

IoD Budget 2006

Summary

- The IoD is calling for a reduction in the rate of corporation tax from 30% to 28%. The average rate of corporate tax across the OECD has fallen from 33.6% in 2000 to 29.8% in 2004. Reducing the rate of corporation tax will stimulate economic activity and boost the competitiveness of the UK economy.
- Tax and spend policies are undermining long-term GDP growth in the UK. Over the 1999-00 to 2006-07 period, public spending is projected by HM Treasury to increase by 6% of GDP – from 37% to 42.9% of GDP. The increase in public spending as a proportion of GDP is even more marked using OECD data – an increase of 8.2% of GDP over the 2000 to 2007 period.
- OECD statistics also highlight a huge swing in relative international performance in public spending. In 1999 – before the build-up began - the public spending to GDP ratio in the UK was 0.3% points below the OECD average and 8.5% points below that in the Euro-zone. In 2007 the OECD projects the UK share will be 5% points above the OECD average and only 1.2% points below that in the Euro-zone.
- Public spending needs to be brought under control because unless we tackle the problem now, it will only get worse. HM Treasury projections show that public spending is set to rise by a further 4.2% of GDP over the next half century. The IoD calls for public spending to be limited to 1.5% per annum real growth over the period from 2007-08 to 2010-11.
- The tax to GDP ratio is increasing significantly in the UK whilst it is falling in almost all of our competitors. Consequently the UK's tax share, as a percentage of GDP, is deteriorating relative to many of our major competitors. The tax gap between the UK and the Euro area is projected by the OECD to shrink dramatically from 7.4% of GDP in 1997 to 1.9% of GDP in 2007.
- There is a vast economic literature showing the negative impact of a larger state sector on long-term economic growth. This report argues that the negative impact of the tax burden on economic growth will increase in the future, unless action is taken to reduce it.
- There should be no increase in the level of taxation and no new taxes.
- The IoD calls on the Government to introduce Regional Comprehensive Spending Reviews aimed at root and branch reform of public spending in the regions. Much of southern England is world class in terms of the public sector GDP share. Much of northern England, Wales, Scotland and Northern Ireland are storing up a huge competitive drag on future economic growth, with public sector GDP ratios in the 50% - 60%+ range.

- The IoD calls on the Government to introduce an annual statement to Parliament on the costs of unfunded public service pension obligations.
- The US Treasury has recently established a Dynamic Scoring unit to model the behavioural consequences of tax changes. We urge the Chancellor to establish a similar unit in HM Treasury. We also call for the publication of both static and dynamic revenue estimates in the Budget and Pre-Budget Reports.
- The IoD calls on the Chancellor to employ earnings indexation of rate bands in order to stop fiscal drag sucking more and more people into the higher rate band.
- The income tax computation should be simplified.
- The corporation tax system will need to be changed to accommodate decisions of the Court of Justice of the European Communities. There should be no other changes until those changes have been made and digested.
- Capital gains tax has become seriously unbalanced, and inheritance tax needs a thorough overhaul.
- Reforms could be made to encourage pension provision and to encourage savings.
- The burden of stamp duty should be reduced. Business rates should not be returned to local control.
- The tax avoidance strategy should change. Policies that do not need to be surrounded by a battery of anti-avoidance provisions should be chosen.
- There are strains in the system of self-assessment for individuals.

Economics

1.1 Introduction

IoD members are increasingly concerned about the conduct of fiscal policy. A new IoD survey has found that a balance of 31% of members think the conduct of fiscal policy is unfavourable towards business. The same survey before the 2005 Budget found a balance of 10% saying fiscal policy was unfavourable towards business.

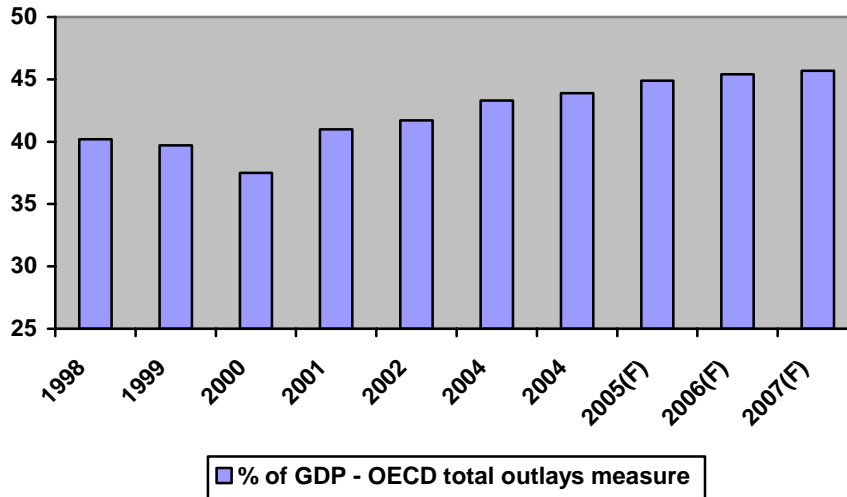
1.2 Public spending

The early years of the 21st century have been marked by a surge in public spending in the UK, which needs to be reversed. Over the 1999-00 to 2006-07 period, public spending is projected by HM Treasury to increase by 6% of GDP – from 37% to 42.9% of GDP¹. What makes this build-up so remarkable is that it has occurred in peace-time in the absence of a recession.

¹ Pre-Budget Report 2005, HM Treasury.

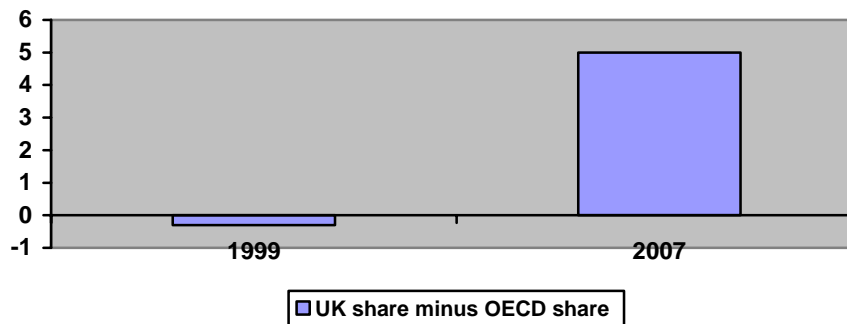
The increase in public spending as a proportion of GDP is even more marked using OECD data² (based on total outlays) – an increase of 8.2% of GDP over the 2000 to 2007 period.

Chart 1.1 General government spending - % of GDP



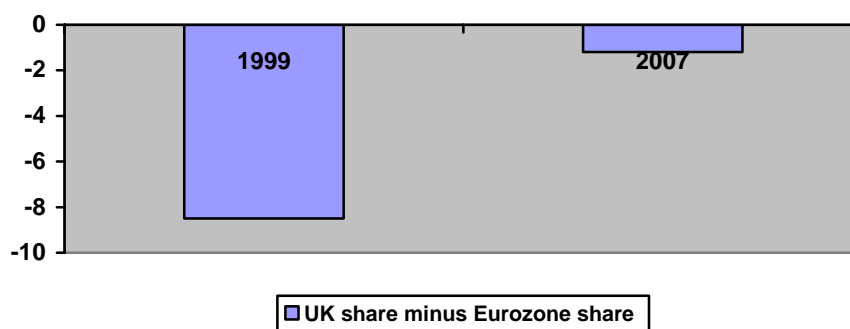
The OECD statistics also highlight a huge swing in relative international performance in public spending. In 1999 – before the build-up began - the public spending to GDP ratio in the UK was 0.3% points below the OECD average and 8.5% points below that in the Euro-zone. In 2007 the OECD projects the UK share will be 5% points above the OECD average and only 1.2% points below that in the Euro-zone.

Chart 1.2 Relative public spending – the UK versus the OECD (% of GDP)



² Annex Table 25, Economic Outlook No. 78, OECD, December 2005.

Chart 1.3 Relative public spending – the UK versus the Eurozone (% of GDP)



Public spending tends to rise rapidly as a proportion of GDP during economic downturns. Following the first oil crisis in the early 1970s, public spending rose by 8% of GDP (from 41.9% in 1972-73 to 49.9% in 1975-76). During the early 1980s public spending rose by 3.7% of GDP (from 44.8% in 1979-80 to 48.5% in 1982-83). Most recently, in the early 1990s recession, public spending rose by 4.8% of GDP (from 39.4% in 1988-89 to 44.2% in 1992-93).³

Unfortunately the business cycle is not dead, despite 53 quarters of continuous GDP growth. The future risk is that an economic downturn could raise the public spending to GDP ratio substantially above what is already a high level.

The Chancellor has pencilled in real spending increases of 1.9% per annum over the 3 years to 2010-11. These projections⁴ imply public spending would fall by 0.7% of GDP over the period. These are tough projections by the Chancellor but the IoD wants to see even tougher action. The IoD has called for spending growth to be limited to 1.5% per annum from 2007-08 onwards. This would require the Government to break with the Wanless Report recommendations on health expenditure over the 2008-09 to 2012-13 period – for a minimum of 4.4% per annum real growth in health spending. This will not be easy to achieve. In the late 1990s the tough spending environment was aided by falling unemployment and reduced debt interest payments. This favourable combination is unlikely to repeat itself over the next 5 years.

Despite the difficulties, public spending needs to be set on a downward path, as a proportion of GDP. There is a vast economic literature⁵ showing that a larger public sector reduces economic growth. The 21st century will not be kind for those countries with large public sectors, facing intense global competition from small-government economies.

³ Table B2, Public Finances Databank, HM Treasury, January 2006.

⁴ Pre-Budget Report, HM Treasury 2005.

⁵ For example, see literature reviews in these studies: *The negative impact of taxation on economic growth*, Graeme Leach, REFORM, September 2003; *Flat Tax – Towards a British Model*, Allister Heath, TPA & Stockholm Network, 2006; *The Impact of Government Spending on Economic Growth*, Daniel J Mitchell, The Heritage Foundation, March 2005.

Unless we tackle the problem now, it will only get worse. HM Treasury's long-term public spending projections also need to be considered. In the latest assessment, published in December 2005⁶, HM Treasury projects that public spending (on unchanged policies) will increase by 4.2% of GDP over the next 50 years. Between the 2004 and 2005 Long Term Public Finance Reports projected future increases have increased from 2.5% to 4.2% of GDP.

We face an uphill battle to bring public spending under control, but it is fight which must be engaged. In order to highlight future spending pressures, the IoD is calling for an annual statement to Parliament on the unfunded liabilities of public service pensions.

Table 1.1			
Long-term public spending projections - % of GDP			
Expenditure	2004-05	2054-55	Change % of GDP
Education	5.5	5.4	-0.1
State pensions	5.0	6.6	+1.6
Health	7.2	9.8	+2.6
Long-term care	1.2	1.9	+0.7
Public service pensions	1.5	2.1	+0.6
Total age related	20.4	25.8	+5.4
Other	20.7	19.5	-1.2
Total	41.1	45.3	+4.2
Source: HM Treasury Long Term Public Finance Report: An Analysis of Fiscal Sustainability, 2005.			

There are other concerns about the impact of high levels of public spending on economic performance. Table 1.2 is taken from a recent report⁷ showing general government expenditure by region in 2003-04. In addition to the huge regional variations, the table also highlights the large swing in the ratio of public spending to GDP, depending on the chosen GDP denominator – GDP at market prices, basic prices or factor cost. GDP at factor cost excludes all indirect taxes and subsidies. The basic prices measure excludes some but not all indirect taxes.

⁶ HM Treasury, *Long Term Public Finance Report: An Analysis of Fiscal Sustainability*, 2005.

⁷ David Smith, *Public spending in the regions*, William de Broe, 2005.

Table 1.2			
General government expenditure by UK region (2003-04)			
Region	Ratio to GDP at factor cost (%)	Ratio to GDP at basic prices (%)	Ratio to GDP at market prices (%)
North East	63.9	62.8	55.7
North West	54.1	53.2	47.2
Yorks & Humber	50.3	49.4	43.8
East Midlands	45.0	44.2	39.2
West Midlands	48.0	47.2	41.9
South West	44.0	43.3	38.4
East	35.3	34.7	30.8
London	40.8	40.1	35.6
South East	33.6	33.0	29.3
England	43.4	42.7	37.9
Scotland	57.1	56.1	49.8
Wales	65.4	64.3	57.0
Northern Ireland	73.2	72.0	63.9
United Kingdom	46.2	45.4	40.2

If one compares regions with countries, the South-East ranks second to South Korea for having the lowest expenditure burden in the world. The South-East is ahead of low tax burden economies such as the US, Australia, Ireland and Switzerland. In contrast, many UK regions exceed Sweden, which ranks highest in the OECD expenditure league, at 57% of GDP.

In an increasingly competitive global economy, where tax competition is so important, the UK is having to finance very high levels of public spending in far too many regions. Far greater convergence in public spending across the UK regions is required. Moreover the convergence must be in a downward direction.

The Government needs to produce regional Comprehensive Spending Reviews incorporating a root and branch re-appraisal of spending across the regions. Much of southern England is world class. Much of northern England, Wales, Scotland and Northern Ireland are storing up a huge competitive drag on future economic growth.

1.2 Taxation

Net taxes and social security contributions are projected by HM Treasury to increase from 34.8% of GDP in 1996-97 to 38.6% of GDP in 2010-11 – an increase of 3.8% of GDP. The IFS have reported that the rising tax burden means that post-tax national income is set to grow at its slowest rate for 25 years⁸.

What impact does tax have on the economy? In other words, is there a negative impact of taxation on long-term economic growth?

⁸ *The IFS Green Budget*, January 2005.

Recent research⁹ reveals that:

- Comparisons of tax burdens and GDP growth reveals a striking contrast between the performance of low (and/or falling) and high (and/or rising) tax burden economies. The fastest growing OECD economies tend to have either very low tax burdens at the beginning of the period or sharp falls in the tax burden subsequently.
- A simple comparison of tax shares and GDP growth, whilst powerful, is not conclusive evidence of a negative relationship between taxation and economic growth. More sophisticated econometric modelling is also required to quantify the relationship. A large number of econometric studies in recent years have found a powerful negative effect of taxation on long-term GDP growth.

These results accord with economic theory, which predicts that taxation will be more distortionary and public spending less productive, at higher stages of economic development. This means that in an advanced economy such as the UK, extra public spending is unlikely to increase long-term growth, but extra taxation is likely to reduce it.

Applying modelling elasticities to the projected increase in the tax burden suggests that by the end of the decade, tax and spend policy could knock around 0.4% per annum off GDP growth. In other words, the increase in the tax burden will cause a reduction in trend GDP growth. The size of this 'tax & spend' effect is plausible given the added disincentive effects to economic activity arising from the increase in the complexity of the tax system – and general regulation where activities are mandated on companies as a substitute for state provision - in recent years.

There are good reasons to believe that the tax burden will play a larger part in determining economic activity in the 21st century than it did in the 20th century. This is because:

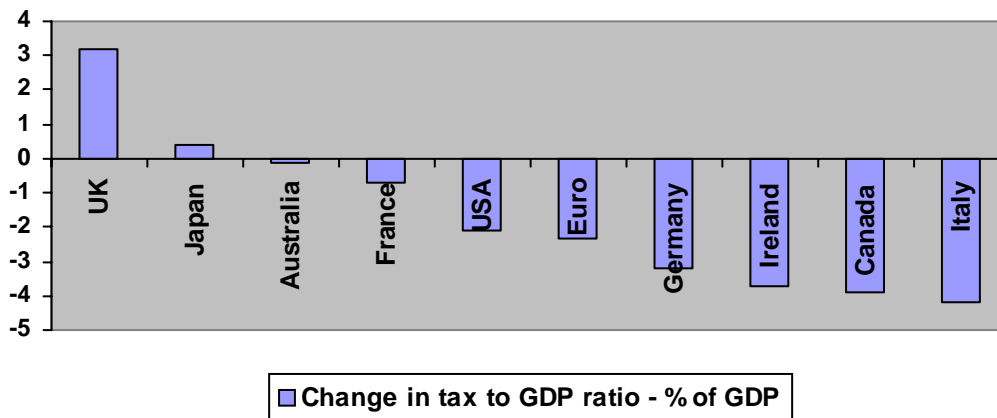
- Post-Fordist working practices, together with more flexible labour markets and performance related pay, stock options etc, suggest that in the future individuals will be in a stronger position to vary their labour supply in response to tax signals. In the 20th century world of collective bargaining and assembly line production this was far more difficult to achieve.
- Higher income earners are more sensitive to tax incentives than those on lower incomes (notwithstanding the huge disincentive effects from the interaction of the tax and benefits/tax credits systems which can result in extremely high marginal tax rates). As economic growth raises average incomes over time, there is a possibility that the economy as a whole will become more sensitive to tax incentives/disincentives.
- The labour supply of married women is widely acknowledged as sensitive to tax influences. Growth in double-income households suggests this effect may be more powerful in the future than in the past.

⁹ See for example: *The negative impact of taxation on economic growth*, Graeme Leach, REFORM, September 2003; *Flat Tax – Towards a British Model*, Allister Heath, TPA & Stockholm Network, 2006; *The Impact of Government Spending on Economic Growth*, Daniel J Mitchell, The Heritage Foundation, March 2005.

- Increases in the number of top-rate taxpayers (paying the higher marginal rate), up from 2.1 million to 3.2 million over the 1996-97 to 2005-06 period. Current projections suggest the figure could rise to 4 million before the end of the decade. A major contributory factor in the 1.1 million increase has been fiscal drag – income tax bands increasing by inflation instead of earnings. The IoD calls on the Chancellor to employ earnings indexation in order to stop this particular aspect of fiscal drag, which sucks more and more people into the higher rate band.

The UK's tax share, as a percentage of GDP, is deteriorating relative to many of our major competitors, as shown in Chart 1.4. The tax gap between the UK and the Euro area is projected by the OECD¹⁰ to shrink dramatically from 7.4% of GDP in 1997 to 1.9% of GDP in 2007.

Chart 1.4 Comparative tax share changes 1997-2007



The IoD has consistently argued for the introduction of a *Third Fiscal Rule* – a commitment to reduce the tax burden as a proportion of GDP over the course of the economic cycle. In this Budget Report we reiterate the call for a Third Fiscal Rule. The idea of a Third Fiscal Rule has overwhelming support amongst IoD members. 83% of IoD members want the Chancellor to make a long-term commitment to reduce the tax burden as a proportion of GDP (59% strongly support, 24% support).

¹⁰ Annex Table 26, General government total tax and non tax receipts, OECD Economic Outlook, December 2005.

Chart 1.5 IoD survey – should the Chancellor make a long-term commitment to reduce the tax burden as a proportion of GDP?

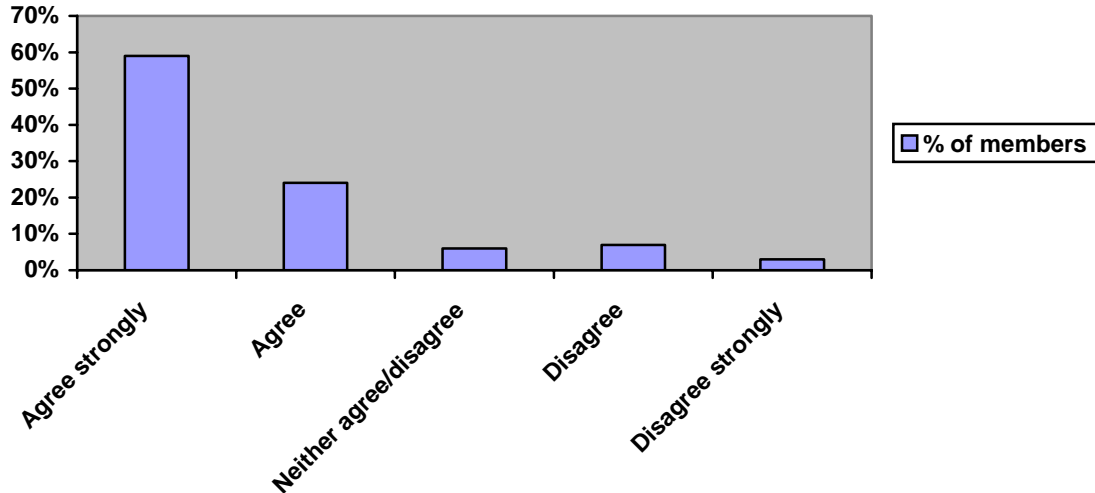


Chart 1.6 IoD survey – in the long term what do you think the UK tax to GDP ratio should be?

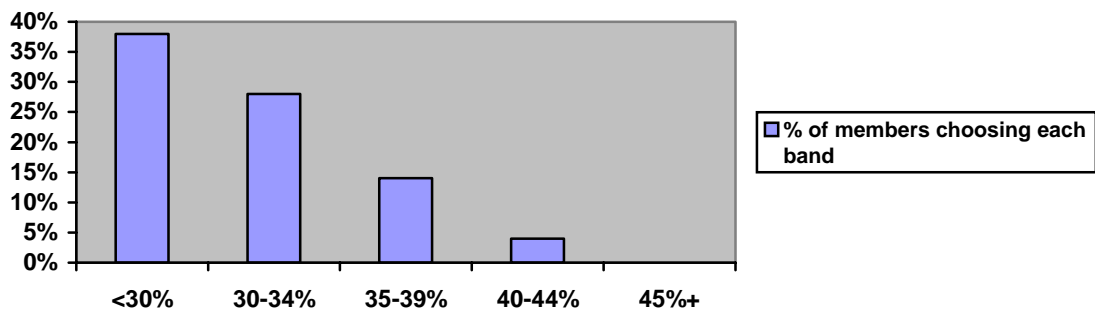


Chart 1.6 shows that two-thirds of IoD members want to see a tax to GDP ratio of 34% or less.

Corporate tax rates

The corporate tax rate advantages once enjoyed in the UK have slipped over the 2000-04 period. Major economies such as Germany, France and Italy have all reduced their rates of corporate tax whilst the rate in the UK has remained unchanged at 30%. The average rate of corporate tax in the 30 OECD economies has fallen from 33.6% in 2000 to 29.8% in 2004. The UK now has an above average rate of corporate tax – albeit marginally.

A recent report from the TPA¹¹ highlights that when Ireland had a corporate tax rate of 50% it generated revenues amounting to 1% of GDP, but now that the rate has been reduced to 12.5% it yields revenues of 4% of GDP. A new report from the CPS¹² has highlighted that growth in corporate tax revenues averaged almost 25% per annum over the 1996-02 period when Ireland reduced its corporate tax rate from 38% to 12.5%.

The CPS report shows how those countries which have cut corporate tax rates (e.g. Ireland, Australia) have experienced strong growth in revenues whilst those which have left rates unchanged (e.g. UK, US and Japan) have experienced weak or flat revenue growth. Other factors are also at work but the potential for stimulating economic activity by reducing rates is powerful.

A major cross-country analysis¹³ of 70 countries over the 1970-97 period found that (controlling for other determinants of GDP growth) cutting the corporate tax rate by 10% points increased annual GDP growth by around 1.1%.

The IoD proposes that the standard rate of corporation tax be reduced from 30% to 28% in the Budget. A static analysis (see below) suggests this would cost £3 billion in 2007-08. The IoD proposes to finance this tax reduction in the following way:

- At least £2.7 billion is found by ending certain reliefs and tax expenditures¹⁴.
- A cautious assumption that £300 million (10%) of the cost is achieved by dynamic (see below) revenue effects.

Dynamic scoring

Dynamic scoring (sometimes referred to as reality-based scoring) attempts to quantify the behavioural effects of tax changes. Unfortunately static effects dominate the major tax models run by HM Treasury and the Institute for Fiscal Studies.

Static models overstate the revenue that will be generated by tax increases and the revenue that will be lost from tax rate cuts. Dynamic models quantify the behavioural response and do not assume that the size of the economy is unchanged regardless of the tax rate.

The consequences of the failure to employ dynamic scoring has been well made by Allister Heath, Deputy Editor of The Business:

“The static methodology provides policymakers with inaccurate numbers and creates a bias against low tax rates. Dynamic analysis acknowledges that taxes do affect the economy through the supply side and that higher tax rates discourage work, saving and investment and therefore will not raise as much revenues as static estimates would suggest”.

¹¹ Heath op cit

¹² *The case for reducing business taxes*, C. Elphicke and W. Norton, Centre for Policy Studies, February 2006.

¹³ *Tax Structure and Economic Growth*, Y. Lee and RH. Gordon, July 2004.

¹⁴ Exemptions for gains on substantial shareholdings £260 million, Enhanced capital allowances for energy saving technology £170 million, Accelerated capital allowances for enterprise zones £90 million, VCT £315 million, EIS £180 million, Professional subscriptions £80 million, Rent-a-room £90 million, Small and Large film tax relief £560 million, Reduced rate for life companies £1,100 million. Total = £2.845 billion.

A dynamic scoring unit has recently been established in the US Treasury. The IoD calls on HM Treasury to introduce dynamic scoring in the UK and incorporate both static and dynamic revenue estimates in the Budget and Pre-Budget Reports.

Whilst we recognise that constructing dynamic models is a very difficult task, it should also be pointed out that existing static model forecasting errors with regard to fiscal projections are huge (the table below does not capture the tax effect alone, but the magnitude of the error factor is the key message).

Fiscal forecasts need to be rooted in reality and static models aren't.

Table 1.4		
Average errors in HM Treasury forecasts of public sector net borrowing		
Period	Average error - % of GDP	Average error - £ billion
One year ahead	1.0	12.1
Two years ahead	1.7	19.4
Three years ahead	2.2	26.1
Four years ahead	3.0	34.7
Source: Based on Table 2.8, End of Year Fiscal Report, HM Treasury 2004		

Tax representations

2.1 Introduction

There should be no overall increase in the level of taxation, either on business or on individuals. Any required improvement of the fiscal position should be achieved by limiting the growth in public spending. In particular, we believe that extensive efficiency savings could be made.

We are also completely opposed to any new taxes, and we urge the Government to withdraw its proposal for a new planning gain supplement.

We trust that the Government will strenuously oppose all proposals to give the European Union any direct taxing rights.

2.2 Personal tax

We would strongly oppose any increase in income tax or in national insurance contributions. If any funds were to be available, they should be devoted to raising the thresholds, particularly the starting point for higher rate tax. We are particularly concerned at the futility of people who are within the higher rate tax band also receiving tax credits. It would be better to concentrate resources for tax credits on those who really need them, while at the same time ensuring that the higher rate only begins to bite at a point where it can be afforded.

The whole area of personal tax has become far more complicated than is either necessary or desirable – witness the huge and opaque computation form that now accompanies the personal tax return. Specific causes of complexity are the application of a rate of 10% to a comparatively small amount of income and the need to carry out an entirely separate calculation for savings income within the basic rate band because this is taxed at 20% and other income is at taxed at 22%. We urge Ministers to consider removing these anomalies.

Our proposal would be to increase personal allowances to compensate for those amounts currently charged at 10%. If it is impossible to reduce the basic rate to 20%, then savings income within the basic rate band could be taxed at 22% and personal allowances could be increased to compensate for the 2% increase in the rate.

2.3 Corporation tax

In recent years there have been numerous changes affecting corporate taxpayers without any attempt to deal with the fundamental difficulties caused by the imputation system. Cases currently before the courts are likely to require the Government to pay substantial sums to companies which have been adversely affected in previous years. There is real concern that, unless the problems raised by these court cases are tackled urgently, the liability will go on rising and will have to be borne by all other taxpayers. It is in the interest of our members and the overwhelming majority of taxpayers to reform the corporation tax system in order to prevent this happening. In 2005, we published a paper¹⁵ advocating a classical system with withholding tax on dividends. We urge Ministers to begin urgent consultations on the introduction of such a system, with a possible introduction date of 2007.

Other difficulties are likely to be generated by forthcoming decisions of the Court of Justice of the European Communities. The December 2005 decision in the *Marks & Spencer* case showed that these decisions can easily leave open sensible ways forward for the UK tax system, but that some changes will be inevitable. It is essential to acknowledge the need for change and to plan for it to happen in an orderly and business-friendly fashion. However, we acknowledge that it is difficult for the Government to discuss in public issues that it is currently litigating.

At the same time there should be a complete moratorium on other corporation tax changes while all efforts are concentrated on system changes. We recognise that the proposed changes to the leasing regime are now settled policy, though we consider them to be premature given that revised accounting standards for leasing have not been finalised. But there should be no more changes of that nature for the time being. The existing corporation tax reform process should be superseded by the need for system changes. A period of stability in other matters is important when major changes are under way.

We call on the Government to abandon its proposal to change corporation tax filing dates. The proposals would increase burdens on companies by sharply reducing the time available to prepare tax returns. There would be hardly any deregulatory benefit from aligning filing dates for statutory accounts and for tax returns, and the alignment would often make the system worse for companies. The current system works perfectly well, and companies have adapted their procedures to it. There is no justification for disturbing the system.

¹⁵ *Corporation Tax: A classical alternative?* Michael Templeman, IoD, July 2005.

2.4 Capital gains tax

The capital gains tax system has become seriously unbalanced, with taper relief for non-business assets being much less generous than taper relief for business assets. This puts considerable pressure on the boundary between the two types of asset, and the very existence of that boundary is itself a source of great complexity.

We therefore call upon the Government to move towards a system that does not have this artificial distinction between classes of asset – although this should not be done by applying the un-generous non-business assets taper to all assets. As a first step, that would at least make the boundary a bit more logical, business assets should include let properties within a trading business.

2.5 Inheritance tax

We remain concerned at the principle of inheritance tax. Income is taxed as it is earned. The net income is then taxed as it is spent, through VAT, or it is taxed if it is saved and not given away at least seven years before death. There is therefore no advantage in saving enough to give a good prospect of an old age in which one is independent of the state and is not a burden on taxpayers. The length of retirement and the need for care are both unpredictable, so people should be encouraged to make adequate provision, not discouraged. (Equalising the treatment of lifetime gifts and gifts on death by taxing all gifts at the same rate would however be wholly unacceptable. It would represent a new tax burden that would be wrong in principle, because people should be able to share their wealth with others as they wish – and the recipients of gifts will pay VAT when they spend the money. It would also be impossible to administer.)

Inheritance tax is causing increasing concern to many people. It is no longer a problem restricted to the wealthy few. Indeed the wealthy can safely give away a large proportion of their assets in transfers that are very likely to be at least seven years before death, and are therefore exempt. Someone with moderate wealth is unable to do this, particularly if his or her main asset is the family home. And it is family homes that are now making many estates liable to inheritance tax, even though other assets may be very limited. The Public Accounts Committee report on the tax published on 12 July 2005 set out the evidence clearly, with the steady rise in the proportion of estates subject to the tax and the ODPM index of London house prices exceeding the inheritance tax threshold in 2004.

The problem has been exacerbated by the fact that the anti-avoidance measures in respect of pre-owned assets were primarily aimed at houses. The Paymaster General made this point in the debate on these measures. We recognise the sense in the Government's policy of legislating to block avoidance, but the effect will be to make the pressure of inheritance tax on families with modest assets much greater than it would otherwise have been. The move against avoidance should now be followed by a long hard look at the burden of the tax as it now stands.

What is more, the starting rate of 40% means that estates in the range from the threshold of £275,000 up to £2m are more heavily taxed than at any time in history, allowing for inflation. This includes the period immediately after the War when estate duty forced many estates to be broken up.

There are also difficulties with the administration of inheritance tax. The Public Accounts Committee report stated that the main return form is difficult to complete. We are also concerned that the trustees of discretionary trusts receive no reminder from HMRC of the need to compute and pay the tax that is due every ten years. This tax can all too easily be overlooked.

For all of these reasons, we strongly support the view of the Public Accounts Committee that the tax and its administration need urgent attention. Since 1997 nothing has been done to inheritance tax apart from the introduction of the pre-owned asset rules and some comparatively modest increases in the threshold. The changing pattern of wealth distribution in this country over the past eight years means that significant reform is now required. A number of measures could be considered, including the following.

- Total abolition but reintroducing a capital gains tax charge on a deemed disposal on death (with the capital gains tax exemption for gains on only or main private residences applying).
- A sharp reduction in the rate of tax. If the rate fell to 10% or less and the existing £275,000 threshold were retained, then it might be acceptable to abolish some exemptions.
- A new relief from inheritance tax for payments made into a pension scheme for a legatee.

2.6 Pensions

There is considerable current debate on the best way to ensure¹⁶ adequate pension provision. The IoD has contributed extensively to that debate. We will not enter into that debate here, but will make a few points about the tax system.

The current relief for older taxpayers is inadequately targeted at the very elderly who have the greatest need for it. In their case the problem is not an inability to pay tax but considerable difficulty in meeting the compliance requirements. The age allowance could be replaced by a complete exemption of state pension income for those over a certain age. (Such people would retain the personal allowance. The exemption would only replace the excess of the age allowance over the personal allowance.) A suitable age would be 75.

As mentioned above, we also propose that payments made by a testator into a pension fund for the benefit of another person should be exempt from inheritance tax. Any such payments would, of course, be set against the limit on the value of the recipient's pension fund eligible for tax privileges. We understand that one of the main concerns that people have about inheritance tax is the concern that their children will not be adequately provided for in old age. One consequence of increasing longevity is that people are now dying at the point when their children near retirement age. Provisions of this kind would make considerable demographic sense.

¹⁶ For example in *IoD Road Map for Pension Reform: creating a pension system for the 21st Century* by Graeme Leach, September 2005.

2.7 Savings

We are concerned at the low level of savings in the personal sector. We believe that there are two main reasons for this. The first is that the limits of amounts which can be put into ISA accounts have only been increased slightly over the original amounts for PEPs nearly 20 years ago. The second reason is that the benefits of PEPs and ISAs that invest in equities and equity collective investment schemes have largely been removed by the removal of the repayment of tax credits on dividends. Little can be done about the second problem but the first ought to be addressed. If the idea of ISAs is to encourage regular saving, it would help if Ministers were to announce a programme of increases in the ISA limit going forward.

2.8 Stamp duty

There is a strong case against further increases in the rate of stamp duty land tax. It is particularly harmful in respect of business properties. There is a case for increasing the starting point for stamp duty land tax further in line with the general increase in house prices, but we are concerned that an increasing proportion of business costs now relate to this tax.

The charging of duty on transactions in shares is a further area where we believe significant reform is necessary. Many other European countries do not have this tax and it has been argued many times in recent years that its continuation risks damaging London as a centre for share trading. Currently it seems that the tax is distorting transactions on the Stock Exchange through the widespread use of contracts for differences. Where a fund manager wishes to invest in a particular company for a period of some months, it is frequently advantageous for him to acquire a contract for difference rather than acquiring shares. The key factor will be the point at which the charge for the contract for difference exceeds the duty. The people who write the contracts for differences are exempt from duty as market makers. The Government has two alternatives. Ideally the tax should be abolished, given the clear evidence that the market needs to avoid the tax in order to function healthily. Alternatively the tax could be extended to include contracts for differences and all similar activities. However, any extension should be accompanied by a reduction in the rate so that the overall revenue did not rise.

2.9 Local taxation

We continue to support the uniform business rate and to oppose any form of local income tax, particularly anything that would have to be operated by employers.

We remain extremely concerned at the level of council spending and the rate at which it is increasing. Given that a significant proportion of this expenditure is financed by business, and that business has no control over the amount which it has to pay, existing government powers to cap local government expenditure should be maintained and used more frequently.

2.10 Tax avoidance

The current approach to avoidance is flawed. Legislation is introduced to achieve a certain policy objective, anti-avoidance provisions are bolted on to that legislation and

when those provisions prove to be inadequate, more provisions are bolted on in later years. It would be better to take the scope for avoidance into account when choosing the policy objective. A policy that needs to be surrounded by a battery of anti-avoidance provisions is ipso facto a mistaken policy, unless it is a policy that is essential to produce an economically acceptable tax system (for example group relief, relief for capital expenditure and relief for interest). Policy objectives that can only be achieved at the cost of extensive anti-avoidance provisions should be changed.

2.11 Self-assessment for individuals

We are concerned at the strains being introduced into the system by reductions in the resources employed on the simple checking of returns. The Public Accounts Committee report that was published on 7 February 2006 gave extensive evidence that the system is not functioning as well as it might, with a significant level of errors being made both by taxpayers and by HMRC.

One aspect is the programme under which returns are no longer issued to many taxpayers. We have no difficulty with this idea but we are concerned about the implications. Many of the taxpayers who are no longer receiving returns will need to declare small amounts of income and if they do not do so, they will find themselves penalised for failing to complete returns. Evidence suggests that many people who receive occasional fees or capital gains have been excluded from the return list, as have many directors. The exact scope of the issue of returns is a matter for the business judgement of HM Revenue & Customs. However, we have a specific concern about a taxpayer who has to request a return form one year, and does not then receive return forms automatically in future years. Such a taxpayer should not have to face any penalties for failure to notify income or gains, because he or she could reasonably expect to be regarded by HMRC as someone who should get return forms. (The taxpayer should, of course, still have to pay any tax due, plus interest for late payment.)

We are also concerned that the penalty regime is making it extremely difficult to have normal technical disagreements. The approach adopted by many inspectors is either to take no action on doubtful technical points or to appear to instigate a full enquiry even though what is at issue is simply a difference of opinion on how on bit of tax law applies to particular facts. We urge HMRC to stop seeking penalties when what is involved is purely a difference of opinion on how the law applies. On the other hand the current £100 penalty for late submission of returns is very low when significant amounts of income are received in untaxed form. We believe that late submission of returns should give rise to a penalty based on the tax lost in addition to any claim for interest. The amount of time spent chasing late returns suggests that the existing penalty regime is inadequate. We are not arguing for an overall increase in the use of penalties but a switch in emphasis from those with genuine technical disagreements to those who wilfully fail to comply with their obligations.