010, or *Can we weather the fiscal storm?* IoD Big Picture, Quarter 2, 2010.

With regard to longer-term public finances in the UK see: *Do the sums add up?* IoD Big Picture, Quarter 2, 2010.

These can all be found at <https://www.iod.com/home/policy/>

2. The UK economic outlook

The economic outlook is always uncertain but never more so than now. In the wake of the financial crisis, mainstream economic models have been found wanting.

The monetary policy transmission mechanism – via interest rates – is impaired with the resulting need for quantitative easing. The widely used new Keynesian framework is based on key relationships which omit an important role for banking and the money supply – a serious deficiency at present. The new Keynesian framework is based on:

- The trade-off between inflation and the level of the output gap.
- The relationship between total spending and the rate of interest.
- A central bank reaction function relating the rate of interest to the level of the output gap and inflation.

The deficiencies in mainstream economic models are not confined to monetary policy. The treatment of fiscal policy may also be mis-specified at times of fiscal crisis, with the possibility of a negative fiscal multiplier (see: Box 1).

Even at a time of fiscal crisis in the UK, we would not expect negative multiplier effects to be strong. However, even a slight negative multiplier would be GDP growth positive and possibly still permit continued near-zero interest rates over the period of fiscal tightening. In contrast, a very strong negative multiplier combined with very deep spending cuts (closing the PSNB deficit by 2014-15) could be sufficiently GDP growth positive also to put significant upward pressure on interest rates. However, this scenario is both politically and economically unlikely.

Box 2.1 **Fiscal multipliers**

The fiscal multiplier is the ratio of the change in GDP to an exogenous change in the fiscal deficit (either a change in spending or taxation).

Different types of multiplier can be used depending on the time period under consideration e.g. initial impact, peak or cumulative multipliers.

If public spending increases by £1 billion and overall GDP by the same amount, the multiplier is 1. The size of the multiplier is country, time and circumstance specific and depends on so-called leakages, such as households saving a proportion of any tax cut or spending the gain on imported goods.

At full capacity an economy should record a zero multiplier but at times of spare capacity the full direct and indirect effects of fiscal policy could push the multiplier above 1.

Fiscal multipliers are normally expected to have a positive sign – an increase in public spending causes a rise in GDP, or a fall in spending causes a fall in GDP. However, in certain circumstances the sign can be negative if a fiscal contraction causes an expansion in GDP – or vice versa.

One L of a recovery

The IoD's latest economic forecasts project UK GDP growth of 0.9 per cent in 2010 and 1.9 per cent in 2011. These estimates are lower than the Office for Budget Responsibility (OBR) forecast downgrade to 1.3 per cent in 2010 and 2.6 per cent in 2011.

Whilst we acknowledge the potential stimulus to economic activity from relatively healthy corporate finances, exchange rate depreciation and the possibility of a negative fiscal multiplier, we believe the economy will still be held back by the dragging anchor from:

- **Weak monetary growth** – A strong cyclical recovery is unlikely until money supply growth increases from current low rates on a sustained basis. Further quantitative easing may be required.
- **The impaired monetary policy transmission mechanism** – The legacy of the financial crisis and continued balance sheet contraction by banks is likely to constrain the availability of funds as compared with previous upturns. This is significant at the present time because of the need for working capital in the early stages of a recovery.
- **Above-target inflation** – CPI inflation is well above the 2 per cent target, at 3.4 per cent. The MPC position is that inflation will fall back below target by the end of the 2 year forecast horizon, because of the downward pressure from the output gap and excess capacity. However, there is considerable uncertainty regarding the size of the output gap with the result that inflation may be 'stickier' than expected. If so, interest rates might have to be increased sooner than expected in the recovery. We think this can be avoided – CPI excluding indirect taxes is at 1.7 per cent – but nonetheless acknowledge the uncertainty.
- **Higher taxation** – The greater the reliance on higher direct taxation to reduce the deficit, the greater the risk of a double-dip recession, in the view of the IoD. If the emergency Budget results in a 2:1 spending cut-tax hike ratio we will be very concerned. We favour a ratio of around 4:1 with any tax increases indirect. The impact on inflation from higher VAT complicates the timing of any increase given that the CPI is already well above target.
- **Reverse interest rate effects** – Previous recoveries have been characterized by interest rates falling during the upswing. Clearly short-term rates are near zero already and so this boost to consumer and corporate confidence will be absent. It is not clear to what extent the confidence factor will be influenced in a positive way by the low level of interest rates or a negative way by the risk/reality of a rate rise – or lack of 'oomph' from rate cuts.
- **De-leveraging by households** – The outlook for consumption is poor given that the household savings ratio remains very low by historic comparison and also with reference to other countries. Net household savings rates (UK figures are normally published gross of capital consumption) were negative over the 1999-2009 period and far below Germany, France, Japan and even the US. Tax increases could further squeeze disposable income and consumption.
- **Private sector expectations** – The debt crisis has spread rapidly from investment banks and financial institutions to concern about sovereign default

risk. With continued speculation about the sovereign crisis spreading from Greece to Italy, Ireland, Portugal or Spain, business confidence is likely to remain subdued. We simply do not know with confidence as yet whether the worst of the financial crisis is behind us or in front. Financial market speculation about prospects for the euro might lead to a significant appreciation of sterling against the euro.

The possibility of a square root recovery

The previous analysis suggests that the cyclical recovery is likely to be closer to an L than a V shape. However, there is obviously the possibility that this interpretation is wrong. If the economy does achieve accelerating above-trend GDP growth in 2010-11 the Bank of England is likely to become very concerned about the inflationary implications of quantitative easing and rapidly change tack from gilt purchases to gilt sales. To do otherwise would risk an inflationary increase in bank lending and the money supply – from a higher money multiplier applied to the £200 billion increase in the monetary base via quantitative easing.

Unlike the L shaped cycle this recession-recovery cycle would look more like a square root symbol, with strong growth which then levels off.

Long-term potential growth

We agree with the OBR's assessment in its Pre-Budget forecast, that underlying trend GDP growth (the rate of potential output growth due to the supply side capacity of the economy) is likely to fall to around 2.1 per cent per annum by 2015-16.

The real risk now is that the more deficit reduction is placed on higher direct taxation and infrastructure spending cuts, the greater the risk of a further weakening in supply-side potential. Making the wrong decisions regarding fiscal policy in these areas in the emergency Budget risks pushing trend GDP growth down significantly.

In contrast, eliminating the deficit and reducing the size of the state to well below 40 per cent of GDP, raises the potential for higher not lower trend GDP growth.

We are at a long-term fork in the road. Shrinking the size of the state significantly could raise potential growth to 3 per cent per annum. Increasing the tax burden significantly and failing to shrink the size of the state risks trend growth falling towards 1.5 per cent per annum.

3. Fiscal consolidation

An expansionary fiscal contraction

The latest editions of *Big Picture*² and *Pulse* publish the IoD's detailed analysis of how the fiscal consolidation should be implemented. Box 2 shows the IoD's 7 rules for a successful expansionary fiscal contraction.

Box 3.1 **7 rules for an expansionary fiscal contraction**

1. The fiscal consolidation should be expenditure not tax based.
2. There should be decisive action not gradualism – faster and deeper cuts than financial markets expect.
3. The need for permanent spending cuts which lower expectations of the future tax burden.
4. The fiscal consolidation has to be tough but also credible and politically sustainable.
5. There needs to be an expectations orientated approach which pre-announces long-term future tax reductions, funded by spending cuts.
6. The only spending area to be ring-fenced should be key transport, energy and ITC infrastructure.
7. Monetary policy should be used to offset fiscal policy and thereby increase the impact of a negative fiscal multiplier.

Recent economic history shows that episodes of fiscal consolidation can be associated with very positive outcomes. 3 UK examples illustrate:

- The March 1981 Budget introduced a fiscal tightening at the bottom of the recession. Monetary policy was eased simultaneously and economic recovery began shortly after.
- The sharp Lamont-Clarke reduction in public sector net borrowing, following the early 1990s recession, resulted in around 600,000 job losses in the public sector, but this did not prevent a sustained economic recovery.
- The strongest GDP growth over the entire 1997-2010 period was during 1997-1999 when the then Chancellor, Gordon Brown, operated a tight fiscal stance over Labour's first 2 years in office.

The IoD has argued that the central aim of the emergency Budget should be deficit reduction by lower public spending. Our analysis leads to the conclusion that at times of fiscal crisis, such as now, deficit resolution based on lower public spending (whilst ring-fencing key infrastructure) could lead to an expansion in GDP – a negative fiscal multiplier.

It is important to state that we are not arguing that fiscal policy multipliers are always negative. Instead our view is based on the specific impact of a fiscal crisis with an exploding public debt and deficit. At times of very serious debt and deficit a negative fiscal multiplier is entirely plausible.

² *Can we weather the fiscal storm?* IoD Big Picture, Quarter 2, 2010. Also see: *Facing up to the perfect fiscal storm* IoD Pulse UK Economic Outlook, June 2010.

The economics literature tends to focus on demand and supply side explanations of how negative fiscal multipliers operate.

Demand side multipliers are based on expectations and see expansionary fiscal contractions as the result of a change in the behaviour of forward-looking consumers. This so-called 'German view' (associated with the German Council of Economic Experts in the 1980s) argues that: *"the direct impact of lower public expenditure growth is clearly negative ... the indirect effect on aggregate demand of the initial reduction in expenditure growth occurs through an improvement in expectations if the measures taken are understood to be part of a credible medium run program of consolidation, designed to permanently reduce the share of Government in GDP ... (and thus) taxation in the future".*³

There are a number of channels by which this effect might operate:

- Lower public spending leads to revised expectations as to the future tax burden (less) and an upward estimate of 'permanent' post-tax income, thereby helping to increase household consumption 'now' – so-called Ricardian Equivalence. Any attempt at fiscal consolidation needs to be decisive and signal a clear break with the status quo. Gradualism is unlikely to change expectations.
- Lower public spending leads to a reduced deficit and reduced risk premia on long-term interest rates – thereby helping to reduce economic uncertainty and 'crowd-in' business investment. Business investment can accelerate strongly during expectations driven fiscal consolidations.
- Lower public spending and reduced risk premia help a revaluation of financial assets (bonds, equities & property) which in turn increases wealth effects on consumption.

Fiscal contractions may not always be literally expansionary. The induced increase in private sector consumption and investment might not literally outweigh the reduction in public spending. However, in these circumstances, if a monetary policy offset is simultaneously operated (extension of quantitative easing) the overall fiscal and monetary package could be expansionary.

Supply-side explanations of an expansionary fiscal contraction focus on investment and the labour market as the channel through which expansionary effects can occur. For example, a reduction in public sector employment reduces wage costs across the whole economy and this in turn improves expected rates of return on business investment.

³ Hellwig & Neumann, *Economic Policy in Germany: Was there a turnaround?* Economic Policy 5, October 1987

It's not just what you do, but how you do it

The IoD's survey of the economics literature reveals that *the composition of the consolidation is the strongest predictor of expansionary fiscal contractions*. The economics literature suggests that virtually all of the non-expansionary adjustments were tax-based whilst all of the expansionary ones were expenditure-based.

Tax-based adjustments typically fail to correct fiscal imbalances and simultaneously undermine GDP growth. The Conservative election manifesto proposed a spending cut to tax hike ratio of 4:1. At the very least this ratio should be maintained in the emergency Budget.

Public spending, GDP growth and deficit projections

The UK faces an enormous fiscal squeeze ahead. It will be essential to reduce the share of public spending in national income. According to the Treasury's definition, total managed expenditure (TME) is projected to be 48.1 per cent of GDP in 2010-11, with tax revenues at 36.9 per cent.

The following matrix shows how TME would fall as a share of GDP in five years' time (2015-16), using various assumptions for nominal annual TME and GDP growth, and taking the projected 2010-11 level of spending and GDP as a baseline, as set out in the March Budget.⁴ Note that a real freeze in TME growth is akin to a 2 per cent nominal increase in spending. Trend GDP growth is projected to be a little over 2 per cent over the forecast period, giving a nominal trend rate of just over 4 per cent.

Table 3.1 – Projections for total managed expenditure as a percentage of GDP based on various nominal GDP and TME growth assumptions

2015-16	Nominal annual GDP growth	3%	4%	5%	6%
Nominal annual TME growth					
0%		41.5%	39.5%	37.7%	35.9%
1%		43.6%	41.5%	39.6%	37.8%
2%		45.8%	43.6%	41.6%	39.7%
3%		48.1%	45.8%	43.7%	41.7%

Reducing the level of government spending as a share of GDP will be crucial to reducing the deficit. The following matrix sets out projections for net borrowing as a share of GDP in 2015-16 based on the various assumptions of nominal GDP and spending growth used above, assuming the tax burden remains at its projected 2010-11 level as a share of GDP, and taking the projected 2010-11 level of spending and GDP as a baseline, as set out in the March Budget.⁵

⁴ Projections for GDP, and TME as a share of GDP, in 2010-11, taken from HM Treasury, *Budget 2010*, March 2010, Tables C1, C3 and C4

⁵ Projections for GDP, TME, and current receipts as a share of GDP, in 2010-11, taken from HM Treasury, *Budget 2010*, March 2010, Tables C1, C3 and C4

Table 3.2 – Projections for net borrowing as a percentage of GDP based on unchanged tax/GDP ratio and various nominal GDP and TME growth assumptions

2015-16	Nominal annual GDP growth	3%	4%	5%	6%
Nominal annual TME growth					
0%		4.6%	2.6%	0.8%	-1.0%
1%		6.7%	4.6%	2.7%	0.9%
2%		8.9%	6.7%	4.7%	2.8%
3%		11.2%	8.9%	6.8%	4.8%

Clearly, some of the projections presented above are unrealistic, but they do show how important spending restraint and growth are to reducing the deficit:

- With 5 per cent nominal GDP growth per annum and a cash freeze in public expenditure, the deficit would be almost eliminated in five years, even without any change in the tax burden.
- Restricting spending restraint to a real freeze over the next five years (approximately 2 per cent per annum nominal increases) is insufficient to tackle the bulk of the deficit over this Parliament, even with reasonably strong economic growth.

It is likely, however, that the tax burden will increase during the recovery, even with no changes to tax rates. Following the recession of the early 1990s, current receipts fell to a low of 36.3 per cent of GDP in 1992-93, before recovering to 37.5 per cent of GDP five years later in 1997-98.⁶ There were tax increases in the early 1990s, but economic recovery did lead to a rise in the tax burden, as incomes and corporate profits, and hence tax revenues, increased.

Assuming that the tax burden does not remain the same as a share of GDP over the next five years, but increases by 1.2 per cent of GDP (the same extent over the next five years as it did between 1992-93 and 1997-98) through a combination of economic recovery and discretionary tax increases, the following table sets out the revised deficit projections under the same set of nominal economic growth and spending increases.

⁶ HM Treasury, *Public Finances Databank*, May 2010, Table C1

Table 3.3 – Projections for net borrowing as a percentage of GDP based on increased tax/GDP ratio and various nominal GDP and TME growth assumptions

2015-16	Nominal annual GDP growth	3%	4%	5%	6%
Nominal annual TME growth					
0%		3.4%	1.4%	-0.4%	-2.2%
1%		5.5%	3.4%	1.5%	-0.3%
2%		7.7%	5.5%	3.5%	1.6%
3%		10.0%	7.7%	5.6%	3.6%

The table above shows:

- With a moderate level of tax increases, a real freeze in public spending over this Parliament (approximately 2 per cent per annum nominal increases) might be just enough to bring the deficit down to a low level in five years' time, provided that economic growth recovers quickly.
- In the absence of a strong economic recovery a real freeze in public expenditure over this Parliament is not enough. A cash freeze in public spending will be necessary.

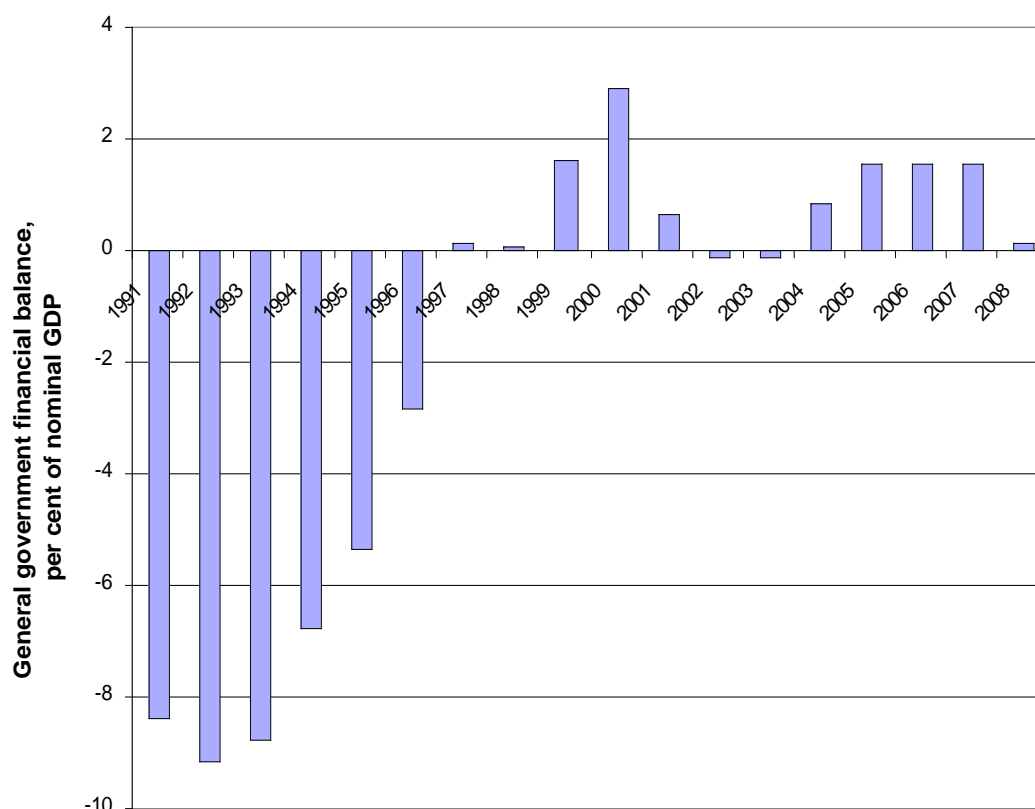
A cash freeze would be a hugely controversial political and economic decision. But it would not be unique. The Canadian Government operated just such a policy in the 1990s.

The Canadian deficit-cutting experience

One of the best recent examples of a rapid and durable fiscal consolidation is in Canada.

Canada's budget deficit in the early 1990s was threatening to get out of control. In 1992, it reached a high of 9.1 per cent of GDP. Just five years later, in 1997, the country was recording a budget surplus and it continued to run surpluses in almost every year up to the current global economic crisis, as the chart below shows.

Chart 3.1: Canada's falling budget deficit ⁷

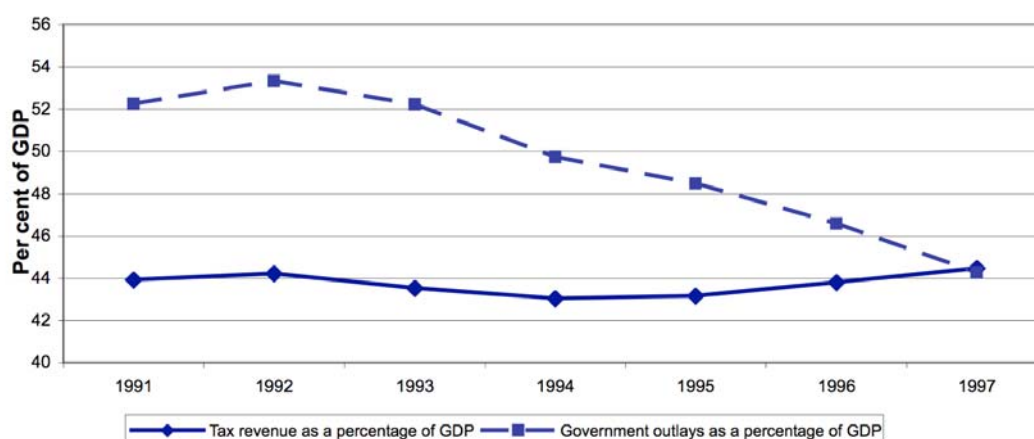


The data show clearly that Canada reduced its deficit through a combination of a sharp reduction in its spending/GDP ratio together with a return to strong real GDP growth.

The chart below compares the role of increases in the tax/GDP ratio and reductions in the spending/GDP ratio in closing the budget deficit. It makes clear that the fiscal gap was closed through spending restraint. Between 1992 (the year of the largest deficit) and 1997, spending fell by 9 percentage points of GDP, while the tax/GDP ratio rose by just 0.3 percentage points.

⁷ OECD, *Economic Outlook No. 85*, June 2009, Annex table 27

Chart 3.2: The comparative roles of tax increases and public spending reductions in eliminating Canada's deficit⁸



Real GDP growth was also a positive factor, enjoying a strong rebound from -2.1 per cent growth in 1991 to an average of 2.8 per cent growth from 1992 to 1997. By contrast, inflation played little role, with Canada's consumer price index falling from 5.6 per cent in 1991 and averaging just 1.5 per cent between 1992 and 1997.⁹ While strong real GDP growth certainly helped to reduce Canada's spending/GDP ratio, the Canadian Government did take some difficult decisions on expenditure.

As the Institute for Government has highlighted, after a number of failed attempts to realise efficiency savings, the Canadians set up a process called "Program Review" that required departments to identify a long list of programmes and activities to cut or transfer out of central government. This was made an urgent necessity rather than an aspiration by the collapse of the Mexican currency, which brought attention to the weakness of the Canadian dollar and the sustainability of its debt. The result of Program Review was that federal departmental budgets were reduced by 20 per cent on average within four years.¹⁰

These cuts meant that, despite other areas of spending rising, between 1993 and 1997, total federal, provincial and local spending was roughly frozen in *cash terms*, which represents a sizeable real terms reduction. Between 1992 and 1997, total government spending at all levels increased by an average of just 0.7 per cent a year in *cash terms*.¹¹

The lesson of Canada is that a cash freeze in overall government spending for the duration of a parliament is possible, that it doesn't prevent economic growth from rebounding, and that it is sufficient to almost eliminate a large deficit over that period.

⁸ OECD, *Economic Outlook No. 85*, June 2009, Annex tables 25 and 26

⁹ OECD.stat

¹⁰ David Halpern and Jerrett Myers, *A model of brutality Britain can build on*, The Sunday Times, 3 May 2009

¹¹ Statistics Canada

4. Specific tax measures

Income tax

We strongly support the proposal to increase the personal allowance substantially. We would however caution against a corresponding reduction in the threshold at which higher rate tax becomes payable, because that would greatly increase the proportion of the population that was subject to the disincentive effects of the higher rate on increases in their income.

The 50 per cent rate should be phased out as soon as possible, for the following reasons.

- It is a serious disincentive to wealthy people who might otherwise come to the UK, and invest and spend their money in the UK. It also labels the UK as a high-tax country, damaging our economic reputation.
- It is unlikely to be the revenue-maximising rate. An independent study of the original proposal for a 45 per cent rate found that the revenue-maximising rate might well be 40 per cent.¹²
- When wealthy people leave the UK, or decide not to come to the UK, not only income tax is lost. Businesses which would otherwise have had them as customers will suffer, and VAT revenues will fall.
- There is also a risk that the corporate tax base will shrink. The 50 per cent rate gives directors a personal reason to leave the UK which will chime with any business reason they may have to take their group holding companies out of the UK.

National insurance contributions

The previous Government proposed substantial increases in national insurance contributions, a move that would damage job creation. The new Government has recognized the danger and proposes to increase the threshold at which employers' contributions start to be payable, while compensating employees by increasing the personal allowance. This is a reasonable approach in the circumstances, but it is important to ensure that it is implemented in full, so that there is no overall increase in the tax burden on employment. There must be no scaling back of the proposed increases in the employer threshold and in the personal allowance.

Corporation tax

The Government favours reducing the rate of corporation tax, and financing this by abolishing or restricting allowances.

There is certainly an urgent need to reduce the main corporation tax rate, in order to help restore the UK's international competitiveness. Over the period from 1996 to

¹² Mike Brewer and James Browne, *Can more revenue be raised by increasing income tax rates for the very rich?* Institute for Fiscal Studies, 2009

2009, the UK slipped from having the joint fifth lowest rate in the OECD to having the joint seventeenth lowest, and from having the third lowest rate in the EU 15 to having the ninth lowest rate. We therefore call for a ten-year programme of reductions in the main and small companies rates, down to 15 per cent.

Ideally, these reductions should not be balanced by other measures to broaden the corporation tax base significantly. They should represent a straightforward reduction in the proportion of corporate profits that are taken by the state. That proportion is far higher than corporation tax rates would suggest, because of the many other burdens such as employers' national insurance, business rates and excise duty on fuel for business transport. Having said that, we do accept the case for reducing headline rates even at the cost of reductions in allowances.

Allowances for spending on very specific types of asset, or for specific types of business, and incentives for specific types of equity investment, could certainly be removed. They represent attempts by previous governments to micro-manage the economy, and that is nearly always a bad idea. A perceived market failure, which may or may not be real, is replaced by a potentially larger, and definitely real, distortion of the market that is created by government intervention.

It is however likely that the Government is contemplating reductions in the main rates of capital allowances. We can see the case for financing reductions in corporation tax rates in this way, but there would clearly be issues for some types of business, and the risk of a new distortion if capital allowance rates fell to below typical depreciation rates.

Controlled foreign companies

The Government has mentioned possible changes to the regime, so as to make the UK more attractive to multinational businesses. We warmly welcome the desire to attract business, rather than to frighten business away. We believe that the Government could achieve its aims within the framework of the existing consultation process and timetable, leading up to legislation in the Finance Bill 2011, and we would encourage the Government to do so. The existing consultation process has been very well-run.

Corporation tax reform plan

The Government has mentioned a five-year plan for reform of the corporation tax system. Some elements might be contentious, for example, a possible restriction on the deductibility of interest expense. So we strongly encourage the Government to publish its thinking in the June Budget for genuinely open consultation, allowing for two rounds of consultation (say June to October and November to February), and not to take final policy decisions until the March 2011 Budget. But it should be announced in June that final decisions will be announced in March 2011, in order to avoid prolonged uncertainty.

Capital gains tax

The Government plans to increase the capital gains tax (CGT) rate to something closer to income tax rates. While exemptions are planned for business assets, the proposal is still fundamentally anti-investment and anti-business. It may even be counter-productive as a revenue-raiser, because many investors will simply avoid making sales. And if rich people are deterred from becoming, or remaining, resident in the UK for tax purposes, it is not only CGT revenue that will be lost. Income tax on at least some of their income, and VAT on their spending, will also be lost.

The proposal would be more acceptable if a generous taper relief were re-introduced. But if that is not possible, we must ensure that the damage to business investment is minimised.

Directors and employees

The most direct threat is to those who own shares in the businesses that they have created, or in which they work. While there are specific exemptions for some employee shares, the main relief is entrepreneurs' relief. This is limited to directors and employees with holdings of at least five per cent.

That five per cent rule denies relief where shares are widely distributed among directors and employees, or where the company has succeeded in attracting outside equity capital which dilutes the stakes of the directors and employees.

It is therefore essential to remove the five per cent rule altogether. All shares that are held by directors or employees should qualify for entrepreneurs' relief.

Other shareholdings

Investments in shares, even blue chip shares, are risky. While the CGT system does include relief for losses, accidents of timing can delay relief for years, or deny it altogether. In addition, gains on shares are equivalent to dividends: payment of a dividend before a sale reduces a gain, and non-payment increases it. So when gains on shares do not qualify for entrepreneurs' relief, the rates should be somewhat below the rates applicable to net dividends (25 and 36 per cent instead of 40 and 50 per cent, and potentially a zero rate for basic-rate taxpayers). A reduction to below the 25 and 36 per cent rates would be needed to allow for the risk of equity investment.

The 50 per cent rate

The 50 per cent income tax rate is a temporary measure. CGT rates should therefore not include the 50 per cent rate. People would merely defer disposals until the rate was withdrawn from the income tax scale.

The annual exempt amount

The Government might be considering reducing the annual exempt amount. This would be a bad idea. CGT is complicated, and it is pointless to apply it to people who only have modest transactions. Keeping a high exemption will allow most people to ignore the tax. This category would include those with privatization holdings (BT, British Gas, etc) and those with modest stakes in unit trusts. Moreover, HM Revenue & Customs already have difficulty in coping with their workload. They could not possibly handle a large rise in the number of CGT returns, or the many queries that taxpayers would have about the tax.

Inheritance tax

It is regrettable that a substantial increase in the inheritance tax threshold has been deferred. Such an increase should remain a longer-term policy objective.

Value added tax

The Government will certainly consider an increase in the rate of VAT. While this might be the least damaging of possible major tax increases, it would still do economic damage.

Environmental taxes

The Government has indicated that it intends to re-balance the tax system in favour of heavier environmental taxes. This may in itself be a reasonable thing to do, but only if all of the following points are observed.

- Increases in revenue raised from environmental taxes should be matched by reductions in the revenue raised from other taxes. Environmental taxes must not become a tool to increase the overall tax burden. Furthermore, the reductions must take effect in the same years as the increases. If the revenue from an environmental tax turns out to have been under-estimated, there must be an immediate compensating reduction in another tax.
- Taxes should apply equally to businesses and to private consumers, and the amounts due should appear on bills or tickets sent to private consumers. This will ensure that consumers are fully aware of the burdens that are being imposed in the name of the environment, and can take these burdens into account when deciding which politicians or parties to support.
- Environmental taxes should be simple in design and straightforward in their application. They must also be introduced with ample warning, and with advance publication of detailed guidance on what needs to be done.
- Environmental taxes should be designed to do their job properly. The level of a tax should match the cost of the environmental damage. The onus must be on the Government to demonstrate the scale of the relevant costs. A full appraisal should be conducted to ensure that a new tax or tax change will not cause the offending behaviour simply to relocate to another country and continue to do the same (or possibly more) environmental damage. All of the data and computations

that justify an environmental tax and its level should be published for public scrutiny, not just a document that gives the same level of detail as impact assessments currently give.

Aviation

There is a proposal to move from the current per-passenger air passenger duty to a per-plane duty. We have serious concerns about this proposal. Airfreight operators who fly freight aircraft would try to avoid using the UK as a hub, preferring nearby countries. This would lead to job losses in the UK. In addition, passenger flights to and from regional airports which cannot reliably be filled, but which provide vital links to hub airports such as Heathrow, would suffer badly from a change to a per-plane duty. Likewise, flights on long-haul routes from regional airports are often hard to fill in the first few years, and their development would be hampered by a per-plane duty.

Business rates

The Government has shown that it recognizes the burden that can be imposed by business rates, by temporarily freezing the collection of unforeseen amounts that are due for prior years. We welcome this recognition, and look forward to its being developed into a recognition that the burden of rates must never be allowed to rise in real terms.

We make this point because rates are a fixed cost (except in the long term, when it become feasible to change premises), and they are unrelated to profits. Even a business that makes significant losses can still have to pay a substantial rates bill.

It is therefore essential to preserve the principle that the total revenue from rates cannot increase in real terms. The principle has already been breached to a limited extent through the introduction of business rate supplements. The Government should ensure that there is very strict business-led control over such supplements, and should not allow any fresh breaches of the principle.

Pensions

The possibility of removing or reducing tax relief on pension contributions has been raised.

If there are to be significant changes to the regime for pension saving, they need to be made as parts of a coherent plan to ensure that people are still able, and incentivized, to make adequate provision for their old age. It is also essential to devise arrangements that are both practical to implement and simple to understand. The previous Government introduced a restriction on tax relief for high-income individuals in the most cack-handed way imaginable, and it is essential to avoid a repeat of that experience.

A simple removal of tax relief would raise a great deal of tax revenue, but it would be very disruptive. A restriction of relief to the basic rate would suffer from the additional disadvantage that employer contributions would need treatment as taxable income with a non-repayable basic rate tax credit to set against the tax liability, or some other equally convoluted treatment.

We therefore call on the Government not to take any precipitate action. If there is to be a well thought-out reform of incentives for saving, including generous ISA limits and opportunities for people to re-arrange their existing provision for old age, that is integrated with reforms to the state pension, then adjustment of the tax relief on pension contributions might well have a role. But piecemeal changes, or changes that were made without adequate notice, would be most unsatisfactory. Traditional pension provision, with the requirement to buy an annuity, is already inappropriate for many people. There is a real danger that clumsy reform could put even more people off pension provision without giving them appropriate incentives to make alternative provision for their old age.

