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THE SPRING 2008 BUDGET: CBI VIEWS AND PROPOSALS

March 2008

CBI PROPOSALS FOR THE SPRING 2008 BUDGET

In recent years, the public finances have deteriorated, and while the 2007/08 outcome may not be that different to the Treasury's October projection, a further borrowing overshoot is now in prospect. Indeed the CBI believes that, on unchanged policy and under quite plausible assumptions, the cumulative overshoot over the next five years could total £50bn. If allowed to run its course, that would risk a further increase in taxpayer interest bills, a complete loss of confidence in the government's fiscal framework, and a monetary-fiscal policy mix serving to reinforce the recent economic imbalances which have squeezed business investment and net exports.

We therefore propose in **section 1** that the Chancellor should pre-announce in this Budget a fiscal tightening beginning to build in earnest from April 2009, notwithstanding the fact that the economy is unlikely to be recovering robustly at that stage. We recognise that offsetting interest rate reductions, which could in principle balance the impact on demand, may not be forthcoming or effective in the present circumstances. But delay would be a more costly option still.

However, there would still be significant long-term costs if the tightening were put in place, but in the wrong way. In particular, we argue in **section 2** that further business tax rises – on top of those announced last year and soon to come in – would be especially damaging. Over the longer term, they would

discourage capital investment and sustainable job creation in the UK, to the detriment of the population as a whole. And in the short-term, even the announcement of business tax rises would risk exacerbating the downturn, by impacting on business sentiment, investment and job creation at a time when final demand from households, overseas and government is weakening. Other tax increases would also be economically damaging, leaving the government with no choice but to re-open the issue of the public spending totals, and reining them back.

In the years beyond 2010/11, continued spending restraint would allow for the broader tax cuts which we believe are necessary to shore up the UK's flagging tax competitiveness. But in the interim the scope for tax reductions is very limited. We nevertheless set out in **section 3** a range of positive tax reforms for SMEs. These are quite affordable, and could help to restore the government's 'enterprise credentials' following last year's Budget and PBR measures which will hit SMEs and their financial backers disproportionately. We also comment briefly on a range of other topical tax issues.

Finally, in **section 4** we look at the possibilities for fiscal policy reform for the longer term. The fact that the government cannot afford even to allow the 'automatic stabilisers' to run their course over the next few years is an unfortunate result of the current fiscal position. We propose reforms to the policy framework to improve the future impact of fiscal policy on the business climate and wider economy.

1. THE NEED TO REPAIR THE PUBLIC FINANCES

Given the demand slowdown, it would normally be appropriate to temporarily relax fiscal policy at this stage. It is usual for governments to allow the 'automatic' cyclical deterioration in the public finances in response to a downturn, rather than seeking to counter that effect. And it can sometimes make sense to relax policy on top, as with the emergency tax-cutting package recently unveiled in the US. It seems clear that the UK relaxation of 2000-2003 helped (whether deliberately or otherwise) to cushion the economy in the face of the global slowdown at that time.

It is therefore very unfortunate that the poor state of the public finances severely limits the room to use Budget policy to cushion the economy through the next year or two. But given the outlook for the public finances on unchanged policy, discretionary fiscal loosening must be ruled out. And while we do not propose any significant discretionary fiscal tightening this year, we believe that the Chancellor should set out in this Budget the tightening required to restore the public finances to health – with a clear effect building from April 2009 regardless of the economic outlook.

1.1 The public finance outlook on unchanged policy

Borrowing for the present year was put at £38bn in the Pre-Budget Report, or 2.7% of GDP, up from the £30bn out-turn in 2006/07 and the Spring Budget projection of £34bn. The latest data suggest that the £38bn figure is likely to be exceeded only

marginally if at all. But regardless of the 2007/08 out-turn, the outlook for 2008/09 and 2009/10 looks very poor, due to:

- The fact that the Treasury projections rely on a clear revival in economic growth in 2009/10, which is in some doubt.
- The fact that the Treasury projections rely on receipts growing by around ½ percentage point per annum more than money GDP. Although such 'fiscal drag' has been typical of the past decade or so (as incomes and asset values have been dragged into higher tax brackets, amongst other things), this effect is normally very much weaker in periods of below-par growth.
- The reliance on revenues generated by the financial sector, accounting as it does for some 27% of corporation tax receipts and 13% of personal income tax paid via PAYE, compared with its 4% share of employment. This sector's income is of course likely to be squeezed disproportionately in the wake of the 'credit crunch'. The fact that revenues are projected to grow by more than GDP suggests that this relative squeeze has not been taken fully into account.

Table 1 sets out the current Treasury financial projections, together with what we believe to be a more realistic outlook, on the basis of unchanged policy. In our judgement the current budget would not move out of deficit until 2011/12.

Table 1: Public finance projections on unchanged policy							
£bn or %	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
<u>HM Treasury, PBR 2007</u>							
<i>Real GDP growth ('cautious')</i>		3	2	2¾	2½	2½	2½
<i>Money GDP growth</i>		6.1	4.8	5.4	5.2	5.2	5.1
<i>Growth in receipts</i>		6.1	5.4	6.0	5.6	5.4	5.5
Money GDP	1323	1404	1471	1550	1630	1714	1802
Receipts	519	551	581	616	651	686	724
Expenditure	550	589	617	647	678	711	747
Borrowing	31	38	36	31	28	25	23
Net investment	26	30	32	34	37	39	42
Current budget surplus	-5	-8	-4	+3	+9	+14	+19
<i>As % GDP</i>	-0.36	-0.60	-0.28	+0.21	+0.56	+0.82	+1.05
<i>Cumulative from 2007/08</i>		-0.60	-0.88	-0.67	-0.11	+0.71	+1.77
<u>CBI projection</u>							
<i>Real GDP growth</i>		3	2	2	2¾	2½	2½
<i>Money GDP growth</i>		6.1	4.8	4.7	5.5	5.2	5.2
<i>Growth in receipts</i>		6.0	4.5	4.7	6.2	5.6	5.6
Money GDP	1323	1404	1471	1540	1625	1709	1798
Receipts	519	550	575	602	639	675	713
Expenditure	550	589	617	647	678	711	747
Borrowing	31	39	41	45	40	36	34
Net investment	26	30	32	34	37	39	42
Current budget surplus	-5	-9	-9	-11	-3	+3	+8
<i>As % GDP</i>	-0.36	-0.64	-0.61	-0.71	-0.18	+0.18	+0.44
<i>Cumulative from 2007/08</i>		-0.64	-1.25	-1.97	-2.15	-1.98	-1.53

1.2 The appropriate fiscal stance going forward

The government has yet to declare officially an end to the economic cycle that it has stated began in 1997/98. However, it would be credible on the basis of the Treasury's latest view on the so-called 'output gap' (published alongside the PBR) to say that the cycle ended in 2006/07. On this basis the government could then declare that the golden rule for public borrowing had been passed over that cycle. But if we are now at the beginning of a new cycle, then it is getting off to a very poor start.

The CBI believes like many others that there is a sound case for reforming the fiscal rules, as part of a wider review of the fiscal framework, and we return to this issue in section 4.2. But regardless of the whether the existing rules are 'optimal', there is a strong case for a clear fiscal tightening in the years ahead, and our proposals – set out in table 2 – aim to balance the current budget over the 2007/08-2012/13 period. While net investment should be left unchanged, other budget action is needed to cut borrowing by £5bn in 2009/10 and £7bn from 2010/11.

To avoid exacerbating the downturn at this particularly fragile stage of the economic cycle (see section 2.3), significant tightening this year should be avoided. But delay beyond next year cannot be afforded.

£bn or %	2007/ 08	2008/ 09	2009/ 10	2010/ 11	2011/ 12	2012/ 13
Current budget to balance	-9	-8	-6	+4	+10	+14
- <i>As % GDP</i>	-0.64	-0.54	-0.39	+0.25	+0.58	+0.78
- <i>Cumulative from 2007/08</i>	-0.64	-1.18	-1.57	-1.33	-0.74	+0.04
Projection, unchanged policy	-9	-9	-11	-3	+3	+8
Adjustment required	-	1	5	7	7	6
Borrowing, unchanged policy	39	41	45	40	36	34
New borrowing path	39	40	40	33	29	28

We hope that the year's forewarning will allow the MPC to set interest rates appropriately lower and that such action would in practice counter the depressing effect on demand of the fiscal tightening. We also believe that such a rebalancing in the monetary / fiscal policy mix would be helpful taking a longer term perspective (see section 4.3). But in making our recommendation, we have taken into account the clear possibility that this relatively 'painless' scenario may not play out:

- The MPC may feel unable to cut interest rates sufficiently, in the context of the ongoing upward pressure on global commodity prices. Although the impact on inflation via domestic channels would merely balance the depressing impact of the fiscal tightening, the MPC will not wish to provoke too rapid a decline in sterling as that would bring additional inflationary risks via the import price channel.

- Even if interest rates were reduced quite significantly, they might not be effective in countering the impact of the fiscal squeeze on demand, due to the shift in household and lender attitudes to personal borrowing and debt. One possibility is that base rate reductions would not lead to market rates following downwards.
- Interest rates would on average be set higher than otherwise over the course of the economic cycle, to balance the potential inflationary impact, with a possible upward impact on the strength of sterling. Business investment could be discouraged as a result, and the trade balance pushed further into deficit amongst other things.

These constraints on monetary policy highlight just how useful it would be to be able to rely on a supportive fiscal policy at this time. But that is not possible because of the financial position. Simply allowing borrowing to run its course would be costly in the long run for three reasons:

- Borrowing is set to overshoot by £50bn or more, cumulatively over the next five years, compared with the Pre-Budget Report estimate. The associated, additional taxpayer interest bill would be approximately £2½bn a year forever. This is on top of the £5bn annual cost of the near-£100bn overshoot in the 2002/03-2006/07 period, compared with the 2001 PBR plan. On the CBI proposals the borrowing overshoot would be halved, saving over £1bn annually on the interest bill.
- The sustainable investment rule as well as the golden rule – as interpreted on the existing basis – would be breached, undermining the government's policy credibility. This would have the potential to destabilise the financial markets and deter much-needed capital inflows.

2. WHY THE TIGHTENING SHOULD FOCUS ON EXPENDITURE RATHER THAN TAXATION

As the government has only recently set out its 'firm and fixed' spending plans for the next three years, 'fiscal tightening' is often equated in the media to 'tax increases'. However, in our view tax rises would be almost as damaging as allowing the finances to drift. We are especially concerned about the potential impact of further business tax rises – the perceived 'easiest option' – as that would almost certainly dent the achievable living standards of the UK population over the decade ahead. Even the announcement of business tax increases to come in next year could exacerbate the downturn this year, by changing firms' behaviour.

The only remaining alternative, household tax increases, would be potentially less damaging for longer term economic prospects than business tax increases. But we would still warn against that course of action. Instead, the issue of the government's spending totals should be re-opened, with an extra degree of restraint embedded along the lines that the CBI argued for ahead of the Spending Review.

Indeed we see spending restraint as not just a short-term requirement, to bring the public finances back onto a reasonably sound footing, but also as an important ongoing policy aim, to eventually shore up the UK's sagging tax competitiveness.

2.1 Recent tax announcements hurting business

Recent Budget policy developments have been unhelpful for the business climate in the UK. As a result of decisions taken in the 2007 Budget and Pre-Budget Reports alone, business and its investors now face a range of tax hikes including:

- The increase in capital gains tax bills specifically targeting investors in business assets
- Restrictions on business rates empty property relief, costing firms whose finances are already stretched, in respect of establishments placing few demands on local public services
- New powers for local authorities to raise revenues through supplementary rates and a community infrastructure levy
- The complete phasing out of industrial buildings allowances within the corporation tax system, with its inevitably unfair retrospective impact
- The rising lower rate of corporation tax, and restrictions on family firms' profits distributions, further highlighting the turnaround in attitude towards SMEs and entrepreneurs
- Real-terms rises in many 'green' taxes – on road fuel and other oils, aviation, landfill and aggregates – with the business share of these payments diverted to fund the government's non-business priorities.

Table 3: Approximate revenue flow impact of the 2007 Budget and Pre-Budget Report measures				
£bn per annum when fully phased in	Measures targeting possible 'anomalies'	Measures with an 'environmental' or similar objective	Other measures affecting business and its investors	Other measures affecting individuals in non-business capacities
Budget:				
Restriction on empty property rates relief			+0.9	
Increase in lower corporation tax rate			+1.5	
End of industrial buildings allowance			+0.5	
Other corporation tax changes			-1.1	
Reform of personal income tax				-2.5
Excise, aggregates & landfill duty: real rises		+1.5		
'Revenue protecting' measures, etc	+0.4			
Pre-Budget Report:				
Capital gains tax reform (as amended)			+1.7	-1.0
Inheritance tax reform				-1.4
Aviation and other 'environmental' taxes		+0.6		
Reform of residence and domicile taxation	+0.5			
State second pension reform	+0.4			
Profit distribution restrictions ('income shifting')			+0.2	
Other 'revenue protecting' measures, etc	+0.3			
Total	+1.6	+2.1	+3.7	-4.9
Of which: approximate business share	(+0.8)	+1.4	+3.7	(Nil)

The net revenue flow impact of last year's Budget and PBR is set out in table 3. The annual impact for business and its investors is significant, building to over £5bn a year even on the basis of:

- excluding the yet-to-be-known cost of supplementary local rates and community infrastructure levy
- ignoring most measures targeting alleged 'anomalies' (often under a 'revenue protection' banner), even though their effect is often to divert funds from businesses to other sectors
- counting only the net rise in aviation duty, rather than the full amount of the transfer in liability from passenger to supplier.

Furthermore, this £5bn figure cannot capture the compliance costs, let alone the wider economic costs, associated with instability in the tax system and uncertainty about the general direction of policy. Nor can it reflect the potential impact on the business environment of some specific changes in the personal tax regime, most notably the proposals affecting non-domiciles.

2.2 The underlying case for restraining business taxation

The CBI has set out many times in the past how, in principle, increases in business taxation will ultimately be detrimental not just to a few wealthy individuals, but to the living standards of the vast majority of 'ordinary' UK residents. But as this message has been consistently misunderstood or ignored by policy makers, we feel compelled to spell it out again (box 1).

This 'in principle' case against business taxes would not matter so much if it were just a theory with little bearing on real world developments. But that is not the case, and attention is turning increasingly to the detrimental effects of business taxation:

- One study¹ has suggested that a ten percentage point reduction in the average effective corporation tax rate of a European country (such as the UK), would result in a 60% increase in US multi-nationals' investment in that country, and ultimately a 15% rise in the associated capital stock.
- The UK Treasury has acknowledged a close link between the capital stock and productivity, suggesting that 80% of the late-1990s productivity gap with France (some 25%) could be explained by our capital intensity shortfall (of some 40%)².
- A further study³ has found that, because of the ability to shift the incidence of capital taxes onto working residents, with the capital stock, productivity and affordable wages depressed along the way, a £1 rise in corporate tax is eventually associated with a drop in the wage level of more than £1.

¹ Devereux and Lockwood, *How are plant location decisions and capital flows in Europe affected by corporate income taxes?*, European Tax Policy Forum, April 2006.

² HM Treasury *Productivity in the UK* series, volumes 1, 6 and 7.

³ Arulampalam, Devereux and Maffini, *The incidence of corporation tax on wages*, Oxford University Centre for Business Taxation, April 2007.

Box 1: The 'in principle' impact of a business tax rise

Initially, the cost of a business tax rise is more likely than not to rest with the firms targeted – or more precisely, their *investors*, whether they realise it or not. This is because immediate adjustment is difficult. The easy option of pushing up prices in response will be ruled out, for the business sector in aggregate, as long as monetary and competition policies are sufficiently robust. Personal ties and commitments, as well as relocation costs, will act as an obstacle to physically moving a business or radically restructuring it. Contractual and legal obligations will make it difficult to re-set wages and/or employment levels. And outside investors may be reluctant, in the face of transaction costs and currency risk amongst other things, to alter their portfolios in response – or may simply be ignorant of the fact that their underlying income or wealth is being targeted.

But even where the cost of the tax rise does rest with investors, this does not mean that 'ordinary' UK residents are unaffected. Approaching 30% of UK shareholdings are owned by *pension funds, insurance companies and unit trusts*, mostly on behalf of UK resident individuals of comparatively modest means. And with retirement funding a major challenge for the future, effectively taxing these income streams looks increasingly misguided.

Over time, potential investors will be put off investing and creating jobs in the UK, as the after-tax return will be depressed. Existing investors will have more opportunity to scale back their own level of financial support than they did at first, and managers greater scope to make payroll adjustments. *Employment* and capital investment will both suffer – with the latter leading over the longer term to lower productivity than would otherwise be the case. This in turn will depress the affordable level of *wages* for those still in work. Productivity and jobs may also be affected by the impact of the tax on entrepreneurial effort, attitude to risk, and efficiency in the allocation of resources.

So at this stage economic activity will be lower than otherwise, with the extra tax bill effectively split between the remaining investors and the remaining employees – regardless of the fact that businesses alone were the original targets in the legal sense. But in today's globalised world, with capital increasingly free to move across borders, the story need not even end there.

Ultimately, completely free movement of capital would lead to the equalisation of after-tax investment returns around the globe. Investment in high-capital-tax countries would be scaled back until such time as only the few projects with a sufficiently high pre-tax return were left. The country's *working residents* would be left to effectively pay the *whole* of the extra tax bill, with an *additional wage* penalty to reflect lower productivity levels and greater difficulty finding employment in the first place.

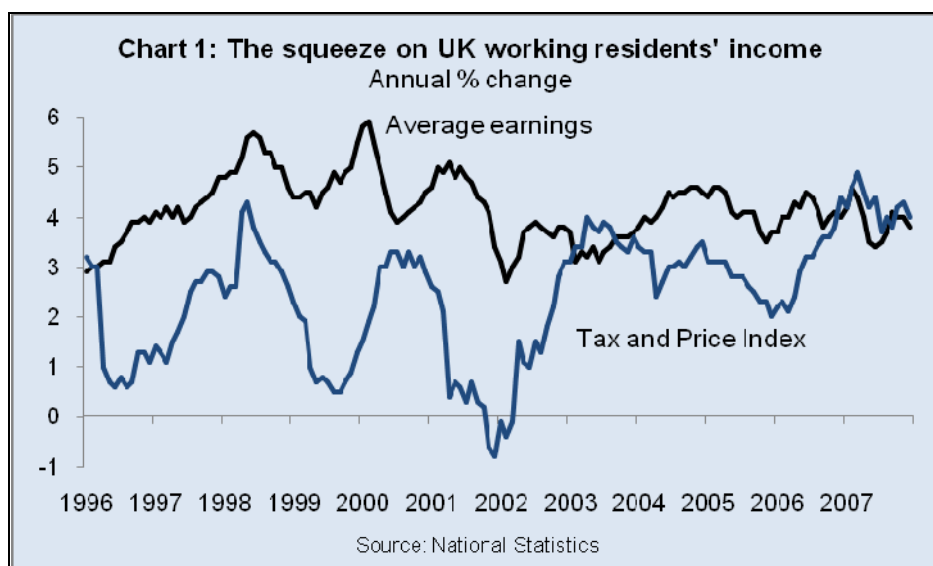
As the overall UK tax burden has been pushed up, from 35% of GDP in the second half of the 1990s towards its 37%-plus target, 'ordinary' working residents have suffered despite the careful avoidance in most Budgets of 'headline' household tax rises. Over the five year period 2003-2007, the gap between average earnings growth and the annual rise in broad household living costs, as measured by the tax and price index, averaged just 0.5 percentage points, in contrast to 2.7 points over the previous five years (chart 1).

And as this gap excludes the impact of employee pension contributions, which have been pushed up, even this picture understates the true squeeze on real take-home pay.

The recent spike in household living costs is however mainly explained by developments in the global commodities and UK housing markets. Personal taxes have added to this rise, as the impact of the many 'family-friendly' Budget announcements has been outweighed by the rise in employee NICs, 'fiscal drag' in the income tax system, and above-inflation council tax rises. But the net impact has been comparatively modest: the difference between inflation on the TPI and RPI measures (reflecting employee taxes) was 0.11 percentage points on average in 2003-07, and the difference between the RPIX and RPIY measures (reflecting council and sales taxes) just 0.05 points.

The more important tax-related story is not, therefore, one of recorded personal taxes pushing up household living costs, but rather one of hidden tax rises initially targeting firms and investors but eventually acting to depress 'pre-tax' wage levels. Here we know that:

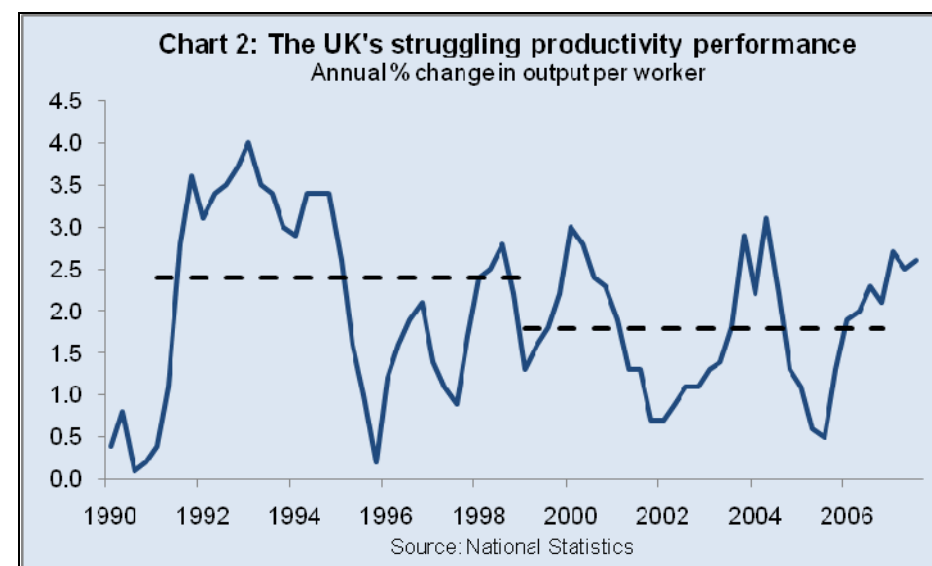
- Budgets since 1997 have added on a net basis to business and investor tax bills, with table 4 listing the key changes in cash terms. Various 'green' and indirect tax adjustments, tax compliance costs, and new regulatory burdens outside of the tax field will have added further to the imposts shown.
- Earnings growth averaged 4.0% over the five years to end-2007, down from 4.4% over the previous five years and clearly below the 4¾% once believed consistent with the 2% CPI inflation target.



Budget 1997	Dividend tax credits restricted	Large ongoing investor cost	Cost £5½bn pa, majority borne by pension funds. Knock-on for employers
	2% corporation tax rate cuts	More modest ongoing business gain	Gain £2bn pa
	Windfall tax on utilities	Large but one-off business cost	Cost £5bn in two instalments
	Higher stamp duty rate bands ¹	Noticeable ongoing business cost	Non-residential duty now £3bn pa - would be £1bn on old system
Budget 1998	Corporation tax payment reform	Large but one-off business cost	£8bn extra paid over 1999-2002, then £½bn pa business saving
	1% corporation tax rate cuts	Small ongoing business gain	Gain £1bn pa
	Capital gains tax reform - taper introduced ¹	Ongoing investor gain but recent partial reversal	Investor gain initially < £½bn pa; estimate later revised up to £6bn pa, before the partial reversal.
Budget 2002	Employer NICs rate up 1%	Large ongoing business cost	Cost £4bn pa
	R&D tax credit introduced ¹	Small ongoing business gain	Gain £½bn pa
	Lower corporation tax rate down 1%	Small business gain until recent reversal	Gain £½bn pa; ended April 2007
PBR 2005	North Sea profits tax rate increased ¹	Noticeable ongoing business cost	Cost £3bn pa

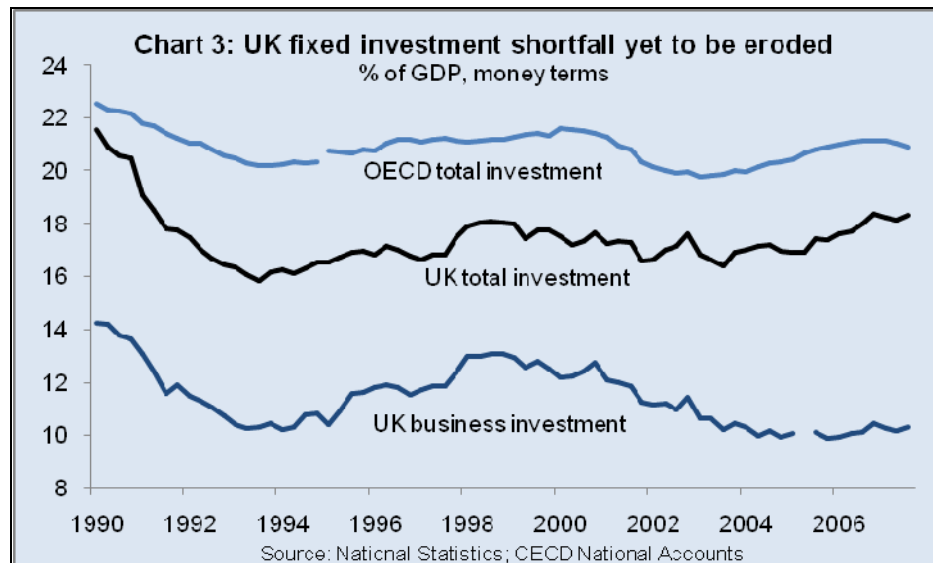
¹ Costings include the impact of subsequent Budgets which built on these measures.

One clue as to why wage growth has been relatively depressed is given by the UK's productivity performance, the improvement of which has been a major aim for government economic policy. Over an economic cycle judged to run from early 1999 until late 2006, output per worker increased by 1.8% per annum. This was broadly on a par with the record over the previous full cycle beginning in 1986, but down on the 1991-99 half-cycle when annual productivity growth averaged 2.4% (chart 2). The comparison is no better taking a 1997-2006 cycle.

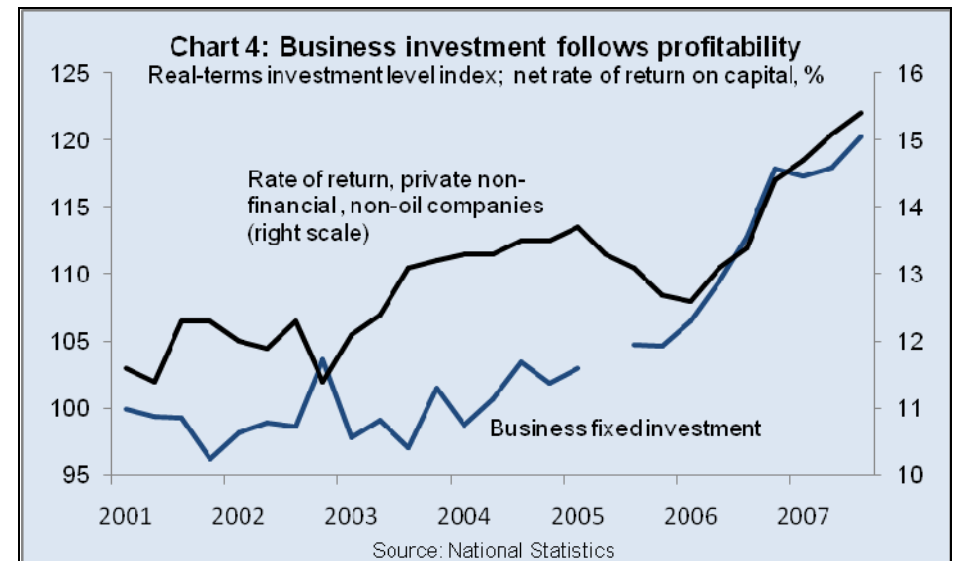


There are many potential factors hampering productivity growth, but three of the prime suspects – poor basic skills, a regulatory environment allowing less flexibility than in the 1990s, and low capital intensity – are all influenced by government policy. As the last is affected by tax policy, we focus on that here.

Business fixed investment recently hit an all-time low as a share of GDP (chart 3), and associated with this the overall investment-to-GDP ratio has remained clearly below the OECD average. Indeed the average gap of 3.8 percentage points since 2000 is no better than the average that prevailed in the 1990s.



The government may take a less negative view than this, for two reasons. The first is that, in the wake of a clear increase in profitability, business investment has recently picked up significantly in real terms (chart 4). (The apparent discrepancy with chart 3 is explained by the relatively flat trend in capital goods prices.) However, we are concerned that this improvement will prove temporary (see section 2.3 below). And looking back, the picture is quite consistent with the theory spelt out in box 1: that as a government attempts to tax the return on corporate investment more, relative to rival locations, investment on the most marginal projects is held back – until such time as the pre-tax rate of return has risen sufficiently.

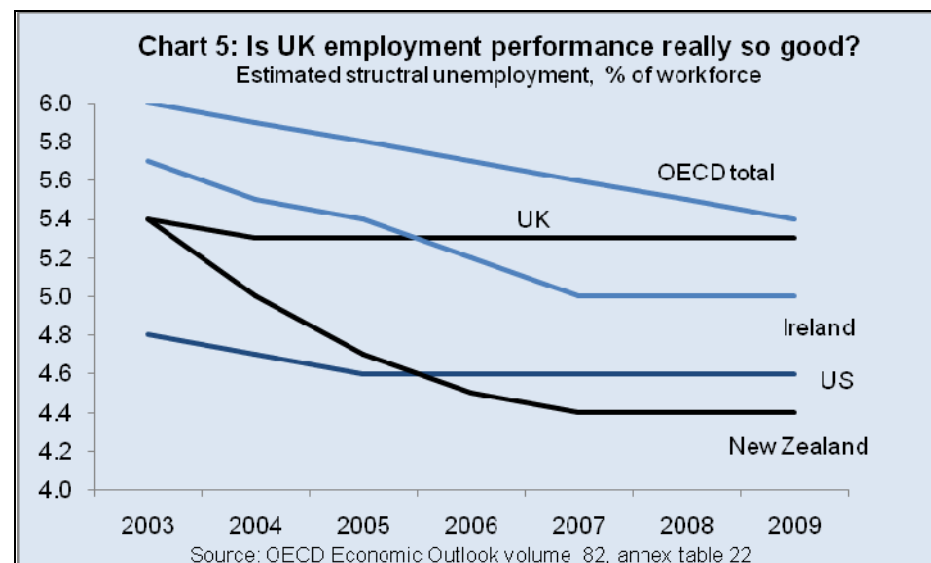


The second reason why the government may take a less negative view than the CBI is the fact that robust productivity growth is harder to achieve alongside a strong employment performance. And the UK's quite reasonable performance relative to previous decades, taking productivity and jobs together, does give some genuine grounds for satisfaction.

However, international benchmarks suggest that our employment position is not as good as often portrayed:

- Our employment growth rate over the past 11 years, of around 1% per annum, is no better than the OECD average and falls short of the US (1.3%) for example.
- Our employment rate of around 72% (based on 15-64 year-olds) is better than the OECD average (68%), but 12 of the other 29 member states have a higher score. Six countries have rates above 77%.
- As previously highlighted, our 'structural' unemployment rate – the rate consistent with stable inflation – is estimated by the OECD to be 5.3%. Of the other 22 states for which estimates are now made, 13 have a lower rate, including Switzerland (2.2%), the Netherlands (3.2%), Japan (3.9%), New Zealand (4.4%), the US (4.6%), Australia (5.0%) and Ireland (5.0%).
- While the UK's structural unemployment rate has been stuck, the trend elsewhere has been clearly downwards, with the OECD total easing from 6.0% in 2003 to a projected 5.4% in

2009 (chart 5). Ireland's rate has gone from above to below the UK's in that time, while New Zealand has seen a significant drop having been on a par with the UK in 2003.



The UK is not, therefore, in such a good position that it can afford to risk driving away internationally-mobile capital. The recent policy trend, of seeking to extract ever-more revenue streams from business and its potential backers, needs to be reversed – not because that would benefit a small minority of individuals who are doing very well anyway, but because not doing so would threaten to further erode the living standards of the vast majority of UK residents.

There is one further reason to avoid business taxes, even more than open and direct taxes on individuals: the former lead to inefficiency at a broad level by distorting public choice. Resident individuals end up paying business taxes in much the same way as personal taxes, but do not perceive this. Resources devoted to public spending will therefore tend to be pushed above the true optimum, as the electorate will perceive the cost to be lower than it really is.

2.3 The immediate case for restraining business taxation

Even if the government were not concerned about the longer-term impact of business tax policy, there is every reason to be especially cautious at this juncture. The growth of consumer spending is clearly slowing, and at best we face a long period of sluggish household spending growth – with an outside risk that households will change their spending and borrowing behaviour quite dramatically. Demand in the UK's major export markets is under threat – and already subdued in the US – and cannot be relied on to maintain growth momentum here. And government spending is already set to slow somewhat, with no scope for fiscal relaxation to counter the consumer and export downturn.

This means that the 'internally-driven' activities of the business sector – decisions about investment and jobs not necessarily justified by immediate sales prospects – will be crucial for the economy's performance this year and next. Business confidence,

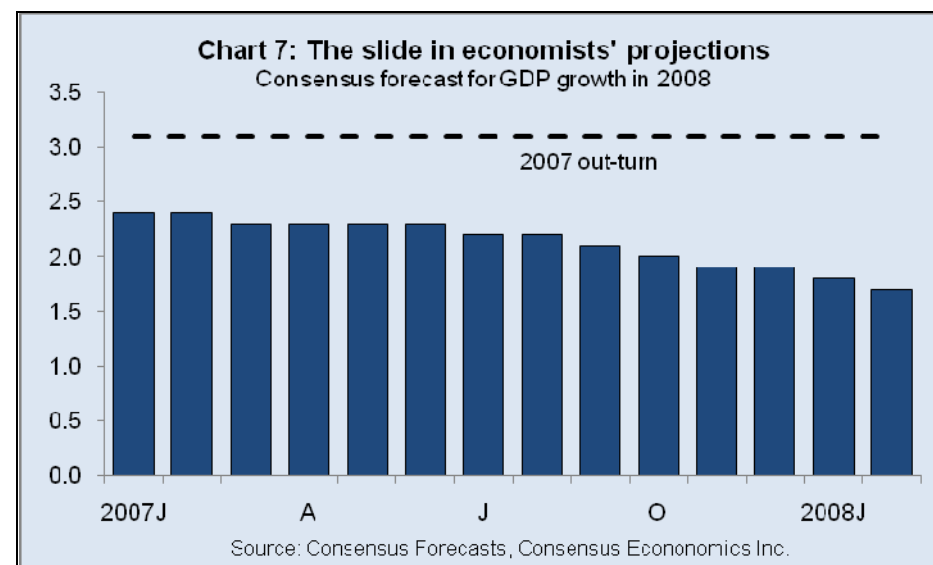
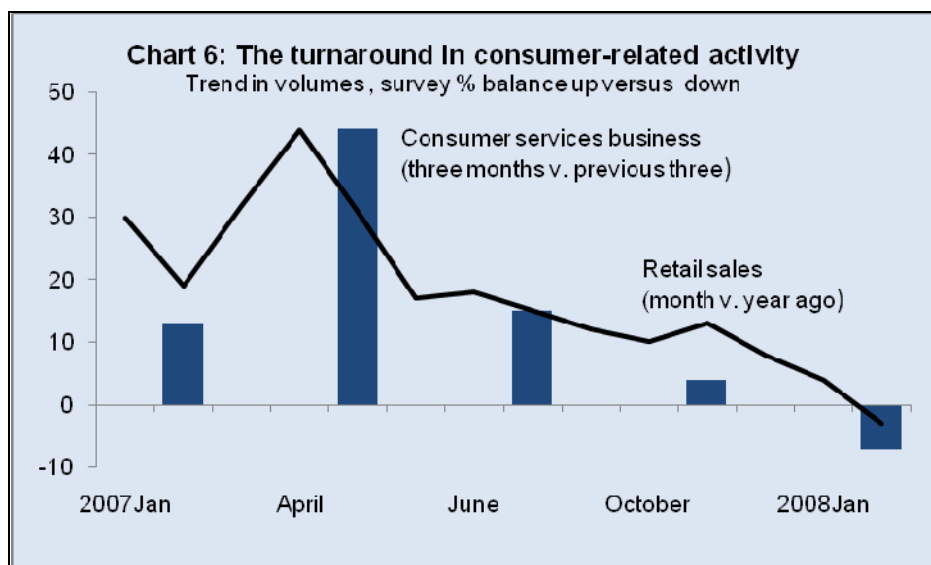
including confidence about the government's attitude to the business climate, will be a key factor in these decisions.

But aside from policy there are three factors threatening business profitability, cashflow and confidence:

- the very same economic downturn in prospect, with that outside chance of something even worse
- potential restrictions on credit availability
- the continued upward pressure on oil, energy and commodity costs, together with the renewed emergence of employer-backed pension fund deficits.

There is now clear evidence of a marked slowdown affecting the consumer-related sectors (chart 6). And this trend is highly unlikely to be reversed this year or next, reflecting:

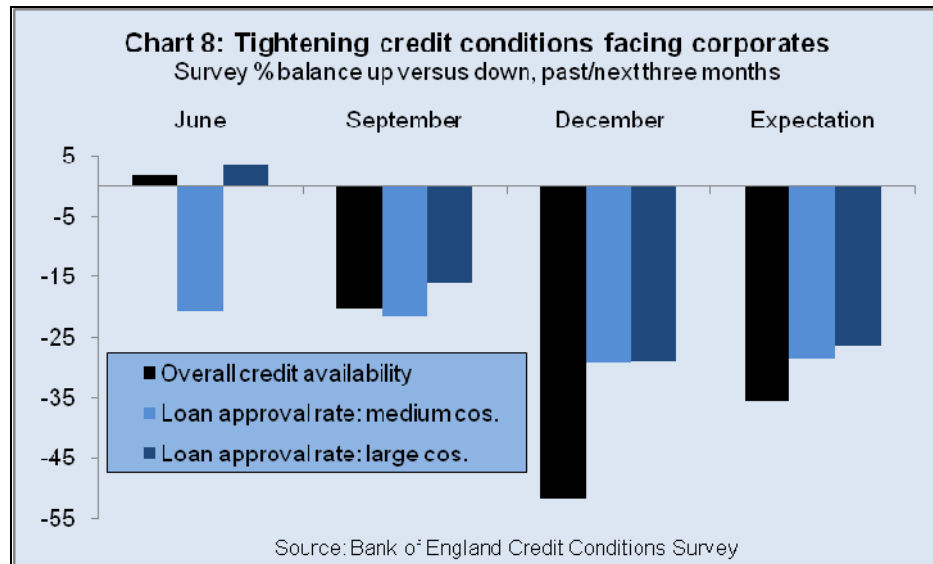
- A continued squeeze on real household disposable incomes, in the face of rising basic costs and the ongoing increase in the economy-wide tax burden
- A likely increase in the aggregate proportion of disposable income saved, reflecting: the low starting point for savings and high level of accumulated debt; the impact of earlier interest rate increases; a reduced ability and/or willingness to borrow, reinforced by the turnaround in house prices; a reduced level of housing transactions; and fears about job security.



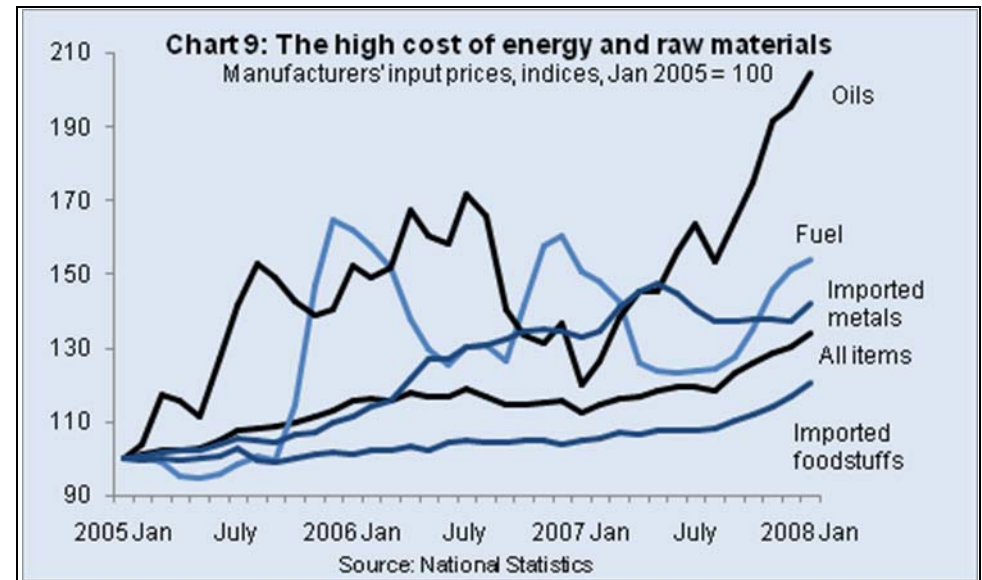
In the face of these developments, as well as developments abroad, GDP growth will almost inevitably be lower this year than last, and the prospects for 2009 do not look that much better. The CBI's latest forecast, made in December, puts economic growth at 2.0% this year and 2.1% next, compared with the 3.1% out-turn for 2007. But if anything, developments since then have pushed expectations downwards, with the consensus economic forecast continuing the slide seen since last spring (chart 7). The mean expert projection for growth this year is now just 1.7%, and for next year 2.0%.

Furthermore, while there is very little chance of growth beating this central forecast, there are very significant downside risks. The mean forecast is for household spending growth of 1.7% both this year and next. But it is easy to imagine a much more dramatic shift in household spending and borrowing behaviour, given the pressures set out above. In addition, the UK will be very vulnerable should the slowdown elsewhere in the world prove more marked than currently expected. Unlike the global downturn of 2000-2003, neither UK households nor the government are in a position to offset the impact on overall demand growth. The scope for interest rates to respond to unwelcome developments is also limited in the face of global commodity price pressures and volatile financial markets – including the currency market.

To date, evidence of the direct effect of the 'credit crunch' on the broad UK corporate sector is mixed. But it is worth noting the Bank of England Credit Conditions Survey (chart 8) which shows corporate credit availability to have been reduced significantly over the three months to December, with lenders expecting a further reduction in the first three months of this year.



Producer input costs have risen very significantly over the past three years (chart 9), and significant demand-supply imbalances at the global level mean that the pressures on these are likely to remain upwards, notwithstanding the cooling in western economies. Following the earlier pressures on the cost of oils, fuel and metals, foodstuffs are the latest commodity type to see a sharp upward price increase.



Against this background, corporate sector profitability is certain to slip significantly from last summer's peak, with cashflow additionally squeezed for those firms needing to borrow.

Plans for investment (table 5) and employment (table 6) are as a general rule already less positive than last spring and summer. They are though nowhere near the low-points seen in past recessionary periods, suggesting that business sector activity may be able to cushion the economy to some extent through the coming, hopefully temporary, hard times. But that could change all too easily if companies conclude that the government's attitude to business has taken a decided turn for the worse. Decisions about business tax will be central to that judgement.

Table 5: Corporate capital expenditure intentions			
Survey % balance, more or less, next 12 months versus past 12 months			
		Last May-July	Latest
Manufacturing	Buildings	-14	-21
	Plant & machinery	-6	-12
Financial services	Land & buildings	+1	+34
	Vehicles, plant & machinery	+8	+4
	Information technology	+51	+55
Business & professional services	Land & buildings	+9	-10
	Vehicles, plant & machinery	+3	+12
	Information technology	+42	+23
Consumer services	Land & buildings	+26	+14
	Vehicles, plant & machinery	-7	-8
	Information technology	+41	-1
Distributive services	All fixed capital	-5	+11
Source: CBI Industrial Trends Survey; CBI/PWC Financial Services Survey; CBI/Grant Thornton Service Sector Survey; CBI Distributive Trades Survey.			

Table 6: Corporate employment intentions		
Survey % balance, up or down, next three months		
	Last May-July	Latest
Manufacturing	-9	-19
Financial services	+24	+4
Business & professional services	+29	+12
Consumer services	+25	-9
Distributive services ¹	-18	-29
¹ Expectation for next month versus year earlier. Source: As table 3.		

2.4 The need for spending restraint

As we set out in section 2.5, greater restraint in public spending than currently planned should not prevent continued improvements in public service delivery. We would not however claim that it is a completely ‘painless’ solution: the level of spending in cash terms will of necessity be lower than presently allowed for, affecting the incomes of one group or another. And while there is clear scope for further efficiency savings, as the government itself recognises, it should be striving to maximise these anyway.

But the truth is that there is no ‘painless’ option, because the present fiscal arithmetic is not achievable. Either borrowing must be allowed to drift higher than currently planned, or taxes must be raised, or spending must grow by less than set out in the CSR. Of these options, spending restraint will ultimately be the least painful for the UK resident population as a whole.

We have already set out how:

- Additional borrowing would add to taxpayers’ future interest bills, further undermine the credibility of the government’s fiscal policy strategy, and result in a fiscal/policy mix tending to crowd out growth-enhancing business investment.
- Additional business taxes would also drive out business investment, ultimately depressing productivity and wage developments, as well as hurting sustainable job creation.

The only remaining alternative, namely increasing taxes levied openly and directly on individuals, would be preferable to either hidden tax rises on business or continued fiscal drift. It would not risk provoking capital flight to the same extent as higher business taxes. It would allow the public finances to be brought back on track earlier than otherwise, ultimately to the taxpayer's own benefit. And it would bring home to the electorate the true cost of the government's spending policies, making for a much better-informed public debate on this important issue.

However this would be very much the second best option when compared with spending restraint. The overall tax burden is already above the OECD average and heading in the wrong direction. And personal taxes can adversely affect growth potential and the climate for doing business through their impact on incentives to train and work, to move where necessary, and to save and invest. They are also, of course, painful in the obvious sense of immediately reducing household disposable income.

2.5 Achieving the required degree of spending restraint

The CBI therefore proposes that the government should re-set the public spending totals, to achieve savings building to £6bn in 2009/10 and £9bn in 2010/11 (table 7). This would allow borrowing to come in £5bn and £7bn lower as required, while leaving some very modest room for necessary tax reform in that time. These monies should mainly be focused on affordable measures to enterprise agenda back on track – details of which

are set out in section 3.1. Additional savings in later years could then fund a clearer reduction in the tax burden.

Even if £15bn of expenditure were cut from the present 2012/13 projection, spending would still grow by an average of 1.8% per annum on top of inflation over the next five years. It would at that stage still be over 40% of GDP, and would be 55% higher in real terms than in 1998/99. That would compare with real growth in the wider economy of some 41%.

Turning to the detail of the proposed savings, government spending on goods and services would on present plans be some £79bn higher in 2010/11 than in 2007/08 – representing a 4.7% annual rise. Pay accounts for around half of this, with procurement making up the remainder. But neither the pay bill nor the procurement bill needs to grow at this rate.

Looking at the pay bill alone, we see no reason why average annual pay growth should exceed 4.0% per annum, in view of the government's stated commitment to contain settlements (with the reference to the 2% inflation target) and the fact that this has been the average for the private sector over the past three years. At the same time, actual hours worked overall could be kept unchanged, while reducing headcount by a modest 1.2%, if absenteeism were managed down over the three years from nine days per annum to the 6.3 days prevailing in the private sector⁴.

⁴ *Attending to absence*, CBI/AXA absence and labour turnover survey 2007.

In total, the potential pay bill saving would build to some £4bn in 2010/11, compared with the present plan which seems to allow growth of 4.4% per annum – before any addition from the yet-to-be allocated reserves.

Turning to pay and procurement spending more generally, we know that the National Audit Office has identified many examples of waste, with studies undertaken in 2007⁵ alone revealing:

- Excesses or other scope for savings, on an annual equivalent basis: from local authority sharing of human resource functions (£1.1bn); in central government office property costs (£330m); and in refurbishment of the government estate ('value for money lost from the £3bn annual spend').
- Over a longer period, a £2.5bn overspend on the 20 largest defence projects.
- Many other examples of scope to improve processes, resulting in either improved quality of output or in savings of an unspecified value.

Many efficiency savings of this nature are already embedded in the government's plans, but we believe on the basis of these and other reported examples of waste that it should be quite possible to find additional savings in the procurement bill building to £4bn – or some 2% of the total – over five years. If that is not possible,

⁵ Based on National Audit Office press releases published during 2007.

then it may be necessary to take a tighter approach to employment levels, by continuing the trend over the past two years, during which time general government headcount has been taken down by 1.0%. (Another way of viewing this is to say that, in effect, some of the efficiency savings already being targeted would be devoted to debt and/or tax reduction, as opposed to 100% being recycled to frontline expenditure.)

Aside from fixed capital investment – where we do not recommend any saving – the other major area of expenditure is the benefits bill, which is set to rise from £157bn in 2007/08 to £179bn in 2010/11. In practice, it would probably increase by a little more on unchanged policy as economic growth disappoints the government's expectations. But a margin building towards £3bn is included in the spending plans and ought to cover this.

We believe that there is scope to achieve savings in the benefits bill of some £1½bn by 2010/11, and a little more beyond, without hurting those genuinely in need, due to:

- Scope to reduce fraud and error, which totalled £2.5bn in the latest year according to the National Audit Office⁶.

⁶ Department for Work and Pensions Resource Accounts, National Audit Office, July 2007.

- Additional scope to curb the incapacity benefits bill, by helping and encouraging those recipients able to work back into employment. Government adviser David Freud has identified significant scope for savings in this benefit, which is currently claimed by 2.6 million people at an overall cost of £12bn per annum⁷. The number of claimants has increased from around 700,000 since the 1980s.

The departmental spending plans include yet-to-be allocated reserves which can also be thought of as ‘spare cash’, building towards £4bn. Taking this into account as well, the overall ‘spare’ resources available on the above basis would reach almost £12bn by 2010/11 and £18bn by 2012/13. However, we accept that a portion of this should be held back to recycle to frontline spending and meet contingencies.

Turning to the coming year, 2008/09, we propose that the net spending reduction should be limited to just £1.5bn. This would allow departmental spending to be left alone, thereby avoiding unnecessary disruption at this stage of the planning cycle. In effect, the saving would be achieved simply by leaving a portion of the reserve unallocated. For this year (but this year only), the ‘in principle’ pay, procurement and benefit savings shown in table 7 should be thought of as being recycled within each individual department.

⁷ Reported interview with *The Daily Telegraph*, 7th February 2007.

Finally, we would make three further points:

- The freeze on aggregate working hours ought still to be consistent with an ongoing improvement in the quality and quantity of public services. ‘Trend’ improvements in productivity are by no means confined to the industrial sectors – across the services sector as a whole output per hour worked increased by 2.1% per annum over the 1997-2006 economic cycle.
- While average pay should grow by no more than 4%, there should be sufficient variation around this to reflect local labour market conditions and allow for appropriate incentives.
- Looking to the very long-term, it is essential that further reforms are applied to the public sector pensions system. Estimates of the associated unfunded liability vary between the official £530bn figure (which relates to 2005) and just over £1 trillion⁸. But savings from reform in this area would not, of course, help with the near-term budget arithmetic

⁸ N Record, *Sir Humphrey’s legacy: facing up to the cost of public sector pensions*, IEA 2006.

Table 7: Achieving the tightening through spending restraint

£bn unless stated	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Employment needed for unchanged manpower ¹ [index]	100.0	99.6	99.2	98.8	98.8	98.8
Average pay level allowing 4% rise per annum [index]	100.0	104.0	108.2	112.5	117.0	121.7
Required pay bill	153.1	158.6	164.3	170.2	177.0	184.0
Pay bill allowed for in allocated totals ²	153.1	158.9	166.0	174.3	182.7	191.4
'In principle' saving on pay bill achievable		0.3	1.7	4.1	5.7	7.4
Additional target for saving on procurement		0.8	1.6	2.4	3.2	4.0
Achievable saving on benefits bill ³		0.5	1.0	1.5	2.0	2.5
Unallocated departmental reserves ⁴		3.2	3.5	3.8	4.0	4.2
'In principle' spare cash available		4.8	7.8	11.8	14.9	18.1
Needed to adjust borrowing		1.0	5.0	7.0	7.0	6.0
Needed for necessary tax reform		0.5	1.0	2.0	5.0	9.0
Retain for frontline and contingency		3.3	1.8	2.8	2.9	3.1
Net spending restraint		1.5	6.0	9.0	12.0	15.0
Present spending plan	589.2	616.7	646.6	678.3	711.0	747.0
New spending plan	589.2	615.2	640.6	669.3	699.0	732.0
Spending as % likely GDP	42.0	41.8	41.6	41.2	40.9	40.7
Annual % increase		4.4	4.1	4.5	4.4	4.7
Real annual % increase		1.8	1.5	1.8	1.8	2.1
Real % increase since 1998/99	42.1	44.6	46.7	49.4	52.0	55.2
<i>Cf: real % GDP increase since 1998/99</i>	<i>28.1</i>	<i>30.7</i>	<i>33.3</i>	<i>35.9</i>	<i>38.7</i>	<i>41.4</i>

¹ Assumes absenteeism managed down to private sector levels by 2010/11. ² Half of spending on goods and services (net of unallocated reserve) until 2010/11, then increased in line with total current expenditure. ³ By tackling fraud and error (worth some £2.5bn annually) and helping some incapacity benefit recipients (worth some £12bn annually) back into work. Additional unemployment-related benefits during the downturn are assumed to be covered by the margin, which builds to £3bn in 2010/11. ⁴ In line with total current spending after 2010/11.

SECTION 3: RE-BUILDING THE GOVERNMENT'S ENTERPRISE CREDENTIALS

Small and medium-sized enterprises and their entrepreneurial backers are set to fare especially badly as a result of measures announced in last year's Budget and Pre-Budget reports. The cost of the increase in the smaller firms' corporation tax rate will eventually build to £1.5bn per annum, while we estimate – based on the limited available data – that investors in business assets could lose some £1.7bn a year as a result of the CGT changes (table 3). SMEs will also pay a proportion of the rise in transport, 'green' and property taxes due to come in, but will if anything be less able to carry these extra costs than their larger counterparts.

Ideally the government would hold the small firms' corporation tax rate at 20%, and spread the benefit of capital gains tax entrepreneur's relief beyond the £1m lifetime limit to the larger investors associated with the most significant job creation. However, with the public finances in such poor condition, we expect fierce resistance to these ideas. But if change cannot be made here, it is vital that the government:

- Delays or significantly amends its tax proposals on so-called 'income shifting', as argued in section 3.2 which sets out our views on a range of currently topical tax issues.
- Implements the range of SME tax proposals highlighted in section 3.1. None of the measures has a cost of any great significance and with scope for tax reductions building to £2bn

in 2010/11 (if our spending restraint proposals are enacted) it should be possible to fund the majority of them.

- Implements a range of SME-friendly policy proposals outside of the tax field, as set out in the CBI's input to the government's *Enterprise Strategy* consultation.

3.1 Specific tax proposals for SMEs and entrepreneurs

▪ Raising finance

Proposal: Make the 'incidental costs' of raising equity finance deductible for tax purposes for companies seeking to raise up to £20million for growth purposes, not exit.

For a business trying to raise finance, the non-deductibility for corporation tax purposes of the 'incidental costs' of raising finance restricts their growth. Since the 'incidental costs' of raising equity finance are not tax deductible (unlike debt finance), businesses may not seek the most appropriate finance for their growth aspirations or growth may be restricted due to the extra tax paid when using equity finance.

Equity finance is more appropriate for businesses seeking large amounts of money to grow rapidly, or those based on highly innovative activities where product or process development needs significant investment before income from sales can be guaranteed. Alternatively, debt finance is normally used by businesses looking to raise a smaller amount of money and

Exhibit A: Going public

An innovative Group in the technology sector is raising equity via AIM with the objective to fund substantial growth over the next five years by investing in infrastructure and creating jobs. The minimum investment level is £10million and the Group expects to pay fees associated with raising the equity of between £800,000 and £1million. Because these costs are not deductible for corporation tax purposes the Group's tax bill is expected to be around £300,000. Such an amount of money could instead fund five to eight new skilled jobs in the Group.

Exhibit B: Demerged company

Following a demerger, a company in the IT industry needed a large amount of finance to take forward a high growth plan, which included exporting to America. The company needed upwards of £3million due to the expensive software needed for growth and therefore it was most appropriate to seek equity finance. Funding of £3.2million was received from a Venture Capital Trust, however the company had to pay the VCT due diligence costs of £700,000, 22% of the total funding. Since these costs were not tax deductible, only £2.5million was left to fund the growth of the business.

where owners want to retain complete control over the business. Therefore, when a business chooses to raise debt finance because it is less costly to do so, the business cannot grow to the extent the owner wishes and the economy forgoes higher rates of

employment, productivity and wealth. Even where the business pursues equity finance despite its inhibitive costs, business growth can be restricted. Taxes paid could instead be used to fund innovation, increase employment or expand operations.

It is anomalous that the 'incidental costs' of raising equity finance are not deductible for corporation tax purposes as the only real distinction between equity and other forms of finance is in the degree of risk involved. This anomaly either penalises or deters businesses from undertaking certain types of spending. The decision on the most appropriate source of finance should be made for commercial and not tax reasons.

If the government, at this stage, does not want to commit to making the issuance of all new equity tax deductible, then the relief could be limited to private companies seeking to raise up to £20million. This would apply to a single fund-raising event only, and not be used for equity release purposes.

- **New ventures and associated companies**

Proposal: Allow associated companies the option of allocating the small firms' corporation tax rate profit limits between them in the most beneficial way.

The decision to spin-out a new venture or to invest in one can be distorted by the tax rules surrounding associated companies. The small firms' corporation tax rate (SCR) exists to incentivise entrepreneurship and fund growth in SMEs but this benefit can

be lost due to the associated companies' tax rules, even if the associated companies' combined profits do not exceed the lower profit limit of £300,000. The profit limit is apportioned equally between the companies, but if their combined profit is split unequally so that one or more has a profit greater than its share of the £300,000 limit, they suffer a higher rate of tax. The tax cost of a business creating a new venture or a business angel investing in a growing business is therefore high; so high that it can prevent rational commercial decisions taking place.

Exhibit C: Frustrated business angel

An entrepreneur, with his own established business of designing and developing products for the hotel industry, invested sums in excess of £100,000 in two successful joint venture start-ups during the nineties. However, the fact that he had controlling interests in both these ventures meant that his own company, which had no trading or other business or financial connection with the start-ups, lost the benefit of the SCR because of the associated company rules. He therefore sold his interests in the ventures earlier than he would otherwise have chosen. Except in one instance, he has not subsequently made such investments despite becoming aware of a number of potentially attractive opportunities because of the impact of the associated company rules.

The exception was a joint venture, in which he took only a 50% interest to ensure that it would not be treated as an associate, but the lack of control frustrated his business objectives for the venture and he sold out at an early stage without realising the benefits originally anticipated.

The spinning-out of a new venture or formation of a joint venture is the natural growth mechanism for many SMEs. It allows SMEs to innovate and take risks without detriment to other businesses.

Also it is often the logical move when trying to expand one part of a business that is not yet profitable and is a good way of preventing the main business from taking the risk of growth. New ventures can also be a staff development opportunity. Promoting an employee to the managing director and minority shareholder of the spin-out provides them with autonomy and financial incentive. New ventures are not just used by growing businesses, they also provide investment opportunities for business angels. Business angels are an important source of finance for growing businesses. They generally invest small amounts of equity finance into start-ups or early stage businesses and importantly take on a mentoring role in the business.

Proposal: Exclude business partners from the definition of associate where there is no substantial commercial interdependence between the companies involved.

In establishing whether companies are under 'common control', the rules attribute to a shareholder the right and powers of his associates, which include relatives and business partners. 'Relative' for this purpose is limited to spouses and minor children where there is no substantial commercial interdependence between companies. But for business partners there is no such limitation. Entrepreneurs and venture capitalists increasingly use

limited liability partnerships as a vehicle for investment without any tax avoidance motive, and are unlikely to be aware of companies controlled by fellow partners. It is unfair for genuine risk takers to be subject to this type of unjustified anti-avoidance penalty, or to such an unreasonable compliance burden.

- **Government thresholds**

Proposal: Review and uplift government thresholds.

Many thresholds affecting SMEs have remained unadjusted over the past few years, with some unadjusted since 1994. The failure to uplift these has dragged a rising number of firms into tougher reporting and regulatory regimes. Many of these businesses do not have the resources and capabilities to deal with the burdens.

The government should review all the SME thresholds for tax and other purposes, as these create confusion and complexity, particularly for growing firms. As an immediate priority, the profit limits which apply for both the small companies' rate of corporation tax and the quarterly instalment regime, should be uplifted.

The current mileage allowance rate for business use of employees' own cars or vans of 40p per mile for the first 10,000 miles also needs revising, as it does not now reflect the true cost to employees of such use. We therefore urge the government to increase the rate to a more realistic level, and to link this with the

appropriate AA mileage rate so that future increases in line with inflation occur automatically.

The government should also increase the current 'relocation allowance' from £8,000. This allows employers to reimburse removal expenses on a tax-free basis up to a limit of £8,000. However, employers are now finding that the £8,000 limit is insufficient to cover the true cost of employee relocation.

Exhibit D: Staff recruitment business

The owner/manager of a recruitment business wanted to set up a separate company to focus on and expand the permanent recruitment side, which at that stage was not profitable, with the person running that activity as the new company's managing director and minority shareholder. This would have provided the MD with both autonomy and a financial incentive.

However, the profit attributable to the main temporary recruitment business was close to the lower SCR profit limit. The effect of setting up a new associated company would have been to make a significant proportion of the original company's profit liable to the marginal small companies' rate. As the new company would initially have been unprofitable, it would not have benefited at all from the SCR. Setting up the new company would have provided an excellent staff development opportunity as well as increased scope for growing the business.

- Investment

Proposal: Provide cash payments of capital allowances to 'loss-making' businesses and extend allowances to include assets leased to SMEs.

Many high-growth firms incur significant capital expenditure before becoming profitable, but loss-makers are unable to benefit from capital allowances. These provide a good incentive for established businesses to invest further, both in terms of financial incentive and as a psychological motivator. They also have the advantage of being well recognised by industry.

The government has successfully tackled this issue in the context of R&D activity by providing for tax credit payments to loss-making SMEs. A similar approach should now be adopted for capital allowances, so that the incentive is timely for growing businesses, compensates for their higher risk exposure and reduces the downside risk. The government should also look at extending the allowances to include assets leased to SMEs. The current exclusion is a clear anomaly.

- Innovation

Proposal: Produce a toolkit for R&D tax credit applications.

SMEs are often deterred from using the R&D tax credit due to the resource needed for and difficulty of applying. There can be a disconnect between what the government and businesses

Exhibit E: Slowing down innovation

An engineering company which engages in R&D has previously been a successful claimant of the R&D tax credit. However when the owner tried to claim for similar expenditure in 2004, £40,000 of the expenditure was deemed ineligible. The owner is continuing to claim this expenditure and that from 2005 and 2006 for similar activities. The struggle to claim the R&D tax credit has had a huge impact on the company. Growth has been restricted, in particular employee numbers have not increased at the rate expected. Furthermore, the slowdown in innovation levels has enabled two competitors to get to market first with similar but lower quality products.

Exhibit F: Uncertain entrepreneur

An SME in the IT industry is undertaking R&D and is likely to qualify for the R&D tax credit. But the owner's accountant has advised that the process of applying for the credit is burdensome and costly, and that the claim might not be successful. In fact the cost to claim may be greater than the possible return. The business has therefore decided to not claim the R&D tax credit. If the process of applying were less bureaucratic and costly, the business would be able to undertake more innovation, thereby employing more people and growing the business.

believe to be eligible, meaning that they face uncertainty and lack confidence in the tax credits. The government must ease the application process if the system is to reach its potential. To this

end the CBI proposes that government should produce an R&D tax credit toolkit to guide businesses through their application. This would provide more extensive guidance than the businesslink.gov website, which only assesses eligibility.

Such a toolkit should include, amongst other things: a clear definition of what counts as R&D for tax purposes; a template for calculating applicable wage costs (for internal and external staff), consumable items, consumable stores, and software; how to demonstrate the project counts as R&D for tax purposes; and examples of common errors.

- Pensions

Proposal: Create a financial support package to ease the cost of compulsory pensions contributions for small employers.

The CBI remains concerned that the introduction of compulsory pension contributions will damage growth and employment in SMEs. Given the competitive pressures facing businesses, offsetting measures are necessary to reduce the financial impact on small employers. The CBI proposes that, notwithstanding a graduated introduction, a time-limited financial support package should be created to cushion the initial cost to small employers.

- Data gathering and policy modelling

Proposal: Build a database with data from SMEs so that budget decisions are based on “real-life data” and dynamic analysis.

To be effective, tax measures need to be well specified and targeted to prevent unintended consequences. But the CBI has concerns about the way that Budget measures are modelled by the Treasury. Most data in the Treasury model is from HMRC and based on tax returns. However, financial information submitted to HMRC is different to the actual financial affairs of a company which guide investment and growth decisions. The Treasury needs to adopt an approach which will enable it to make better informed decisions. To be more accurate, the CBI proposes that the Treasury builds a simple model based on the data which informs the decisions made by businesses. To form this database, data from at least 15 companies will be needed. Profit and loss accounts, balance sheets and cash-flow data are the minimum data requirements and should be updated on a monthly basis. Dynamic analysis should also be used to understand the behavioural changes which result from policy change.

- Business transfers

Proposal: Simplify the assessment of sale proceeds for tax purposes, with vendor-financed sales treated as capital not income.

Rules for using vendor financing for management buy-outs can be complex and costly, and should be reformed with urgency. To prevent HMRC taxing the disposal as income and instead as a capital gain, the vendor must take specific financial instruments in the acquisition vehicle which must be Qualifying Corporate Bonds

(QCBs). These include the requirement that they are convertible into a non-sterling currency. However the cost of doing this can run into several thousands of pounds and is complicated. Furthermore, if the wrong bonds are taken out and the buy-out is unsuccessful, the vendor could be taxed on the value of the deal even though the cash is never received. Vendors can avoid this charge, but only by using an artificial gift mechanism involving a charity, for which the charity gets no tangible benefit.

Exhibit G: Retiring business owner

A business owner decided to retire and needed to sell his business. Having built the business from start-up, his preference was for the business to continue trading rather than close. His management staff offered to buy the company for £1million, paying half through a bank loan and their own resources and the balance over five years at £100,000 per annum. However due to the risk of using QCBs and the cost of applying for an artificial gift mechanism, the business owner decided not to sell to the management. As there were no other offers to buy the business, it closed and the assets were sold.

The government should enable such business transfers to be as smooth as possible. The continued functioning of a business through the transition of ownership can help to drive investment in innovation and skills, and ultimately improve productivity. The potential of successful business transfers cannot be

underestimated. Some 96% of business transfers survive the first five years after the transfer. This compares with 75% of start-ups who are still operating after five years. Also, as a government investigation into business transfers has noted, a significant benefit of changes to ownership is innovation⁹. For example there may be changes to organisational structures or the development of new processes and products.

▪ **Entrepreneurs**

Following Budget 2007, a number of changes were made to the way risk capital schemes operate. The main reform was the introduction of an annual £2million per company investment limit across three risk capital schemes, Venture Capital Trusts, the Enterprise Investment Scheme, and Corporate Venturing Scheme. Additionally investments were restricted to companies with less than 50 full time employees. The CBI understands that the reforms reflect EU State Aid rules but is disappointed that no effort was made to mitigate or soften the impact of these new restrictions. Going forward improvements should be made to these schemes and the government should seek to remove these restrictions by using the EU's block exemption for SMEs.

⁹ *Passing the baton – encouraging successful business transfers*, BERR 2004

- **Enterprise Investment Scheme**

The Enterprise Investment Scheme has been able to encourage more business angels into the market and the decision to increase the length time in which approved EIS funds must be invested from six months to 12 is welcome. This should enable investment decisions to be made after proper consideration and without undue time pressure.

Proposal: Review the 'connection' definition clause.

However, many of the EIS rules can be broken inadvertently, and there is often no way of correcting the situation. Welcome changes were introduced to enable inadvertent receipts of value to be “corrected”, and it would be helpful if there were provision for other inadvertent breaches of the rules to be corrected without loss of relief. For example, it is virtually impossible for a business angel with EIS relief to lend money to a business in which he is a substantial investor without losing relief, even if it is the only way of keeping the company afloat. If he is not repaid, the business angel is likely to lose relief under the ‘connection’ definition, where the loan is considered on the same basis as the nominal value of share for these purposes (a similar clause was removed for venture capital many years ago). This anomaly should be looked at with some urgency.

Exhibit H: Wasted efforts

Prior to Budget 2007 a medium sized manufacturer was looking to raise £800,000 for acquisition. However since the company had more than 50 employees the changes made in the Budget meant that the money could not be invested. Although the company eventually used a loan there were negative impacts on the company. The owner preferred to use equity finance due to the tax incentives but now has to make interest payments. Additionally as the company was near to the end of the finance deal and no warning was given prior to the Budget's announcement, the money used to find investors and receive advice was wasted and it took longer to receive its finance.

Exhibit I: Broadcasting company

The changes to the risk capital schemes had a negative impact on a small company in the broadcasting industry. The company wanted to raise money through EIS to fund an acquisition. It complied with all of the eligibility requirements prior to Budget 2007. However although it complied with the rule on employee numbers post Budget, it was unable to gain funding as it needed more than £2million.

Proposal: Include music publishing in EIS.

A further anomaly exists around the exclusion of music publishing from EIS based on a misunderstanding of the nature of risk involved. At present EIS only applies to the creation of copyright by the musician but ignores the role and risk taken by the music publisher. They often generate or make possible copyright, rather than passively administering them.

Exhibit J: Music publisher

A company in the music industry is a publisher of print and performance music, covering a range of genres. A key part of their work is conceiving the idea of a publication and commissioning the contents. One example is their series of publications of instrumental pieces. The content for the series was made specifically for the publication and therefore, without the company taking a commercial risk, the content's copyright would not exist.

Proposal: The employee EIS test should be spread over time.

The EIS rules set a variety of restrictions on the size of an eligible company, in particular the seemingly arbitrary requirement that a business employs fewer than 50 employees at the time the share certificates are issued, regardless of the numbers employed on average over a longer period. This can work against companies intending to expand, and who may wish to raise funds later as well as now.

Exhibit K: Fundraising florist

A CBI member advises a chain of florists, which currently employs 47 staff and is eligible for EIS in all other respects. The business has sales of £4m, is loss making and is raising funds to expand its retail portfolio and invest in internet sales. The business would like to raise funds now, and again in a year's time once it has got closer to break-even. By the time of the second fundraising the business will employ more than 50 people. The fewer than 50 rule causes a severe problem for the business's future fund raising plans. The total required is £1.5m ideally raised in two tranches of £750k - one now and one in 12 months. To attract EIS the business must raise all the funds it needs now at a low valuation and it may not even be possible to raise all the money now as the amounts are relatively large for a business of this size. Equally it may not be possible to raise the second tranche in the future as this tranche will not attract EIS.

The employee test should be spread over time. If for example the average of the last two years' audited accounts' employee numbers were used, this would avoid the need to calculate headcount continuously.

- Venture Capital Trusts

Proposal: Reintroduce the 40% income tax relief for investments in technology VCTs.

VCTs are another source of equity finance for growing firms. In Budget 2006 the rate of income tax relief for VCTs was reduced from 40% to 30%. The tax relief for technology VCTs should be enhanced back to the level of 40%. As the Sainsbury Review notes, there was a significant reduction in the amount raised by VCTs in the last financial year and there are signs that access to finance in the technology sector is becoming difficult as fund managers are becoming more risk averse. VCT subscribers face a real deterrent due to current market conditions and high-risk levels. Thus enhanced relief is essential to encourage more equity funding for smaller technology companies.

- Smaller quoted companies

Proposal: Extend EIS and VCT benefits to investments in smaller quoted companies.

Traditionally, smaller quoted companies in the UK receive too little attention and under-perform against international competitors. New measures are needed to assist this key sector to reach its potential. Enterprise Investment Scheme (EIS) and Venture Capital Trust (VCT) -style benefits should be extended to investments in smaller quoted companies by both individual and institutional investors to tackle this problem.

- Demergers

Proposal: Simplify tax rules for demergers.

The tax regime for corporate demergers is also extremely complex, with major traps for the unwary, and is consequently expensive to navigate in terms of professional fees. There are serious inconsistencies between the relevant capital gains reliefs and the stamp duty and SDLT exemptions. The impact of this is felt particularly by growing owner-managed and family businesses, whose development often reaches a stage where different parts of the business are managed by different people with increasingly conflicting interests.

These may reflect different aims and objectives, different risk profiles or different financing requirements. Such factors may well lead to the conclusion that a demerger is the best way forward if the full potential of all parts of the business is to be realised. There should be statutory provision for demergers carried out for bona fide commercial reasons to be free of all capital taxation, by providing full relief from corporation tax on chargeable gains, stamp duty and SDLT in these circumstances.

3.2 Further views on topical tax matters

While SMEs and entrepreneurs should be the main focus of Budget policy action this year, given last year's tax increases and the constraints on the public finances, in the longer term the broader tax burden also needs to be capped and reduced. And in the meantime there are a number of tax matters of concern to business of various sizes, on which we set out our views here. In several cases the CBI is engaged in ongoing dialogue and/or has submitted a response to government consultation. The CBI's *Technical Tax Proposals* set out recommendations on a greater range of detailed matters.

■ Corporation tax, capital gains tax and major tax reform

Last year saw two major tax reform packages affecting business and its investors, to corporation tax and capital gains tax. Elements of these, most notably the cut in the main corporation tax rate, were welcomed by the CBI. But we made clear at the time our concern with other elements: the rise in capital gains tax bills for entrepreneurial investors; the rise in the lower corporation tax rate mainly affecting SMEs; and the complete phasing out of the industrial and agricultural buildings allowance.

Our concerns here include the net cost to business of the reforms as a whole; the higher proportionate cost to many individual firms and investors; and the direct impact of the resulting change in prospective returns on future investment. These reasons alone could justify extending the scope of the new entrepreneur's relief

beyond the proposed £1 million lifetime limit, holding the lower corporation tax rate at 20% (in line with the new income tax rate), and continuing to make at least some allowance for buildings which genuinely depreciate over time – though financial constraints almost certainly rule out these options out for now.

But the reforms also raise two additional points of principle:

- Because they affect the return on investments made in the past, each package will have a retrospective impact.
- The measures proceeded without prior consultation and, in the case of CGT, the subsequent handling of possible further change created additional uncertainty and left very little time for affected investors to change their arrangements.

One result is that taxpayers' legitimate expectations have been overturned – strong grounds for claiming 'unfairness'. Associated with this, the behaviour of potential future investors will be affected. Where the tax system is unpredictable and unstable, 'hurdle' rates of return are pushed up, with business investment constrained and international competitiveness undermined.

■ The consultation process

Indeed CBI members have become increasingly concerned at the number of instances of major legislative change with a significant, and often retrospective, impact on taxpayers without any previous public consultation. When consultation does take place

on these matters, it only addresses the details of implementation rather than the substantive issues, frequently leaves the policy intention unclear, and allows insufficient time for proper consideration of complex legislation. Lack of adequate consultation often results in the provisions being drafted extremely widely, with the potential to catch many more taxpayers than intended, and too much reliance being placed upon guidance and HMRC practice to limit their scope.

Aside from CGT, current examples include financial products avoidance, residence and domicile, and income shifting. Implementation of these three should be deferred to Finance Bill 2009, to allow further consultation with business on the basis of a clear understanding of the policy aim, and enable the measures to be accurately targeted, without unfairly catching arrangements put in place years ago under a different set of circumstances.

Advance consultation is also important for more minor legislative and regulatory changes, such as the August 2007 changes in the treatment of employer-provided health screening, where the failure to consult led initially to unintended consequences, and where uncertainty has continued because of delay in producing the related guidance.

- [Business rates and local supplementary levies](#)

The true impact of the loss of business rates empty property relief will be felt when changes come into force this April. The CBI opposed the proposal when first suggested in Sir Michael Lyons'

review of local government finance and continues to oppose it as legislation comes into force. We believe that the loss of the relief will lead to a slowdown in the rate of development and limit the ability of businesses to operate flexibly. It is unrealistic for firms to be able to market and re-let property within the proposed three and six month relief periods. This measure will not only affect landlords, but corporate occupiers of all sizes who are unable to pass on vacant premises because of particular lease terms. We urge the government to monitor closely the effect of these changes, not just on local authority vacancy rates but on a wide range of indicators such as rates of development and flexibility of leases – and to be aware of the effect on individual sectors and businesses which may not be picked up in high level statistics.

We understand that the government intends to legislate for business rate supplements in the next parliamentary session and look forward to working with the government to ensure that local authorities are made fully accountable for their new powers and that appropriate safeguards are in place. The CBI was clear in the run up to the publication of the white paper that business rate supplements would only be acceptable if affected businesses were given a vote on each and every local scheme. The government has only partially adopted this principle, but the CBI continues to believe that the best way for businesses to have confidence in the scheme is through a business vote.

The CBI welcomed the decision to drop the proposed planning-gain supplement (PGS). We consider the alternative tariff-based

community infrastructure levy (CIL) to be a potentially fairer and more practical approach to deliver the government's objective of raising additional revenue from new development to support the delivery of local, sub-regional and regional infrastructure in England and Wales. The Planning Bill, now progressing through parliament, contains the powers necessary for local authorities to levy CIL and is intended to take effect from April 2009.

These powers must ensure that CIL is levied and administered in a consistent and predictable manner, with no room for the re-introduction of any development-gain tax similar to PGS. It should only apply to development which is likely to create a demonstrable demand upon local infrastructure: businesses wishing to undertake a modest extension to an existing premises should not be charged disproportionately.

It is hard to be precise about the impact of CIL on business conditions – as a revenue-raising tool for local authority areas its scale and application are likely to vary to reflect local circumstances. But we do expect the application of CIL by local authorities to be undertaken in a proportionate and fair manner: levies must be calculated using a clear set of local infrastructure priorities, capable of delivery within reasonable timescales.

- **Environmental taxation**

The CBI's recent report, *Climate change: Everyone's business*, highlighted the importance of fiscal measures to help stimulate the UK's transition into a low carbon economy. Areas of potential

opportunity include the "greening" of property taxes such as business rates and council tax, to encourage improvements in the energy and carbon performance of existing buildings. We will be developing our position on green taxes over the coming year and urge the government to commit in the Budget to consider actively the scope for fiscal reform as a way of incentivising faster and more extensive adoption of emission reduction measures.

A thorough review of the government's approach to green taxes should also include greater transparency about the use of revenue from existing and future green taxes. A key business condition for fiscal reform in this area is that any change should be revenue neutral. The landfill tax, which has up to now been revenue neutral, has with the demise of the BREW programme (aimed at helping business become more resource efficient and funded from additional landfill tax revenues) effectively become another general revenue raising measure. There is also uncertainty about how revenue from auctioning under the Emissions Trading Scheme will be used. Such examples risk undermining trust in government and the strength of its commitment to environmental improvement.

- **'Income shifting' rules**

The CBI is responding separately to the consultation on so-called 'income-shifting'. The government's aim here is essentially to prevent couples owning a family business from using their personal tax allowances and lower tax bands to the full,

regardless of their individual contributions (financial or otherwise), on the grounds that to do so is unfair. We are concerned about the potential disproportionate increase in compliance burdens for a far wider range of businesses than those actually engaging in 'income shifting'.

- **Non-domicile tax rules**

The CBI is also responding separately to the consultation on new tax rules for non-domiciles. We welcome the government's recent clarification concerning certain aspects of the rules affecting those opting to pay the £30,000 charge. But we continue to have concerns, both about the potentially harsh impact on some of those affected – the additional tax impact will fall much more heavily on working professionals than the 'super-rich' – and about the signal sent to the wider world about the UK government's attitude to foreign contributors to UK business success.

Although this is essentially a personal tax issue, the impact on the climate for doing business is potentially very significant. In particular, we believe that the rushed implementation, combined with the lack of prior consultation, is changing the UK's competitive position. We urge the government to defer implementation until 2009, both to allow for proper consultation and to ensure that those affected can become familiar with the new rules and re-organise their affairs in a reasonable timeframe.

- **Taxation of foreign profits**

The CBI has made representations on the issue of corporate taxation of repatriated dividends of foreign subsidiaries. We support the idea of exempting these revenue streams from UK tax, as is common practice throughout the world. But there is no case for any significant change in other corporation tax rules – in a revenue-raising direction – as a consequence. The direct revenue cost to the exchequer will be very small, in comparison to the knock-on benefit for the wider economy of the additional repatriated funds expected.

- **Taxation and business-university collaboration**

One further concern relates to business-university collaboration. Where a collaboration is deemed by HMRC to be a 'secondary purpose activity', then the university will be subject to corporation tax on associated income streams. This contrasts with activities accepted as 'primary purpose', where no tax is deemed to be due from the university because of its charitable status. We are concerned at signs that HMRC may, in its interpretation of the Charities Act 2006, widen its interpretation of 'secondary purpose activity' to go well beyond the purely commercial 'with profits' contract research traditionally captured by this rule. Moves in this direction must be avoided, so as not to discourage the type of engagement between businesses and universities which the government has been keen to encourage to date, and which is vital for the UK's longer-term prosperity.

4. IMPROVING THE APPROACH TO FISCAL POLICY

The CBI shares the concerns of many about the government's whole approach to fiscal policy. When the code for fiscal stability, fiscal rules, emphasis on 'prudence' and Pre-Budget Report were introduced in the 1990s, we like many others welcomed the new regime as a large step in the right direction. The rules and code offered the hope that fiscal policy would be used in a way consistent with the both smooth-running of the economy over each cycle and longer-term economic and financial sustainability. Similarly, the Pre-Budget Report idea, together with the code, suggested that transparency, openness and consultation would play a central role in the policy-making process.

In the event, developments in all of these areas have been a disappointment. While the letter of the 'golden rule' has not been breached, there are widespread doubts about the 'spirit' of the approach. Had a more prudent approach been taken, the UK would not now be facing the policy dilemma spelt out in section 1. There would be room not just to allow the 'automatic stabilisers' to run their course, but to temporarily relax fiscal policy on top to help support the economy through the difficult period ahead.

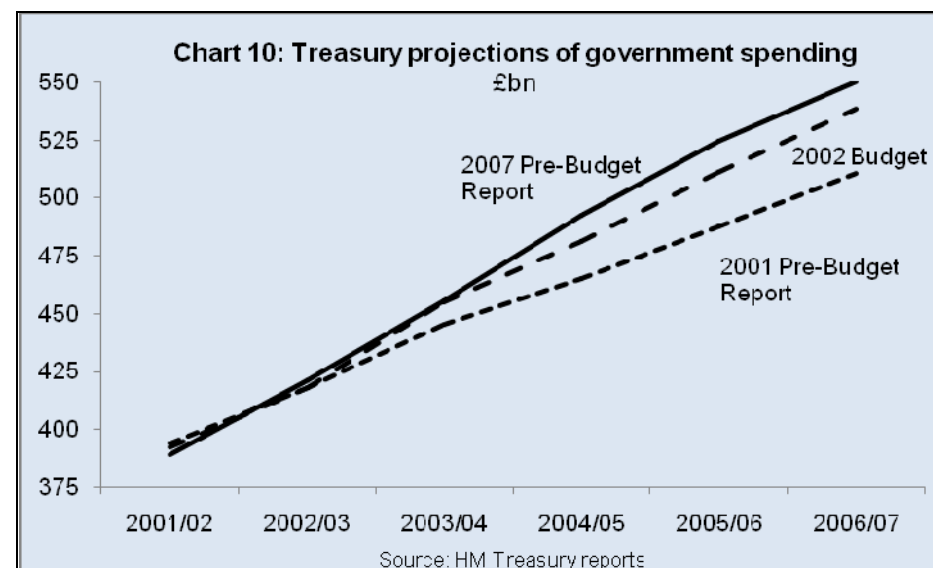
Consultation meanwhile has typically been confined to measures of a technical nature, usually with modest benefits for business, but completely absent on the major reforms, often with a large business cost. And at the very broadest level, there is a growing disparity between the stated policy of prudence, stability and

competitiveness, and the reality of fiscal deterioration and stealth tax rises.

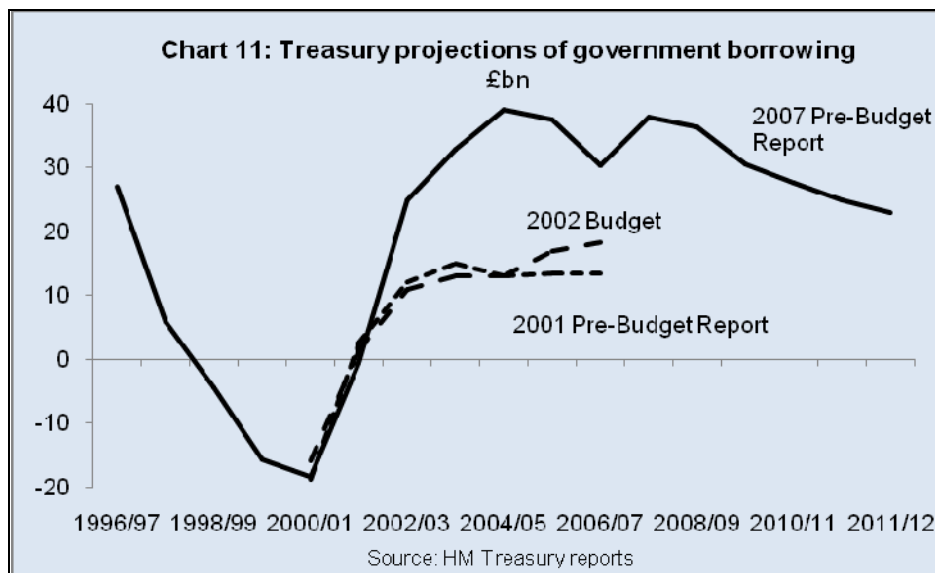
Going forward, a new approach is needed in all of these areas.

4.1 Recent trends in the public finances

The root cause of today's policy dilemma lies in the government's approach to fiscal policy since 1999, and especially since 2002, as priority was subtly shifted away from maintenance of sound public finances, towards a ratcheting-up of public expenditure with more limited attention paid to the ability to fund this. Table 8 and charts 10-11 illustrate this policy.



£bn	Money GDP	Total receipts	Total expenditure	Net borrowing
PBR 2001 projection	1263	497	511	13
Budget 2002 projection	1284	520	539	18
Out-turn in PBR 2007	1323	520	550	30
<i>% excess over 2001 projection</i>	4.8	4.6	7.6	



4.2 Reinforcing the fiscal framework

The apparent conflict between this recent public financial drift and the Treasury's maintenance that its 'strict' fiscal rules 'continue to be met' has contributed to the growing view that the rules need to be reformed. The CBI shares that view.

As set out earlier, the government is in a position to declare that the economic cycle ended in 2006/07 and that the 'golden rule' for borrowing had been met over that cycle. In absolute terms, the current budget was virtually in exact balance over that decade, but in terms of GDP share – which the government has adopted as the 'true' measure – there was a clearer surplus, thanks to the annual surpluses in the early part of the cycle.

Nevertheless there will be questions as to whether the 'spirit' of the rule has been breached, bearing in mind the two crucial years added to the beginning of the cycle, and the simple fact of a significant and continuous deficit in recent years – so that the rule can be declared 'passed' only because of those surpluses of several years ago. The rules should therefore be revisited with a view to strengthening and rationalising them.

We certainly do not recommend a wholesale shift in the 'golden rule' concept. Of course no rule is ideal: for example, it would make just as much economic sense to exclude the cost of teacher training as to exclude the cost of school building from the definition of spending that must be covered by current revenues.

But the capital-current spend split is easily measurable, and an acceptable basis for the rule.

Rather, we propose that the new rules should build on the concepts already in place. On the one hand, the new framework should take into account the theoretical possibility that the existing rules could be too constraining in some circumstances:

- The present golden rule is asymmetrical. The smallest of deficits over the cycle means that it will technically have 'failed'. Consequently, there ought in theory to be a tendency to try to 'over-meet' the rule – with the Chancellor aiming to achieve a clear surplus on the basis of 'average expectation', to allow room for unexpected surprises.
- The present sustainable debt rule, whereby (through the cycle just ended at least) net debt must be below 40% of GDP, must be met in each and every year, rather than on average over a number of years.

Of course a strong case can be made for building in an extra degree of prudence. After all, at the global level 'economic power' is shifting, in broad terms, away from the west and towards the Middle and Far East – and most notably to countries whose governments have build up significant financial assets rather than debts. But if there is to be a fundamentally new aim, it would be much better to make that explicit – aiming for a particular current budget surplus for example, or for balance on the overall budget over a run of years – rather than build it in implicitly.

But more importantly, far from the rules having turned out to be too constraining, in practice they have clearly not been constraining enough. In part this relates to the degree of flexibility allowed to policy makers, including:

- Difficulties in measuring the economic cycle, effectively allowing decision-makers to choose and move between alternative definitions of the cycle, whether according to genuine subjective judgement or simply to make it easier to meet the rule.
- The fact that large surpluses made several years ago can on the present rules be used to justify deficits today, regardless of how appropriate or otherwise that may be taking into account economic and financial considerations.
- The fact that the Chancellor himself is 'judge and jury', deciding on crucial facts including the starting and finishing points of each cycle, and the related question of whether or not a full fiscal year (such as 2006/07) should be included in one or other, or both, economic cycles.

On the golden rule, the CBI would support the principles previously floated by the IFS, that it should be symmetric, forward-looking and less reliant on judgement about the cycle. On this basis, the Chancellor would set out forecasts for the current budget over several years, with a view to having a 50% chance of exceeding a central target and a 50% chance of falling

short. The policy framework would then mirror that for monetary policy, where the MPC sets interest rates to broadly achieve a 50% chance of inflation coming in below target and a 50% chance of being above. The most obvious target would be zero and – with net investment at around 2¼% of GDP – we would not regard that as unsustainable. But the case for aiming at a clear surplus should not be dismissed without further debate.

However, to underpin rather than further undermine the credibility of this policy, it will be essential for the Treasury forecasts to be scrutinised by an arms-length independent body, such as the Bank of England or NAO for example.

A similar framework could also apply to the debt rule. A particular target or target path would be chosen by the Chancellor, justified on economic and financial grounds, with policy set to leave a 50-50 chance of exceeding or falling short of the target. The target would not, of course, be independent of the target and projected path for borrowing. An outside body would again be needed to assess the likely accuracy of the forecast and assumptions, and it would be good practice if that body were also able to comment on the appropriateness of the targeted debt level.

In the absence of reform along these lines, it will certainly be essential for the Chancellor to state in this Budget what the ceiling or target for net public debt will be over the new economic cycle, and to clarify matters following the acquisition by the public sector of Northern Rock.

On that subject, the CBI does have some concerns, but it would be wrong to adjust the fiscal policy stance in the short-term simply to respond to the apparent conflict with the ‘40%’ rule. While the Rock has considerable debts, it also has financial assets in the form of mortgages, and we would hope that the vast majority of the debt would never actually have to be borne by the taxpayer. It would make sense to publish the public financial position including and excluding Northern Rock, and for the debt rule to apply to the latter.

But this does raise the question of whether ‘net public sector debt’ as currently defined is the right target. Ultimately it may be optimal to target a broader estimate of public sector liabilities, with a more sophisticated treatment of ‘contingent liabilities’ and an extension to include pension liabilities amongst other things. The forthcoming completion of a new system of accounts – ‘whole of government accounts’ – may provide an opportunity to debate the merits and practicality of a shift in that direction.

4.3 The fiscal-monetary policy mix

A loose fiscal/tight monetary policy mix is less investment-friendly and less financially sustainable than the opposite pattern. Unfortunately, it is the former policy mix that has characterised the UK over the past several years, bringing with it an associated depressed level of business investment, quite possibly a stronger exchange rate than otherwise, and an accompanying squeeze on those sectors most heavily exposed to international trade.

By 2006, the rise in government spending had helped to drive public and private consumption combined to 85½% of GDP, which is very high by historical and international standards. As a result, even the UK's comparatively modest level of total investment – 18% of GDP – could only be achieved alongside a 3½%-of-GDP trade deficit. This looks unsustainable and, going forward, we hope that better balance can be achieved through a shift in the monetary-fiscal policy mix, allowing both private sector investment and the net trade position to improve simultaneously.

We also see scope for better co-ordination between the monetary and fiscal authorities. At the very least, steps should be taken to ensure that an unwelcome policy mix does not arise by 'accident', as a result for example of different economic projections by the Bank of England and Treasury. Different assessments of the 'output gap' (explicit or implicit) could for example result in the Treasury seeing no problem with a particular path for government borrowing, only for the MPC to try to offset what it sees as an inflationary impact through higher interest rates. One option worth exploring would be to run a common forecasting model, on which both monetary and fiscal policy judgements would then be based.

4.4 Improving openness and consultation

As set out earlier, the CBI and its members have become increasingly concerned about the policy-making process, including the failure to consult on matters of vital importance to business. Whether or not the underlying aim of a proposed idea

is of broad benefit or otherwise to business, where firms are affected they are in the best position to advise government on the scope for unintended consequences. Potentially affected taxpayers should also, in normal circumstances, have a right to know sufficiently in advance when the tax arrangements on which they have based their affairs are to be overturned.

We very much hope that, in future, prior consultation will be reintegrated into the policy making process, and the practice of springing surprise reforms in each Budget and PBR avoided.

4.5 A longer-term tax strategy

Finally, while the relatively poor state of the public finances is a major obstacle to tax reduction in the near term, the ambition to bring the overall tax burden down over a longer period should not be forgotten. Once the economy is back 'on trend' with borrowing back to an acceptably low level:

- Fiscal drag would on unchanged policy push up the tax-to-GDP ratio automatically, as real GDP growth of 2½% per annum is typically associated with real revenue growth of around 3%.
- As a result, if government spending grew by 2.5% per annum into the medium term, in line with GDP, discretionary tax reductions building to 1.9% of GDP in year ten (some £27bn in today's terms) could be announced, while leaving spending, revenues and borrowing all unchanged as a share of GDP.

- But if real-terms spending growth were held to 2% per annum over that time, tax reductions building to almost 4% of GDP (approaching £60bn in today's terms) would be achievable, with the tax burden ending up two percentage points of GDP lower than at the outset.
- The gross tax reduction figure would be even greater than this, if for example 'green' tax revenues turned out higher than otherwise as a side-effect of any objectively-justified policy reforms in that area.

This would allow a wide package of tax reductions over time, incorporating for example:

- A concerted reduction in taxes adding to the business cost base, which could benefit all firms regardless of their profits position at the time, in some cases shifting loss-making ventures into profit. It could make sense to align the employer NICs rate (now 12.8%) with the employee rate of 11%, and accompany this move with a similar 15% cut in business rates bills. If two more minor taxes for which there is little if any economic rationale – stamp duty land tax on business property transactions, and insurance premium tax on business policies – were phased out as well, the exchequer cost of this package would amount to just over 1% of GDP.
- Reforms to corporation tax, along the lines to be set out in the CBI Tax Task Force report to be published in the near future.

- The remaining room for manoeuvre could be used to reform the wider tax and benefit system, which can also affect the business climate and longer term sustainability of the public finances. For example, to level the 'tax playing field' between UK equity investment and other savings vehicles, stamp duty on shares could be eliminated (exchequer cost 0.2% of GDP), restrictions on the value and payment of dividend tax credits eased, and the capital gains tax treatment of shareholder gains – already eaten into by corporation tax – lightened. There would be scope to further improve incentives for work, mobility and saving through changes to the combined rates and thresholds for employee income tax and NICs, stamp duty land tax on housing (which could be phased out altogether at a cost of 0.35% of GDP), rates of working tax credit withdrawal, and means-testing of pensioner benefits.

If 'dynamic' modelling were used then tax changes along these lines would appear even more affordable. For example, if early reductions in business tax boosted GDP growth to 2.8% from the fifth year onwards, revenues could be expected to come in some £20bn higher in year ten (in today's prices) than on the 'static analysis' model, in the absence of further policy change. The real-life case of Ireland is even starker. The moderate tax policies of the past two decades have – through their impact on economic growth – left that country in a position to enjoy a higher level of taxpayer-funded expenditure per head than the UK, despite (or more likely, ultimately because of) its lower tax-to-GDP ratio.