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The manufacturers' organisation

# Our Tax Challenge

## How to Address the Tax Burden on UK Manufacturing

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# Foreword

Tax is an increasing cost and concern for UK manufacturers. A tightening fiscal position means it is also an increasing preoccupation for government as it seeks to strike a balance between improving public services and infrastructure while preserving the UK's competitiveness. It needs to avoid inefficient public spending that would act as a drag on the economy's long-run growth potential, as would an overly costly tax system that reduces incentives for work, entrepreneurship and innovation.

The growing internationalisation of business also poses a number of challenges to the UK tax system. UK tax revenues are under threat from the competitive tax rates offered by new EU members and some developing countries. Legal challenges at the EU level are eroding government's ability to determine tax measures solely at a national level.

We are concerned that the tax balance in the UK is tipping the wrong way. While some headline rates of tax have been lowered, business still faces a rising tax burden. New taxes, for example in the environmental area, as well as higher National Insurance Contributions (NICs), have added to day-to-day business costs. For manufacturers, who already struggle to pass on higher operating costs to their customers, this makes it ever harder to achieve the profits needed to fund investment in the future of their business. Business has also had to cope with the growing volume and complexity of the tax system, pushing up the administrative costs of paying taxes.

On a more positive note, government has recently been willing to review aspects of the business tax system such as the traditional schedular system for corporation tax, and has tried to simplify administrative aspects of taxation. New tax incentives such as the R&D tax credit and enhanced capital allowances for new technologies have been introduced to encourage innovative activities with wider benefits to society. The recent merger of key tax authorities into a unified Her Majesty's Revenue and Customs (HMRC) is an opportunity to do even more.

Overall, however, manufacturers report growing concern at the business tax burden. Tax is increasing the cost of doing business in the UK. These costs make it difficult for companies to reap the full benefit of strong and stable economic growth. They also detract from the UK's international competitiveness at a time when external competitive challenges are greater than ever before. A competitive and low-cost tax system is an important part of how government can help manufacturing address the challenges it faces.

This report is our contribution to the debate on how the tax system can better serve its necessary objectives without compromising the competitive position of UK business. It provides an overview of business taxation in the UK, examines how the tax burden has changed over time, how it compares with our major competitors, and explores key tax dilemmas facing business and government.

Martin Temple
*Director General*

# Introduction and summary

## Introduction

Tax should be a two-way street. Value must be delivered in return for business tax revenues and government spending should enhance, not discourage, economic activity in the private sector.

The tax burden affects business activities in different ways, depending on what is taxed. Profits, capital gains, employment, natural resources and day-to-day business activities all provide bases for taxation. Tax can affect:

- profit margins – taxes on business inputs and resources raise costs that are difficult to pass on to customers;
- international competitiveness – a higher tax burden relative to other countries reduces the competitiveness of UK business and influences decisions on where to locate production;
- decisions on investment and growth ambitions – the after-tax cost of different capital and ownership structures;
- decisions on employee recruitment and wages – the payroll costs of administering employee taxes;
- time and money spent on tax activities – the time and people cost of administering tax paperwork and in tax planning; and
- incentives for certain activities, such as research and development (R&D) or pollution – taxes can adjust the cost of these activities to better reflect their true benefit or cost to society.

How individuals are taxed also has an important impact on business. Taxes on capital influence decisions by risk-taking investors. The tax and benefit system influences decisions on work and spending that will affect a firm's labour supply, employment policies, and demand for products and services.

Not all taxes affect different business sectors in the same way. Manufacturing has particular interests in certain business taxes including capital allowances, tax treatment of leased assets, tax incentives to encourage innovation and environmental taxes. New developments facing the tax system, such as the prospect of road user-charging, and in securing improvements to UK infrastructure (including transport and education), are also important to manufacturing. Increasingly we expect tax to be an important factor in UK manufacturers' decisions on where to locate production and R&D activities. Research by EEF shows that only regulation is seen as a more negative influence than tax in assessing the competitiveness of the UK as a location for business.

In Section 1 of this report we look at how the UK tax burden compares with that of other countries and how it has been developing of late. We also consider particular issues of concern to manufacturers in meeting this tax burden. In Section 2 we look at how the UK tax and spending system needs to develop to deliver value to business while ensuring that taxes rise no further. We also examine how a reduction in the tax administration burden could be delivered through lowering the compliance costs of taxation. In Section 3, we look at how the tax system is being used to deliver policy objectives that impact on manufacturing, including R&D, environmental and climate change targets, and easing congestion through a possible road user-charging scheme.

## Summary

- **The tax burden is growing.** The UK's traditional advantage on tax is being eroded by tax cuts in other countries and the growing complexity and reach of the UK tax system. As the share of government spending in the economy has risen towards 45% of GDP, the tax burden is set to rise to its highest level for 35 years. Between 1997 and 2006, only a small handful of OECD countries such as South Korea and Iceland will have seen a greater increase than the UK in their tax burden. By comparison, the US, most large EU countries and the newly acceded members of the EU have seen their burdens fall.
- **Business is paying more tax.** In 2005/06 business will be paying approximately an additional £2.2 billion annually in corporation tax (i.e. tax on company profits and capital gains) and an additional £5.5 billion in other business-related taxes (e.g. NICs and environmental taxes) as a result of budget changes announced between 1997 and 2004.
- **Further increases in the business tax burden must be avoided.** The stronger economic growth and stability of today should be accompanied by a falling, not rising tax

burden. Even with government spending already at 45% of GDP there is pressure for taxes to rise further to cover higher than expected current spending. This is a key concern for manufacturers whose margins are already being squeezed by numerous other competitive pressures in the economy, such as the rising costs of energy, raw materials, insurance and pensions.

- **Avoid further increases in input taxes.** Rising competition has made it ever harder for manufacturers to pass on increased costs to customers. The government should therefore reconsider its current reliance on increasing input taxes such as NICs and environmental taxes. When considering any additional measures, it must take into account much more fully both the impact on competitiveness and the ability of companies to make the profits required to invest in the future of their business.
- **Need for further improvements to fiscal policy.** Considerable improvements to the operation of fiscal policy have already been made. However, greater transparency and independent monitoring of the government's two fiscal rules would improve fiscal discipline and reduce the chances of unplanned surprise tax increases.
- **Value for money.** Tax is a two-way street. Value must be delivered in return for business tax revenues. The government must succeed in its objective of delivering 2.5% annual efficiency savings in its spending. Important investment in key business infrastructure such as transport must no longer be crowded out by unplanned increases in current spending.
- **Reduce the tax burden by reducing compliance costs.** Reducing the complexity and administrative costs of the tax system is one way to reduce the business tax burden. Improvements to the early stages of the tax policy-making process and better assessment of the real-world impact of tax changes would avoid the need for costly policy reversals further down the track. The merger of tax authorities into HMRC provides an excellent opportunity to improve substantially the way business and tax authorities interact and to reduce the costs of collecting and paying tax.
- **Neutrality, simplicity and transparency should be bedrock principles of the tax system.** The reasons and justification for any departure from these principles should be spelt out clearly. Reference to these principles should be included in the development of any new, or amended, tax measure.
- **Using the tax system to influence behaviour.** Increasingly the tax system is being used to help achieve policy objectives such as raising UK levels of innovation. Experience with the R&D tax credit, however, shows the need to ensure that these measures are not undermined by costs and difficulties for companies accessing them.
- **Environmental taxes are not the only solution.** There is a growing reliance on environmental taxes and regulations. Experience with the climate change levy shows the limitations of some environmental taxes in contributing to wider environmental goals and highlights the competitive costs they impose on manufacturing. Providing more positive approaches to innovate, including through the tax system, is more likely to lead to the major technical breakthroughs needed to address key environmental problems.
- **New approaches to taxation should not add to the tax burden.** The prospect of a national distance-based road user-charging scheme may bring congestion and environmental benefits. However, transport taxes are already high and any road user-charging should replace, not add, to these taxes. There are still numerous questions to be answered before any consensus can be forged, and there must be clear commitments to deliver improvements to the UK's overall transport infrastructure.

# 1 How we compare with other countries

## Summary


- The UK's traditional low-tax advantage is eroding as other countries improve the competitiveness of their tax systems and as new low-cost countries join the ranks of competitors.
- A key feature of the recent tax system in the UK is a greater reliance on input taxes, including environmental taxes. These taxes directly raise the costs of manufacturing and are difficult to pass on to customers.
- UK corporation tax rates compare favourably with the US, France and Germany but these countries offer a greater range of selective discounts. Meanwhile, emerging competitors such as Poland are considering radical approaches to taxation, including flat tax rates.
- The development of UK tax policy is broadly in line with trends in other OECD countries, including 'making work pay' income tax policies, a greater reliance on consumption and input-based taxes and incentives for R&D.
- However, the tax burden (at around 40% of GDP) is growing in the UK, unlike in many other OECD countries. Between 1997 and 2006 only South Korea, Norway, Greece, Portugal and Iceland will have seen a greater increase than the UK in their tax burdens. Between now and 2009/10, UK national income after tax is set to grow at the slowest rate for 25 years.
- In the UK, manufacturing sees only regulation as a more negative factor than taxation in considering the UK as a competitive location. In 2005/06 business will be paying approximately an additional £2.2 billion annually in corporation tax and an additional £5.5 billion in other business-related taxes following tax changes implemented since 1997.
- Growing taxation and government spending are increasing the risk of harming the UK's economic performance. This can be seen from declining growth in private sector employment, weak stock market performance relative to our competitors and falls in international competitiveness rankings.
- UK manufacturing profitability has fallen in six out of the last seven years. Further increases in taxation will make it ever harder to break out of the cycle of weak profitability and low investment.


## UK tax system is losing competitiveness: Business views UK taxation negatively

Today, UK business views taxation negatively. In a 2004 EEF survey of 500 UK firms, companies saw the level of taxation as the second most negative factor, behind the level of regulation, in influencing the UK's position as a competitive location, as shown in Chart 1.

In this section we look at why manufacturing industry feels this way. We start by comparing how the system measures up with competitor countries, how the overall trends in policy compare with what has been going on elsewhere, and then look at changes in the overall tax burden. The key messages are that our traditional advantages are eroding and that manufacturing is suffering from a rise in taxation on inputs that affect the cost of doing business, and are extremely difficult to pass on to customers.

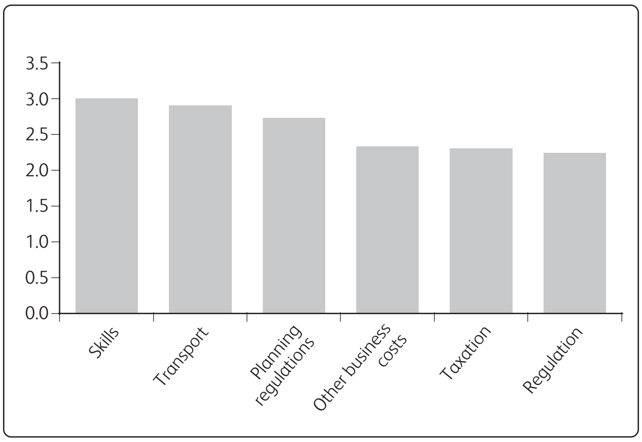
## Comparing tax systems

Table 1 compares business tax regimes in selected countries. Some of the key points to emerge are:

- **The headline UK corporation tax rate of 30% is still competitive** against Japan (42%), the US (35%), France (35%) and Germany (approximately 39%).
- **Established competitors are cutting rates faster than us**. For example, Germany's rate of 39% has been cut drastically from the mid-1990s when it was nearly 60%.
- **New competitors are offering more competitive rates**. For example China and Poland both offer rates of less than 20% in certain circumstances (usually for foreign processors). Estonia, a small country, has taken a radical step of a zero rate for profits reinvested into business. Meanwhile Poland is also considering a move to a more radical system of flat-rate taxes at around 20%.
- **Comparisons of headline rates can sometimes be misleading.** Some countries (e.g. the US) offer numerous complex reliefs, which are often temporary. Over recent years these have included enhanced capital depreciation write-offs for small business investment and reductions in the tax rates on dividend income. These can significantly reduce the tax

Chart 1 Taxation seen as negative for UK business location

Mean scores for factors contributing to the UK being a competitive location for manufacturing. 1 = a significantly negative score and a score above 3 = an overall positive rating




Source: EEF *Competitive Challenges*, 2004

bill that companies in certain sectors may be paying at any one time.

- **The UK is still competitive on the share of dividend tax collected through corporation tax.** The UK share is similar to France and Japan and lower than in the US and Germany. However, the 1997 removal of the dividend tax credit for certain non-tax-paying shareholders such as pension funds has impacted negatively on some companies. For those companies operating pension plans, the cost of doing so has risen, and therefore this cannot be viewed as a positive move for most businesses.

- **The UK levies a broader range of miscellaneous or input taxes on business than other countries**. In European countries these taxes tend to be labour-based social security contributions, while the UK relies more on a larger number of smaller input-based taxes, particularly in the environmental area. Energy and environmental taxation take a greater share of UK GDP than in many European countries, and in 2002 the UK had an above EU average share of environmental taxation in GDP. Over the same period only Denmark collected more energy tax revenues than the UK. As we will see in Section 3 of this report, the UK also has amongst the highest transport taxes in the EU.

## Direction of policy similar to competitors

Table 2 compares UK tax policy to other OECD countries in recent years and suggests that it is developing along similar lines to other OECD countries. However, a number of other developments have raised taxation in the UK relative to competitor countries. These have included:

- A retrospective one-off windfall tax on large utility sector profits levied in 1997/98 at a cost to shareholders at the time of £5.2 billion.

- Changes in 1999 to the timing of corporation tax payments for large companies. This brought forward payment of taxes for a few years during the transition to a new quarterly instalment payment scheme.

- A significant focus on new anti-avoidance measures for corporation tax. This reduces the scope for businesses to legally manage and minimise their tax burden and is designed to protect and possibly increase corporation tax revenues.

- A 1% rise in NIC rates applying since 2003/04.

## Tax burden rising

Despite the fact that the overall direction of UK tax policy is similar to other OECD countries, some of the additional measures introduced in the UK mean that the UK tax burden is rising and that we are losing competitiveness on tax relative to these countries. Table 3 shows that taxation and government are taking a growing share of GDP in the UK.

This increase in taxation means that post-tax national income is set to grow at its slowest rate for 25 years. The Institute for Fiscal Studies estimates that average annual growth in national income after tax of 2.4% since 1997 (measured as national income minus receipts) only matched that of the early to mid-1990s despite faster economic growth. Looking ahead, national income after tax is forecast to grow annually by only 1.8% between 2005/06 and 2009/10 (see Chart 2 on page 8). This is because tax revenues are forecast by the government to rise further to finance planned spending and to meet the Chancellor's fiscal rules. If this forecast proves accurate, national income after tax will not have risen so slowly in the UK since the recession of the early 1980s.

## Table 1 Comparison of business tax regimes in selected countries

| Country | Corporation tax rate (2004) | Share of dividend tax rate collected through corporation tax | Business input taxes | R&D tax incentives | Additional comments |
|---|---|---|---|---|---|
| UK | 30 % | 63.2 % | Stamp duty, insurance tax, transport excise taxes, environment taxes, regulator fees | Yes | |
| US | 35 % (approx. 40 % if state taxes are included) | 77.6 % | More reliance on income than consumption taxes. Examples of input tax include insurance tax, transport excise taxes and company licence tax | Yes | Generous tax reliefs significantly reduce corporation tax burden, despite high corporation tax rate |
| France | 35 % | 61.8 % | For example, local *taxe professionnelle* on non-payroll business activity (but exemptions for manufacturing), insurance tax and document registration tax | Yes | |
| Germany | 38.9 % | 72.8 % | For example, insurance and stamp duties, energy taxes | Not at national level | Proposal to drop corporation tax rate to 32.3 % and increase dividend tax to help adjust for revenue loss |
| Estonia | 0 % on retained earnings, 26 % on distributed profits | – | No local business taxes and no stamp duty | No tax incentives provided at all | A small economy, but approach has prompted interest in flat taxes by new EU entrants |
| Poland | 19 % (lower rates in special economic zones) | 55.2 % | No local business taxes, but stamp duty is charged | Investment tax relief provided; covers R&D | Proposal to move to a flat tax system for all income, corporation and consumption |
| Japan | 42 % | 63.4 % | Complex tax system with additional minor business taxes such as stamp duty on documents, planning and property taxes | Yes | |
| China | 33 % (lower rates of 15 % or 24 % if foreign and located in special zones) | – | Stamp duty/business tax on service activity and sale of business assets. Additional consumption tax on production industries | Yes, and other incentives can be awarded by discretion | Tax reform due in 2005. WTO membership constrains scope for discretionary tax treatments |

Sources: Various, including *KPMG Corporate Tax Rate Survey, 2004*

Notes: (1) local taxes taken into account where applicable; (2) column three shows the share of the overall tax rate on dividend income collected through corporate income taxes as opposed to individual income tax

## Table 2 UK tax policy changes largely in step with OECD trends

| OECD trend | UK performance |
|---|---|
| **Lower tax rates but broader tax bases** | Main corporation tax rate reduced from 33% to 30% between 1997 and 1999. Compensating base-broadening included anti-avoidance measures and abolition of the dividend tax credit |
| **'Make work pay' initiatives on income tax** | 1999 introduction of lower (10%) starting rate and 1% reduction in basic rate of income tax in 2000 |
| **Move towards dual income taxes (lower taxes on capital than on labour)** | Introduction of taper relief for capital gains tax in 1998 to reduce amount of tax payable the longer an asset is held to encourage long-term investment |
| **Integration of social benefits into the tax system** – e.g. refundable tax credits to encourage low income groups into the workforce | Introduction in 2003 of working tax credit and child tax credit, separating support for adult workers from support for children |
| **Relief for taxation on dividend income** encouraging companies to distribute rather than retain their profits | 1999 abolition of advanced corporation tax (ACT) charge on dividends; provided some tax relief for companies with small UK-based profits relative to overseas dividend income, but in 1997 the dividend tax credit paid to shareholders to avoid double taxation became non-refundable, negatively affecting non-tax-paying shareholders – e.g. pension funds |
| **Greater reliance on consumption taxes** | For business, implementation of new input taxes – e.g. climate change levy and increased fuel duty – based on the costs of doing business rather than on profits |
| **Reduction in complexity** | No significant substantive improvements. Tax law rewrite project under way addresses legal complexities only. Limited reform of corporation tax envisaged to better align the schedular system with accounting principles. Some administrative improvements made to facilitate better government–business interface on tax issues, including Inland Revenue's Large Business Service and the merger of HM Customs and Inland Revenue |
| **Introduction of market-based environmental instruments/taxes** | Enhanced capital allowances for energy-efficient technology introduced in 2001. Climate change levy, emissions trading scheme, aggregates levy and landfill tax introduced. Reduction of employer NICs to compensate for climate change levy |
| **More favourable tax environment for small business** | Small company tax rate reduced from 23% to 19% between 1997 and 2002. Introduction of a minimum tax rate of 19% levied on distributed profits and 0% on retained earnings if profits are less than £10,000. More generous capital allowances for SMEs of 40% made permanent from 2000 |
| **Tax incentives to encourage R&D** | Volume-based tax credit for SMEs allowing 150% deduction of qualifying R&D expenditure introduced in 2000. Credit for large companies at a rate of 125% introduced in 2002 |

Source: OECD, *Recent Tax Policy Trends and Reforms in OECD Countries, 2004* and EEF analysis

## Business is paying more

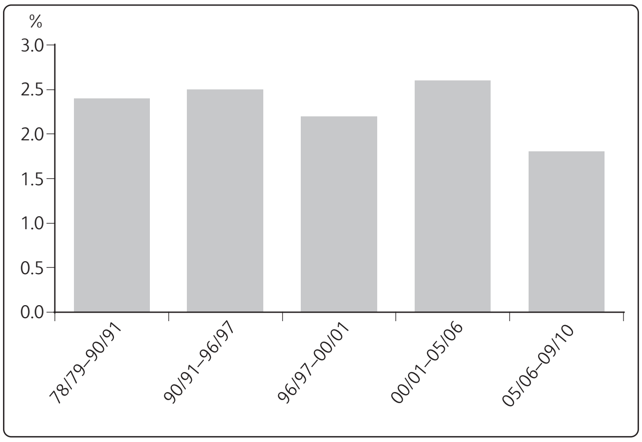
In 2003/04 the government collected almost £400 billion in taxes. Corporation tax on profits and rates on business property made up nearly 12% of this revenue. However once the full range of taxes relevant to business are included, business paid considerably more – in total £134 billion in tax in 2003/04. This is approximately one-third of total tax revenue.

Since 1997 there have been over 120 adjustments to business-relevant taxes. Some changes have raised revenue and others have reduced it, for example through tax rate reductions and tax incentives. The exact business tax burden is difficult to isolate as some business-relevant taxes are levied on individuals rather than business (e.g. employee NICs, dividend returns) but will still affect business performance through individual incentives to work and invest. Other taxes, such as stamp duty and air passenger taxes, are not levied exclusively on business, although business pays a share of these.

The evidence suggests the UK business tax burden is rising, despite cuts in the headline rates of corporation tax. Table 4 shows that by 2005/06 business will be paying approximately an additional £2.2 billion annually in corporation tax (i.e. tax on company profits and capital gains) and an additional £5.5 billion in other business-related taxes (e.g. employer NICs and environmental taxes). Some of the increases incorporated in the figures, such as the timing of corporation tax payments, will also drop out in future years due to their temporary nature.

Chart 2 Post-tax national income set to grow at slowest rate for 25 years

Average % increase over recent and forthcoming parliaments




Source: IFS, *Election Briefing 2005, Taxation*, series editors Robert Chore and Carl Emmerson

In Table 4 we attribute the payment of capital gains tax to business, although it also falls on private individuals. To the extent this burden on private individuals influences investment behaviour, capital gains tax is associated with the business tax burden. Our figures include the 1997 removal of the dividend tax credit for pension funds. Removal of this tax relief has been worth an annual £5.4 billion to the Treasury, but some have argued that the impact has fallen on investors and holders of pension plans rather than on business. However, the resulting reduction in equity returns and shortfalls in pension funds, which many businesses have been trying to fill, mean that it is correct to attribute the bulk of this effect to the business and investor sector.

## Table 3 UK tax burden on the rise

| | 1996/97 | 2004/05 | 2009/10 (forecast) | Trends |
|---|---|---|---|---|
| **Net taxes and NICs as % of GDP** | 34.8 | 36.3 | 38.5 (highest level for 25 years) | Rose in late 1990s, fell back after stock market fall in 2000 and has been rising since 2003 |
| **Current government receipts as % of GDP** | 37.1 | 38.3 | 40.6 (highest level for 11 years) | Compares slightly more favourably with 1979–1997 average of 40.6%, but expected to rise in future |

Sources: HM Treasury, *Budget 2005*, and IFS, *Election Briefing 2005, Taxation*

Notes: (1) approximately 30% of receipts collected by government are returned to the private sector in social security payments and tax credits (2) in 2004/05, government's net tax collection is forecast at £425.6 billion

## Table 4 New measures mean business is paying more

Cumulative impact on business taxation of measures introduced between 1997 and 2004 (£ billion)

| | Average 1997/98 to 2002/03 | 2003/04 | 2004/05 (forecast) | 2005/06 (forecast) |
|---|---|---|---|---|
| **Taxes on profits** (e.g. corporation tax and capital gains tax) | 4.93 | 0.97 | 1.28 | 2.19 |
| **Taxes on inputs** (e.g. NICs, fuel duties and environmental taxes) | 1.17 | 4.93 | 5.02 | 5.57 |
| **Total** | **6.10** | **5.90** | **6.30** | **7.76** |

Sources: HM Treasury *Budget Books* and EEF calculations

In Table 4 we also assume that business pays one-fifth of stamp duty, one-third of vehicle excise duty, insurance premium tax and air passenger duty, and one-half of road fuel duties.

## UK tax competitiveness eroding

Though the UK still has one of the lower tax burdens in the OECD (position 12 out of 27 in 2005), its position is slipping. In Chart 3, we compare total tax and non-tax receipts as a share of GDP. (Non-tax receipts such as licensing fees are typically around 2% of GDP in the UK.) The chart shows that in 1997 the UK tax burden was 39.1% of GDP – just below the OECD average of 39.2%. While the OECD average has since fallen back to 37.6%, the UK's has risen to 41.6%. The gap with the eurozone has also closed substantially.

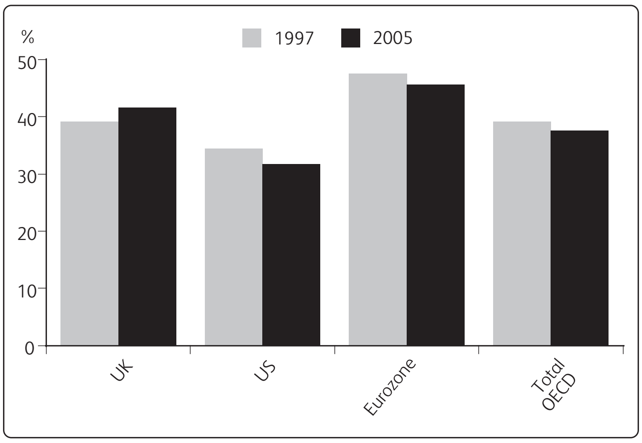
The UK's deteriorating position is explained by the fact that it is one of only 11 countries that will have seen the tax burden rise between 1997 and 2006, while it has fallen in 16 of them. In fact, between 1997 and 2006 only South Korea, Norway, Greece, Portugal and Iceland will have seen a greater increase than the UK in their tax burdens (as forecast by government receipts), as shown in Chart 4. By comparison, the US, most large European nations and the newly acceded EU member states such as Poland have all seen their burden fall over this period.

## Rising tax and government spending starting to hit economy

Taxes have risen to fund the rising share of government spending in the economy. This has grown from 41.4% of GDP in 1997 to 45% in 2005. This partly reflects a concerted effort to prioritise key public services such as the National Health Service to compensate for lower levels of investment in the past. At around 45% of GDP in 2005 this spending is broadly in line with OECD averages and is still somewhat less than some European countries (see Chart 5). However, as we have already explored, the direction of change in the UK is out of step with other OECD countries, which are trying to reduce the role of government in their economies. While the share of the UK government in the

Chart 3 UK tax burden rises above OECD average

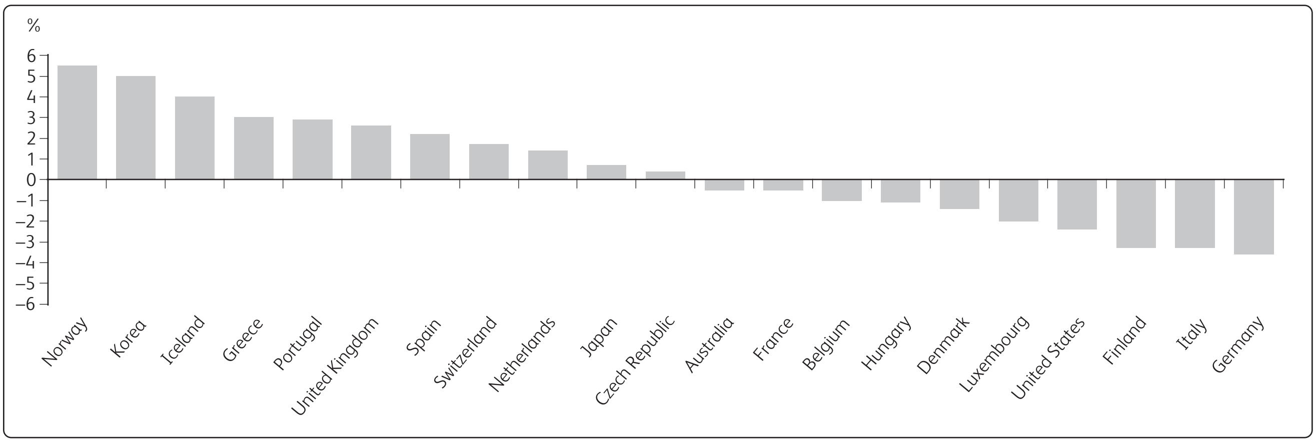
General government total tax and non-tax receipts in 1997 and 2005 as a % of GDP




Source: OECD, *Economic Outlook 2005*

Chart 4 Taxes rise in the UK but fall in most OECD countries

% change in general government current tax and non-tax receipts as a % of national income between 1997 and 2006




Source: OECD, *Economic Outlook 2005*

economy was also over 40% in the late 1980s and early 1990s, unemployment was much higher then, depressing tax receipts and boosting welfare spending.

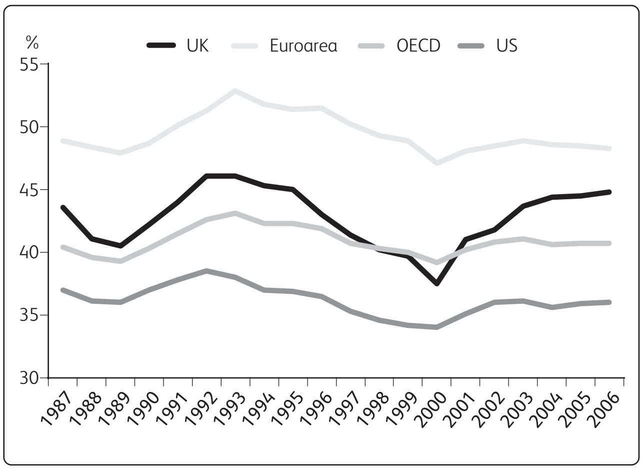
A high share of government in the economy threatens economic growth when the costs of raising taxes outweighs the benefit of new government spending, and when productive private sector activity is crowded out by less efficient government activity. There is no agreement about at which point this occurs and country experiences have differed considerably. A complex and difficult to use tax system that makes payment and collection of taxes expensive, combined with poor-quality public expenditure, will also increase the likelihood that this turning point is reached sooner rather than later.

There is evidence that economic growth in the private sector may be constrained by rising government spending and investment. Spending and resource accumulation in the traditionally less productive public sector can 'crowd out' more productive and wealth-creating activity in the private sector. This means that public sector-led growth could result in a lower overall growth rate than might otherwise be expected. While UK economic growth has been strong until recently, there are some signs that this might now be happening.

For example, labour market data shows that public sector employment has been growing strongly since the late 1990s and its rate of increase has outstripped that of the private sector in recent years. By contrast, as Chart 6 shows, since 2000 the rate of growth in private sector employment has largely been falling. Public sector employment is only 20% of all employment, but in both 2002 and 2003 public sector jobs increased by around 150,000 a year, while the corresponding increases for private sector employment were 165,000 and 119,000 jobs. By early 2004, 10% of public sector jobs held had been created since 1998. The corresponding figure for the private sector was less than half this at 4.7%.

Chart 5 Rising share of govt in UK economy bucks international trend

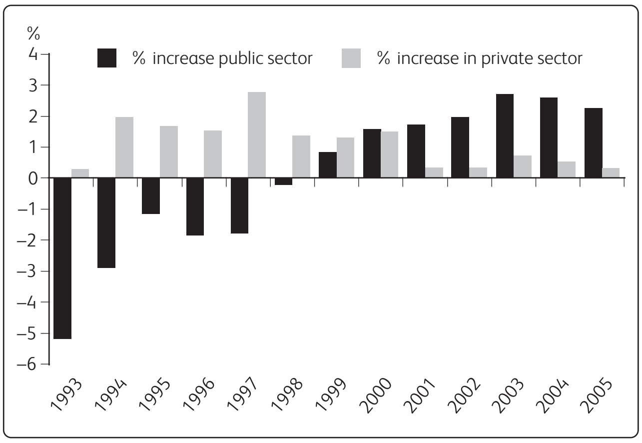
Central government outlays as a % of GDP




Source: OECD, *Economic Outlook 2005*

Chart 6 Private sector employment growth has stalled

Annual % increase in numbers employed (year to Q2, except for 2004/05, which is year to Q1)



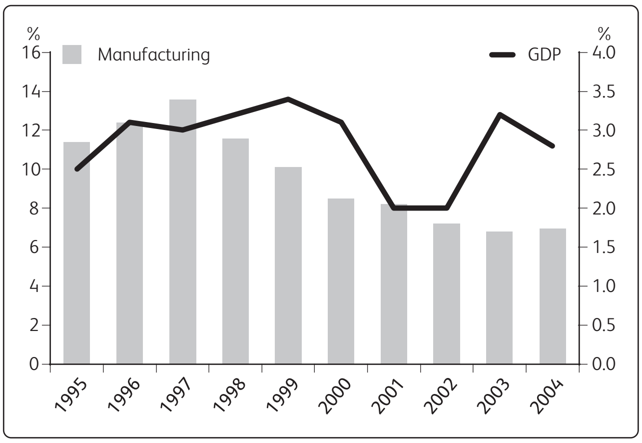

Source: EEF and Office for National Statistics

Although the rate of public sector job growth has eased over the past year, possibly in response to new public spending efficiency requirements, the rate of private sector job creation has continued to decline. Overall, the evidence suggests that labour resource has been diverted to public sector activity.

This is further supported by a survey conducted by the Chartered Institute of Personnel Development (CIPD) showing stronger wage growth in the public sector. Over the last four years, salaries for public sector employees have grown more than their private sector counterparts, with a 17% pay differential for the public sector 'median' worker. Improved public service remuneration is welcome if it improves the conditions for effective and efficient public service delivery. However, combined with the growth in public sector jobs it may make labour market conditions more difficult for the private sector.

Chart 7 UK manufacturing profitability fails to keep up with GDP growth

Profitability as % annual net rate of return on capital and % annual GDP growth




Source: EEF and Office for National Statistics

Another signal that private sector economic activity may be weaker than what would be expected from whole economy growth rates can be found in the stock market. The UK stock market has actually underperformed relative to other countries since 1997, despite strong GDP growth rates of between 2% and 4%. The value of equities has fallen by 0.1% a year in the UK, compared with annual rates of growth of 4.2% in the US and 5.1% in France. This weak performance may reflect assessments made by investors of the present and future impact of growing tax and regulatory costs on company value. Furthermore, if this weakness reflects the fact that GDP growth is being generated by increasing public rather than private investment, we may be storing up trouble for the future as

## Table 5 UK manufacturing profitability trails competitors

Profitability as the ratio of profits to capital employed

| Country | % |
|---|---|
| Belgium | 21.0 |
| Australia | 20.3 |
| Finland | 18.9 |
| Spain | 13.8 |
| Denmark | 12.0 |
| Netherlands | 12.0 |
| Canada | 10.6 |
| Mexico | 7.4 |
| Norway | 6.7 |
| Korea | 5.5 |
| Hungary | 5.0 |
| US | 4.4 |
| UK | 3.6 |

Source: Office for National Statistics, *Economic Trends*, October 2002 additional public spending is unlikely to match the wealth creation capability of the private sector.

A growing public sector and rising tax burden may also be reflected in weaker international competitiveness. Although the evidence is mixed, it suggests that tax plays a role in influencing competitiveness by adding to the costs of business. In international competitiveness rankings, both high- and low-tax countries perform well, although there is some evidence that corporate taxation influences competitiveness more than personal, social or indirect taxes. Using a range of different indicators, including taxation, the IMD World Competitiveness survey shows the UK slipping from position 12 in 1998, to 19 in 2003, and to 22 in both 2004 and 2005.

## Profitability under pressure

UK manufacturing profitability has fallen in six out of the last seven years. Returns in this sector are roughly half those in the services sector. Chart 7 shows that manufacturing profitability has not bounced back with GDP growth as would normally be expected.

In international league tables for 2000/01 compiled by Laura Citron and Richard Walton of the Bank of England, UK whole economy profitability comes out fourth among 23 developed countries. However, a similar exercise for UK manufacturing places profitability at the bottom of 23 developed countries, as Table 5 on page 11 shows. This ranking is unlikely to have improved over recent years, given a combination of rising costs and a generally unfavourable exchange rate.

This squeeze on corporate profits illustrates the competitive challenges facing manufacturing. While a range of costs such as raw materials, energy, pensions and insurance are rising, price rises are hard to achieve. Rising taxation, particularly if it adds to operating costs, further depresses profitability. Manufacturing needs to escape from a cycle of weak profits and low investment, and any further increase in business taxation will make this task ever more difficult.

# 2 How does the tax and spending system need to develop?

## Summary

In a tightening fiscal environment, given concerns that growth in public spending could detract from future economic growth, we must avoid any further increase in business taxation and in government spending as a share of the economy. This could be achieved through:

**Further improving the stability and transparency of the government's tax and spend activities to avoid spending getting ahead of tax revenues:**

- Improving forecasting transparency by publishing more clearly the probabilities of meeting fiscal targets.
- Enhancing independent scrutiny with an independent body to make official tax revenue forecasts, judging if the fiscal rules are on track to be met.
- Improving costings of fiscal policy to identify more accurately the impact of new policy and tax measures on the public finances.

**Improving the value from the spending of tax revenue, including through greater efficiency in public spending and delivering promised infrastructure improvements:**

- Improving the efficiency of government spending and ensuring the commitment to deliver annual efficiency gains in public spending of 2.5% leading to savings of £21 billion by 2007/08 is met.
- Providing more transparency and an independent assessment on progress in the delivery of pledged investments.

**Delivering a cut in the UK business tax burden by reducing the administrative and compliance burden of taxation:**

- Improving tax policy making by:
  - Applying progress made on better regulation initiatives to taxation, including designing quantifiable targets for reductions in the tax administrative burden.
  - Improving regulatory impact assessments and including greater transparency on how costings are developed.
  - Automatic review of measures to see whether anticipated costs and benefits are borne out.
  - Provision of a clearer policy rationale for new tax measures.
  - Front-loading of more comprehensive analysis into the policy development process, particularly where tax revenues are to be recycled directly back to taxpayers.
- Easing the compliance burden by:
  - Streamlining compliance features of different taxes.
  - Publication and promotion of plain language guidance.
  - Facilitating access to existing tax reliefs.
  - Ensuring that statistics collection via the tax system takes place at minimum cost.
  - Improving links and relationships between government and tax authorities.

## Tax rises must be avoided

During the government's first term, public finances improved as spending growth was limited and buoyant stock markets boosted tax revenues. Now, public spending growth has accelerated while corporation tax revenues have struggled to keep up with forecasts. Economic growth has slowed this year, adding to concerns that it will not be sufficient to generate the tax revenue needed for planned spending. This is fuelling speculation that taxes will need to rise at some point in the future.

EEF is opposed to any further tax increases on business, particularly to fund over-budget current spending. We are also wary of attempts to raise new revenue from business, for example by closing down legitimate routes previously used by businesses to manage their tax burden. The same concern holds for introducing or changing tax measures and legislation in a way designed to raise revenue rather than to address legitimate policy concerns.

In the longer term, we believe the ratio of public spending to GDP has reached the threshold of what is sustainable in providing key government services, without crowding out private sector activity and jeopardising economic growth.

In this tightening fiscal environment the priority must be to avoid any further increase in taxation. To achieve this, several approaches are needed:

- Avoiding any further increase in government spending as a share of the economy given the concerns that it may detract from future economic growth and competitiveness.
- Further improving the stability and transparency of the government's tax and spend activities to avoid spending getting ahead of tax revenues.
- Improving the value from the spending of tax revenue, including through greater efficiency in public spending and delivering promised infrastructure improvements.
- Reducing the administrative and compliance burden of taxation.

## Improving the fiscal rules

The government operates two fiscal rules to encourage a prudent approach. It has already significantly increased the transparency of the public finances. Table 6 explains the rules and looks at progress in meeting them. Recent revisions to GDP in the late 1990s have prompted the Chancellor to put back the start of the current economic cycle from 1999/00 to 1997/98. This substantially increases the prospects of meeting the 'golden rule' in the current economic cycle but does nothing to suggest that taxes will not need to rise over the next cycle.

In the longer term, based on government forecasts of economic growth and planned expenditure out to the year 2009/10, current receipts (i.e. tax) for the government need to rise by just over 3% a year. This is greater than the rate of economic growth expected at around 2.3% a year over that period, suggesting that economic growth alone will not deliver the required revenues.

However, the government looks on course to meet the other fiscal rule, the 'sustainable investment' rule. This discourages the government from increasing its long-term debt to finance current, or day-to-day, spending.

Further improvements in the transparency of how the rules operate could help provide notice of a problem where public spending was getting too far ahead of tax revenues or to prevent this happening in the first place. For example, rigorous independent analysis of projections for tax revenues would help to avoid situations whereby increased spending is financed by expected growth in tax revenues that does not materialise. Increased transparency would allow more lead time to reconcile the two, avoid unwelcome and surprise tax increases, and help to rein in growth in public spending.

The way in which progress towards meeting the rules is measured and conveyed can have an important bearing on whether additional tax revenue will be needed in the future. The golden rule currently represents each annual budget position as a share of that year's GDP, and adds them up across the whole economic cycle. This means that a surplus of £5 billion in 1999, for example, counts for more than a deficit of the same amount in 2005 because the economy (or the denominator) has grown over that period. Given that the current cycle started with a large surplus, this method makes it easier to meet the golden rule now.

However, if we enter the next cycle with deficits, these will loom larger as a share of the economy relative to the surpluses required later on to balance the budget over the economic cycle. Moreover, the ability of the government to shift the goal posts by redefining the dates of the economic cycle while it is still in progress allows difficult decisions on tax and spend policies to be massaged over different, and possibly more politically convenient, time periods.

This shows that the rules may not be exerting sufficient control on spending and borrowing. In some respects, the setting of the fiscal rules is fairly arbitrary and the greatest damage from either not meeting, or amending them, may be lost credibility. It is unrealistic to advocate that all fiscal policy is 'outsourced' to an independent arbiter in the way that has been done for monetary policy. However, these problems demonstrate the benefits of further transparency and independence in the monitoring of fiscal policy. The following improvements should be made to the operation of fiscal policy:

- **Improved forecasting transparency.** Without altering fiscal targets, it should be possible to publish more clearly the

## Table 6 The fiscal rules explained

| Rule | Description | Progress |
| --- | --- | --- |
| **The golden rule**: government should only borrow to finance investment spending (spending for the future) while current spending (spending today) should be covered by tax and other revenues | The average or cumulative balance of current budget balances over the economic cycle should be zero or positive | Current economic cycle had been estimated to cover 1999/00 to 2005/06 but the starting point has now been changed to 1997. It seemed likely that the rule would not have been met. However, the change to the start and end dates of the cycle gives more leeway for extra borrowing and for the rule to be met. However, meeting the rule remains difficult in the next cycle |
| **The sustainable investment rule**: public sector debt should be kept at a stable and prudent level | Public sector debt (net of financial assets – mostly foreign exchange reserves) should be no more than 40% of GDP. The rule needs to be satisfied in each year of the economic cycle | The debt-to-GDP ratio is comfortably under 40% at around 34%, and it is unlikely to be breached, although inclusion of 'off budget' items such as the Private Finance Initiative would bring up this figure |

Sources: EEF and IFS, *Election Briefing 2005: The Public Finances*

probabilities of meeting a forecasting target. Uncertainties pervade any exercise in forecasting, but at present that level of uncertainty is not easy to discern in the government's published forecasts on spending, taxation and economic growth. Instead, cautious underlying assumptions (reviewed by the National Audit Office) are used to adjust forecasts before publication. Improving transparency would help outsiders to identify the prospects for meeting targets as different events take place.

- **Enhanced independent scrutiny**. An independent body could make official tax revenue forecasts, judging if the fiscal rules were being adhered to. Currently the National Audit Office only reviews whether fiscal forecasting assumptions are reasonable. An independent body could also comment on the revenue implications of new tax proposals and decide on the start and end points of the economic cycle over which the current rules need to be met. Decisions on the fiscal rules themselves, spending plans and taxation, would remain with the government.
- **Improved costings of fiscal policy.** Better costing of new policies would identify more accurately their impact and would assist forecasting. It would also help identify unnecessary compliance costs at an early stage.

## Ensuring tax revenues are well spent

The fiscal rules are also designed to prevent day-to-day government spending crowding out important investment in the UK's infrastructure. Over the economic cycle, government can borrow only to fund public investment. However, in the shorter run these rules do not necessarily ensure that public infrastructure investment pledges will be met. This is partly because the rules need to be met within an economic cycle, and not from year to year, allowing investment to be deferred to the end of the cycle and delaying much-needed infrastructure improvements. These problems are compounded by a blurring of the lines between 'current' or 'investment' spending and whether the spending is 'on' or 'off' government books (for example under the private finance initiative).

Transport investment is one area of particular interest to manufacturers. In the initial years of the current government, annual increases in transport spending of around 5% were on a par with key priorities such as health and education. However, this came to a halt in the 2004 spending review and transport spending is now planned to grow only in line with annual GDP growth at around 2.3% to 2.5%. Accordingly, some of the initial targets in the ten-year transport plan produced in 2000 have already been dropped or amended. For example, a significant share of the money initially allocated to improved railways infrastructure has been diverted towards financing maintenance of the existing stock. Revised plans imply a level of spending that may be insufficient to meet the initial targets. A reclassification of road maintenance as capital, rather than current spending, further muddies the waters.

While a pound spent on public capital expenditure will not always produce more value than a pound of current spending, failure to deliver important investment at a time of buoyant economic performance and rising government spending is worrying. Possible routes to addressing these problems are:

- **To improve the efficiency of government spending so that more is delivered for a given spend.** This has already been recognised and reflected in the 2004 spending review, which committed the government to delivering 2.5% annual efficiency gains in public spending, leading to savings of £21 billion by 2007/08. This is an ambitious target and difficult to measure but the government must meet it. Careful monitoring and assessment of progress is needed, including ensuring that efficiency gains realised are not used to justify a further increase in the ratio of government spending to national income.
- **To ensure a greater level of transparency on the delivery of pledged investments.** The National Audit Office already independently reviews government spending for efficiency and effectiveness. However, regular, independently prepared progress reports on whether key spending pledges are being realised, reasons for divergence, and recommendations on adjustments to spending and investment plans are needed. They would help in assessing whether the value for money implied by spending plans is actually realised.

## Cutting compliance costs and making better tax policy: The administrative burden is growing

Recent evidence suggests that the administrative burden of taxation has become a growing problem. For example, a survey by the Institute of Directors in 2003 showed that 78% of its members were spending more time and money on tax-related paperwork. These concerns were acknowledged in a recent House of Commons Treasury Committee report. Although the complexities in measuring the administrative burden meant the Committee could not measure the direction of change for costs in this area, it concluded that current government targets to reduce these costs were not rigorous enough.

The compliance aspect of tax continues to grow. The most recent Finance Bill alone contained 563 pages of legislation and associated guidance to digest. Recent changes to transfer pricing legislation require all intra-group transactions within the UK to be priced and recorded in accordance with the transfer pricing legislation that has traditionally been applied only to cross-border transactions. The cost of payroll administration is probably the largest tax administration cost for employers and this task has been made more complex as obligations to administer student loans, personal tax credits and maternity pay have been loaded onto their payroll. Studies of payroll compliance costs show that they are regressive and hit smaller and medium-sized firms much harder than larger firms.

Over time, the UK tax system has evolved piecemeal, resulting in lengthy and complicated bodies of legislation and guidance. So far, no government has undertaken a substantial reform or simplification. Instead, partial reforms have delivered small improvements or have in some instances themselves resulted in more complexity. The recent merger of Customs and Excise and Inland Revenue into a single department – Her Majesty's Revenue and Customs (HMRC) – is a chance to step up efforts to improve the tax policy process and to reduce the compliance costs of taxation.

However, some of the current initiatives are unlikely to deliver much for business. For example, corporation tax reform seems set to fall short of its ambition to simplify the schedular system. In addition, the current tax law rewrite project is aimed at tax practitioners and lawyers and will not result in substantive simplification for business. The introduction of self-assessment by business of their tax position has reduced the chances of numerous tax authority assessments and appeals. However, less positively, it has shifted a share of the burden of tax administration from tax authorities to taxpayers.

More encouragingly, reviews are under way on the links between tax authorities and small and medium-sized business, and expectations are high that they will deliver improvements in documentation requirements and HMRC service delivery. Some improvements have already been made for large corporates – for example establishment of the large business office to streamline dealings with HMRC.

## Improving tax policy making

If the potential operational impact on companies of implementing a new tax measure were more integral to the early stage of tax policy development, 'nasty' compliance surprises further down the track could be minimised. Good tax policy making can also reduce the need for complex anti-avoidance measures to fill loopholes caused by unnecessary complexity in legislation.

- **Applying progress made on better regulation to taxation.** Improving the quality, and reducing the quantity, of government regulation is a key objective of the current government. Progress in applying better regulation principles must also be reflected in the taxation area. The government has recognised the importance of improving the administrative burden of taxation. However, it also needs to make sure that better regulation principles pervade the policy-making aspect of the tax system. The government has recently announced that regulation action plans will set quantifiable targets to reduce the regulatory burden, and this should also be applied in the field of taxation.
- **Improving regulatory impact assessments (RIAs)** aiming to assess the costs, benefits and risks of a government policy proposal. A welcome development is that from 2005 HMRC will publish impact assessments of all operational changes that could significantly affect business (e.g. new tax forms). However, there is still room for improvement, and tax RIAs should be more rigorous and clearly isolate new costs over and above existing compliance obligations. This would also allow better feedback from business on whether the assessment reflects 'real-world' business operating practice
- **Increased transparency on how costings are developed** would help an accurate assessment of whether correct assumptions are being used and whether the compliance costs are in proportion to the benefits of the measure. An example is a current proposal to ensure that longer-term financing leases are taxed equivalently to debt finance for firms making capital investments. The costings contained in a partial regulatory assessment are fairly opaque. However, closer analysis shows that the proposals may catch a number of lease transactions not intended by the policy's original objective. This could raise the cost of capital for investing firms, making it harder for firms to break their reliance on internal financing for capital investments – a barrier that the government has previously indicated it is concerned about.
- **Measures should be automatically reviewed to see whether anticipated costs and benefits are borne out, and amended when they are not**. An example where this has worked is the reversal of the requirement for employers to pay personal tax credits to employees on behalf of the government. Following serious concerns raised about the additional costs of this measure to payroll administration it will be slowly phased out between November 2005 and April 2006. However, an early and more robust regulatory impact assessment could have avoided this situation.
- **Clearer policy (as opposed to technical) rationales should be provided for new measures**, including an assessment of how they fit with the government's ambitions for the tax system, such as consistency, transparency and responsiveness to market failures. Considering the interaction between related tax and regulatory measures would help avoid situations where tax measures pull in different directions from other areas of government policy. For example, the current tax treatment of employee physiotherapy and rehabilitation services is inconsistent with the government's wider objective of getting people back to work through faster rehabilitation. If an employer provides treatment for a work-related physical condition it is not a taxable benefit. However, if the injury is not work-related, but the employer still offers the rehabilitation, it is charged as a

taxable benefit on the employee. Quite apart from the accounting cost of treating the two similar transactions differently, the disincentive for treatment may cause employees to stay at home awaiting NHS treatment, delaying their rehabilitation.

- **Front-loading more comprehensive analysis into the policy development process** would also prevent unsatisfactory results further down the line where tax revenues are to be recycled to taxpayers. For example, environmental taxes (where revenues are returned to taxpayers through a corresponding cut in another tax or through business support programmes) should be predicated on evidence that those paying the lion's share of the tax will actually have access to the recycled revenue.

## Easing the compliance burden

A number of steps based around improved risk management by tax authorities, greater flexibility and improved communication should also be taken to help relieve the compliance burden of taxation.

- **Compliance rationalisation**. There are numerous taxes with different bases and thresholds to be calculated, information requirements, and tax rates to be calculated. Where feasible, harmonisation of compliance elements of different taxes should be pursued, especially given that more standardised approaches following the merger into HMRC should now be possible. One example that has long been identified is the difference between PAYE and NIC taxes that are calculated based on different definitions, documents and time periods. A further area where rationalisation is needed concerns which aspects of commercial expenditure are tax deductible, with the dividing lines often arbitrary. Key costs imposed by government regulations, such as expenditure to meet health and safety requirements, should also be tax deductible.

- **Publication and promotion of plain language guidance.** By their very nature, tax rules are usually dense and complex. Publication and dissemination of current 'plain English' guides with links to more detailed information sources is essential. Guidelines of this nature may shortly be published for the SME R&D tax credit scheme, a welcome initiative five years after the credit was first introduced. Low awareness and uptake of good tax initiatives for business, such as the VAT flat-rate scheme, could be overcome by using multiple routes to communicate with business, particularly through organisations that are already delivering support to business such as the Manufacturing Advisory Service and Business Links.

- **Improving access to tax reliefs.** Tax reliefs such as the R&D tax credit operate to promote beneficial activity that might not otherwise be provided by the market. However, compliance costs and administrative delays can prevent the uptake of these reliefs. A recent EEF and CBI survey showed that the R&D credit is making a mark in encouraging R&D with 18% of companies increasing their spending directly as a result of it, and that most companies who had used the credit previously were also planning to apply for it again.

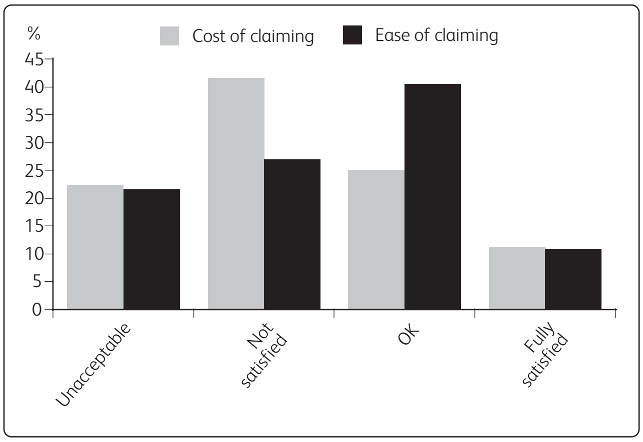
### Table 7 Problems in accessing the R&D tax credit

| |
|---|
| Over 30% of SMEs in the survey graded the handling of their claim by Inland Revenue as unacceptable |
| Over 40% of SMEs thought the ease of claiming the credit was unacceptable |
| For 54% of respondents of all company sizes the cost of claiming the credit was seen as unsatisfactory |

Source: CBI/EEF survey of experience with the R&D tax credit, April/May 2005

Chart 8 Experience with ease and cost of claiming the R&D tax credit

% of respondent companies (all sizes)




Source: CBI/EEF survey of experiences with the R&D tax credit, April/May 2005

However, a number of frustrations were voiced with the process of claiming the credit (see Table 7 and Chart 8). These negative perceptions and administrative costs may deter firms from claiming the credit and undermine the overall objective of increasing R&D activity. An open attitude whereby tax authorities helped firms understand their eligibility for reliefs, rather than placing the onus on them to prove it, would be a step in the right direction in reducing compliance costs.

- **Review statistics collection via the tax system.** Information on business activity is sometimes collected through tax documents in order to compile official statistics. Care needs to be taken that information demands are not onerous. The current process of collecting EU trade data from companies to use in the balance of payments statistics under the VAT/intrastat system is one example where many manufacturing companies have to implement costly information collection procedures not required of companies in the services sector.

- **Improving communication links and relationships.** Following the creation of HMRC, the government is consulting on how to improve links with small and medium-sized businesses of up to 1,000 employees. Implementing a more finely tuned, risk-based approach to compliance, more flexible payment options, single points of contact, reducing form filling and building better relationships are all on the agenda. Common problems for companies or their tax advisers in working with tax authorities currently include being unable to get through to call centres and a reluctance to use e-mail communications. Lack of consistency in the decisions of tax officials, advice and record keeping, and lack of access to staff with specialised knowledge is also causing frustration. The reopening of old tax enquiries and a lack of clear service standards that can be expected by business do not seem to fit the new customer service perspective meant to accompany the change in HMRC's terminology from 'taxpayer' to 'HMRC customer'. Accordingly, business will have high expectations of this consultation exercise.

# 3 Using the tax system to achieve key objectives

## Summary

There are some fundamental principles for a good tax system, including simplicity, transparency and neutrality. There may be cause to depart from the principle of neutrality to encourage behaviours that support wider public policy objectives. However, it is difficult to imagine situations where simplicity and transparency could justifiably be set aside completely.

- **The need to debate new approaches to taxation.** Greater reliance on consumption taxation and/or flat rates has potential to deliver significant simplification and cost savings, although they are not without problems. A debate over the future direction of the tax system is welcome. The current complexity of taxation should not be used as a defence against considering change.

There are a number of areas where the tax system is being used to contribute to wider policy objectives and that have a significant impact on manufacturers. These are not always positive. A number of steps should be taken to improve policy outcomes while limiting the negative effects on the manufacturing sector.

- **The R&D tax credit should be enhanced**. The credit is a positive tax incentive for retaining high-value manufacturing in the UK. Experience of the credit shows that it is making a difference but that it could be improved, for example, by extending coverage across a wider range of R&D costs, extending and/or clarifying the definition of R&D, increasing the rate of the credit, considering a mix of a volume and a more generous incremental-based credit to encourage additional R&D spend, enhancing the range of payment options and improving handling of claims.
- **Manufacturers' experiences point to the need for an improved approach to environmental taxation.** This should include acknowledging that taxation of business should not be the default option for addressing environmental problems. There should be flexibility to adapt environmental measures to avoid cumulative costs. More positive incentives would encourage wider environmental solutions and the tax system should provide positive incentives to develop environmentally friendly technology. Revenues from environmental taxes need to be accurately targeted back to manufacturers by improving awareness and access to government-sponsored environmental programmes.
- **Any move to a distance-based road user-charging scheme raises many questions for manufacturers**. Before a consensus can be brokered on this issue, assurances are needed on the set-up costs, objectives and use of the revenues. Business needs to know that such a fundamental change to road taxation would be accompanied by an equally fundamental step-up in transport policy and provision, and that business needs will be considered in the design of charging systems.

## The importance of simplicity, transparency, and neutrality: Flat rate and consumption taxes

A good tax system should be as simple and as transparent as possible. It should also be neutral and avoid undesirable distortions in behaviour. In a large and complex country such as the UK, operating in an increasingly integrated European context, this is perhaps easier said than done. Nonetheless, these key principles should drive the evolution of the tax system and departures from them need to be clearly justified.

Over recent years the tax system has been consciously used to support wider public policy objectives. The R&D tax credit is perhaps the most important example for manufacturing. Other initiatives are focused on the environment area, such as the climate change levy, and have less desirable effects on manufacturing. The current discussion on whether the UK's road congestion problem could be addressed by a road user-charging scheme is another example of a new approach to taxation and again is an area of considerable interest to manufacturers.

There is a longer-term question over whether the mix of taxes in the UK is evolving in the right direction. Given the piecemeal development and complexity of the tax system, it is difficult to get a clear picture of the strategic direction of the system. However, a debate has been surfacing on whether a greater reliance on flat tax rates and consumption taxes might provide the best way forward. These have the potential to deliver

## Table 8 Arguments for and against greater reliance on consumption taxation

| Pros | Cons and uncertainties |
|---|---|
| Research shows efficiency gains for the whole economy | Difficulties in taxing immovable property, financial services and agricultural activities |
| Elimination of tax distortions on savings and investment | Business acts as tax collector for government |
| Neutrality (if well designed) – e.g. neutral to international competitiveness as exports are zero rated | Can be regressive. Special exemptions to overcome regressive problem lead to reduced neutrality |
| More efficient revenue raising | Could discourage trade in services through double taxation arising from different approaches to 'source' and 'destination' taxation |
| Simplification: consumption taxes are levied on a cash flow rather than an accrual basis. They are often simpler to calculate for this reason as flows are taxed at the time of consumption rather than accrual or realisation. If more reliance on consumption taxes allowed a reduction in corporation tax rates then exemptions in the corporation tax regime would also probably be reduced to maintain the tax base. This would remove some of the complex accounting calculations associated with, for example, depreciation accounting for capital allowances and capital gains charges | Equity questions for pensioners as their past income has already been taxed and now their future consumption will be more heavily taxed |
| Lower compliance costs through tax simplification. This assumes that consumption taxation is accompanied by reduction or removal of other taxes | Would involve considerable structural change to the tax system. Politically difficult and would incur costs in setting up a new tax infrastructure |
| | Reduced ability to pursue public policy objectives through the tax system if other taxes and their exemptions are reduced/removed |

significant simplification, remove unintended distortions and cut compliance costs.

The new mobility of capital has made it more difficult to rely on it as a base for taxation. While labour may be easier to tax, recent emphasis has been on ensuring that the tax and benefit system encourages work. This has raised the possibility that moving tax away from capital and labour and towards broader consumption activities may be a way to protect the tax base and remove distortions.

Similarly, moving to flat rates of taxation has been advocated as a response to growing complexity in the tax system. A flat-rate system involves a single rate of taxation on a very broad base – for example levying income tax at 20% of personal income (or corporate income) regardless of its level. Advocates say this approach has the advantage of simplicity, reducing scope for avoidance (by removing loopholes created by complexity) and that it could boost tax revenues.

Some basic pros and cons of a tax system based more heavily on consumption taxes are highlighted in Table 8. Many of the same points apply for flat-rate tax systems, including the concern about their possibly regressive nature.

A flat tax approach could also attract foreign investors and encourage economic activity, savings and investment through lower rates of taxation. In eastern Europe a number of countries have recently introduced flat rates, including Slovakia, Estonia, Romania, Georgia and Russia, while Poland is currently considering such a move. This has been linked to boosting economic growth in these countries, although they are at a very different stage of economic development, which may limit direct extrapolation of their experiences to the UK.

Moving to a system that relied almost exclusively on consumption taxation and/or flat rates would be a fundamental structural change that would throw up transitional challenges. Nonetheless, a debate over the future direction of the tax system is welcome, not least in drawing attention to how the current system could still be improved. The entrenched complexity of the current system should not be used as an excuse to avoid a robust debate on the best future fundamentals for our tax system and the need for simplicity, transparency and neutrality.

## Tax incentives

Tax incentives or reliefs aimed at wider policy objectives are a step away from a neutral tax system. However, there are instances where this may both benefit business and support broader public policy objectives. These include situations of market failure, for example, where investment in R&D and apprentice training creates returns to the economy larger than the return to an individual business. The tax system can also be used to compensate for competitive disadvantages created by other government policies, without undermining (and in fact supporting) the wider policy objective.

A case may also be made where other countries are providing competitive incentives and contributing to market failure in the UK, although care is needed to avoid a competitive spiral of incentives across countries. An example is the R&D tax credit, where it seemed right to at least match what other countries were offering to potential investors elsewhere. Small businesses may also face particular disadvantages, such as the regressive costs of tax compliance, where special tax measures may help to redress imbalances.

### The R&D tax credit experience

However, it is not always easy to get the right balance between making incentives and reliefs workable and affordable for government versus ensuring it is easy and cheap for business to access. For example, the R&D tax credit appears to be contributing to the government's longer-term objective of increasing R&D spending to 2.5% of GDP by 2014. However, an

**Table 9 Views on the shape of the R&D tax credit**

| |
|---|
| 50% of companies are not satisfied with the definition of R&D used for the credit and no medium or large-sized companies were fully satisfied with the definition |
| 50% of SMEs and 32% of large companies believe the credit should cover a wider range of R&D costs |
| 31% of SMES and 56% of large companies believe the rate of the credit should be increased |
| The average reduction in overall R&D costs from the credit was 4% compared to an intended maximum of 9.5% and 7.5% for SMEs and large companies respectively |

Source: EEF/CBI survey of experience with the R&D tax credit, April/May 2005

EEF and CBI survey, covering almost half of R&D expenditure in the UK, highlighted a number of areas where improvements to the design and operation of the credit could make it more effective. In Table 7 we identified that concerns were expressed about the credit's operation. Further views were also expressed about how the generosity of the credit might be improved to decrease the costs of R&D and to raise the credit's profile with investment decision makers (see Table 9).

These results suggest a number of avenues that could be pursued to enhance the credit, including:

- **Extending coverage to a greater range of R&D costs**. This would include staff training, security of research facilities and research information gathering. In Canada, for example, capital expenditure costs are not just 100% written off against tax but are also included in calculating R&D costs eligible for the additional tax credit.
- **Extending and/or clarifying the definition of R&D.** It would then cover those development and design activities that are integral to disseminating and commercialising R&D activity but which may currently be in the grey area of the definition.
- **Increasing the rate of the credit.** This would locate it on the radar screens of company decision makers and encourage particular forms of R&D – e.g. in the climate change area. Given limited cost coverage and the costs of

making an application it is difficult to benefit from the maximum claimable reduction in R&D costs allowed by the credit. SMEs are at a further disadvantage, as although their credit rate is higher, they are saving on tax at a lower rate of corporation tax than larger businesses.

- **Reviewing the design of the credit.** Moving to a mix of a volume and a more generous incremental-based credit for R&D over and above a firm's historical R&D level might encourage more R&D on the margin.
- **Making the credit payable to large companies.** Currently only SMEs receive an immediate cash benefit, but it could also help large companies with cash flow issues. The tax benefit could be credited against other taxes such as NICs.
- **Claiming eligibility.** Allowing the company that funds the R&D, rather than the company to which they outsource it, to make the claim.
- **Improving the handling of claims.** This would deliver a more consistent service level and reduce costs and delays in the processing of claims.

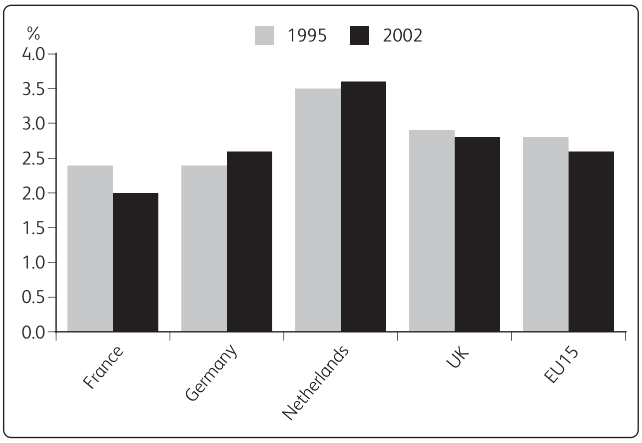
## Environmental taxes not the only route to environment solutions

UK manufacturing has made significant strides to limit its impact on the environment during the past 20 years and is developing as a world leader in new environmental technologies and low carbon solutions. However, current government policy is still biased towards taxing activities that pose environmental risk rather than on supporting technology development. The rationale behind this is that environmental taxes make business pay for some of the wider environmental costs of their activities and cause them to reduce these activities. A full list of current measures is contained in the appendix.

A more positive approach could pay greater dividends in helping business to reduce environmentally risky activities cost effectively, but also to develop more far-reaching environmental solutions. Supporting better environmental practices and technology is an alternative to taxation and may lead to real competitive and environmental advantages.

Chart 9 UK environmental tax burden nudges ahead of EU average

% shares of environmental taxes in GDP




Source: Eurostat

It is essential that competitiveness concerns be considered alongside environmental effectiveness when new environmental policies are introduced. No more so than when other countries have implemented less onerous measures or none at all. The cumulative impact on business of simultaneous environmental measures in both the tax and regulatory areas also needs to be recognised. New EU product and process regulations, such as on chemicals (REACH) and the Waste Electrical and Electronic Equipment (WEEE) Directive, seem likely to impose additional costs beyond what is necessary to meet their environmental objectives, and may overlap or duplicate objectives of environmental taxes.

Chart 9 shows that the UK has a greater reliance on environmental taxes compared with Germany and France, although in 2003 the share of environmental tax revenues in national income did slip back slightly to 3.1% of GDP. However, environmental tax revenues are still an important part of the overall tax take and they rose by 54% between 1994 and 2003.

### The climate change levy

Experience with the climate change levy (CCL) illustrates key questions about the impact of environmental taxation on UK business. The government's current review of the climate change programme provides an opportunity to launch an improved approach to environmental taxation and regulation. This opportunity must be grasped as the evidence suggests that we are not on track to hit the government's target of reducing carbon dioxide emissions by 20% from the 1990 level. This casts doubt on the efficacy of current policies to meet the longer-term goal of a 60% cut by 2050.

The CCL was introduced in 2001 to encourage energy efficiency and reduce carbon emissions by placing a levy on the use of gas, coal and electricity in the business sector. Some energy-intensive sectors regulated under the integrated pollution prevention and control (IPPC) system, such as food and drink, chemicals and steel, were able to negotiate climate change agreements with the government. In return for meeting certain emission targets they receive an 80% discount on the climate change levy. Eligibility for these agreements is tightly defined and many manufacturers remain unable to access the discount. This is unfortunate as the climate change agreements, more than the levy, appear to be delivering emission reductions.

To compensate for the cost of the levy, employer NICs were reduced by 0.3% and the Carbon Trust established to deliver energy-efficient projects to business. This follows the idea of a 'double dividend' held up to promote environmental taxes. This predicts that an environmental tax creates two benefits – better environmental practice and a wider gain from using the tax revenue to fund a reduction in another tax (e.g. NICs) which may be undesirably distorting activity in other areas (e.g. the labour market). The compensating tax cut could mean that taxes such as the CCL are revenue-neutral to business.

However, this 'double dividend' has not materialised. EEF member company experience indicates that the levy has led to competitive disadvantages for manufacturing with no significant impact on emissions. We therefore strongly oppose calls to double the levy to reflect the 'true social cost' of carbon. This is especially so in the absence of widely accessible climate change agreements or climate change measures directed at a wider range of society and of viable short-term energy alternatives.

## How has the CCL worked?

The levy has done little to promote energy-efficient behaviour across many manufacturers. The levy has come at a time of numerous other competitive challenges, constraining the ability to invest in more energy-efficient technologies or pass on the extra costs to customers. An EEF survey in the levy's first year showed that, almost without fail, companies believed they would not be able to pass on any of the increased costs to their customers, with the tax being absorbed into margins.

A government-commissioned evaluation by Cambridge Econometrics of the levy estimates it will result in a 2.3% cut in carbon dioxide emissions by 2010, compared with 2002 levels. The bulk of this comes, not from manufacturing, but from the commercial and public sectors where initial energy savings have been easier to make without major restructuring. Industry sectors, excluding the basic metals and chemicals sectors, are expected by 2010 to have made only a 0.51% cut in carbon dioxide emissions against 2002 levels according to Cambridge Econometrics.

The fact that energy prices have also been rising recently, independently of the levy, without a corresponding fall in emissions demonstrates that competitiveness and other structural barriers may be preventing the price effect of higher energy costs translating into emission reductions. In fact, the government's environment accounts show that greenhouse gas emissions from manufacturing (particularly metal industries) have actually risen by 3% since 2003. In previous periods of restructuring and reducing energy-intensiveness, industry actually made more progress in reducing emissions, including in the period 1990 to 2002 when they fell by 28.5%.

The climate change agreements appear to have been more successful. Companies with agreements have often significantly overachieved their energy reduction targets, although some of this improvement may also have been driven by structural changes within industries. Evaluations by the Tyndall Centre on climate change show that the incentive provided to reduce emissions by the combination of the levy and agreements may have outperformed the levy on its own in economic terms (by avoiding additional cost pressure from the tax on margins) and in environmental terms (greater emission reductions and potentially earlier investment in energy-saving technology). However, the exclusion of many manufacturers from the agreements is hindering their ability to make meaningful energy savings, with the bulk of emissions reductions coming from other sectors.

The use of reduced NICs to make the levy revenue-neutral has also caused problems for manufacturers as it is unlikely to balance out the rise in energy costs caused by the levy for firms in energy-intensive, but not labour-intensive, sectors. The investment cost of introducing new energy-efficient capital equipment and processes is also higher for more energy-intensive sectors and is not addressed through the NIC cut. The energy efficiency programmes run through the Carbon Trust are meant to help address this. However, there is still some way to go before the programmes are integrated into the mainstream of UK manufacturing and it is unlikely that many will recoup the cost of the levy through this channel.

Alongside the levy there have been other pressures on manufacturing margins, including an average increase in prices of 33% for gas and almost 35% for electricity for EEF members over their last contract period, with much larger increases of 50–80% for those contracting more recently. These price increases have not been felt to the same extent in continental Europe, partly because of the less liberalised energy markets over there. These competitive pressures make it more difficult to fund the investments in environmental technology needed to improve energy efficiency and to avoid the levy damaging competitiveness. While European countries have also imposed similar energy taxes, they generally provide a wider range of exemptions. From a competitive standpoint the UK's 'first mover' leadership role on emission reduction targets has also yet to bear fruit in persuading key manufacturing competitors like the US and developing countries to follow suit. Therefore, manufacturers in other countries are not facing the same energy price disadvantage.

## The future of environmental taxation

Manufacturers' experience to date with the CCL suggests an improved approach to environmental taxation is needed.

- **Taxation of business should not be the default option for addressing environmental problems**. For example, the CCL cannot be a substitute for other, more politically difficult solutions, including the tough decisions needed on viable low carbon energy generation capacity and on domestic energy use.

  There should be more emphasis on incentivising behavioural change rather than on 'sticks' such as taxation. This would help manufacturers balance the demands of reducing their environmental impact while maintaining and finding new sources of competitiveness. Experience with the climate change agreements also shows the ability of business to meet clear targets through the incentive of a reduction in the CCL. Climate change levy agreements should be open to all manufacturers who can commit to emission reduction targets.

  Comprehensive cost–benefit analysis and ongoing evaluation is needed across a fuller range of potential solutions, with business competitiveness a central concern alongside environmental effectiveness. Evaluation of the CCL suggests that there may be barriers to manufacturers changing their environmental behaviour in response to higher energy prices from the levy, and these barriers need to be addressed. Proposals to increase environmental tax rates or introduce new taxes should be conditional on this happening and proposals should be benchmarked against energy cost structures in other countries.

- **There should be flexibility to adapt measures to avoid cumulative costs.** Where there are multiple measures in place such as regulation, sectoral initiatives and tax – e.g. CCL, climate change agreements and the EU emissions trading scheme (EU ETS) – their cumulative impact should be calculated and unnecessary overlap avoided. Improved regulatory impact assessments as outlined in Section 2 of this report could help here. There should be flexibility to change and remove measures to reduce the cost of compliance. For example, energy markets have delivered prices well above those envisaged at the time of the levy's introduction. This therefore questions the need for the levy at its current levels. As is the case for the fuel duty escalator, any move to increase the levy should be put on hold. The development of the EU ETS also questions the need for the CCL in the longer term. As a first step, those sectors already involved in the EU ETS could be made exempt from the levy.

- **More positive incentives would encourage wider environmental solutions.** Solutions to pervasive environmental problems need to be approached from a variety of different angles. In the climate change context it would harm manufacturing competitiveness if all measures were targeted at increasing the cost of carbon. Competitiveness safety nets and incentives to quicken the pace of structural and technology change are needed. There should be more emphasis on positive measures encouraging the innovation and investment needed to help manufacturers reduce their impact on the environment.

An international leadership role on climate change involves leading on technological change, and not solely on reduced emissions. If international climate change frameworks, post the Kyoto protocol, better reflect this mix, more countries might be persuaded to contribute. Positive measures at the domestic level should encourage the research and technology development needed to produce solutions to environmental problems. Business also needs help with the costs of shortening normal investment cycles, allowing a response to short-term pressures such as the CCL and rising energy prices at the least cost.

- **Use the tax system for positive incentives.** The tax system can play a role. The R&D tax credit could be more generous for climate change-related technologies, as has been done for vaccine development. The current system of enhanced capital allowances could be widened and made less prescriptive, for example by removing the positive list of eligible technologies and introducing a negative list or an energy-efficient requirement for eligibility. Government-led export promotion activities by UK Trade and Investment could also be directed to helping UK companies find new market opportunities to disseminate environmental technology more broadly.

- **Make sure revenues are refunded to the right place.** Finally, where environmental taxes are used, they could be better designed. For example, they should be much closer to revenue-neutral for those industries affected most by the measure. Programmes to deliver environmental assistance back to business such as the Carbon Trust and the BREW Programme should be monitored carefully to ensure those paying levies are benefiting from the programmes in a meaningful way. The programmes ideally should be delivered through organisations such as the Manufacturing Advisory Service already working at an operational level with business and integrated with other business support initiatives.

  In some instances programmes also need to be more closely aligned with the specific environmental problems being taxed. From a climate change perspective, the levy would be more revenue and competitiveness neutral if a greater proportion of revenues raised was redirected to incentives (tax-based or otherwise) to invest in energy-saving technology.

## A role for road user-charging?

Road congestion is widely experienced in the UK. For business, the key cost stems from uncertainty and lack of predictability for a wide range of activities involving transport, including employee punctuality, just-in-time supplier deliveries and transport to markets. The strain on roads is predicted to get worse, with levels of road travel expected to increase further in the absence of intervention (see Chart 10).

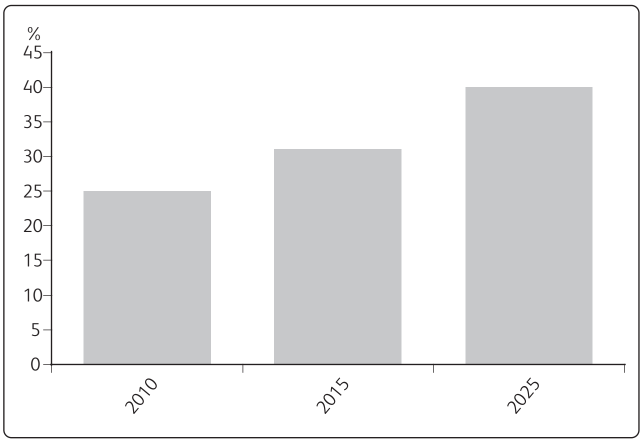
The government is seeking a political consensus in tackling road congestion. The option receiving the most attention is a national distance-based road user-charging scheme. This would represent a move towards user-charging to regulate the demand for roads as an alternative to traditional road taxation. In June 2005 the Transport Secretary, Alistair Darling, indicated that tests of a national road-pricing scheme to replace the current system of motoring taxation were needed.

A 2004 feasibility study commissioned by the government stated that national distance-based charging would be technologically possible within 10–15 years and could deliver a 40% reduction in congestion with only 4% fewer cars using the roads. Charges could range from 2p a mile to £1.43 a mile on the busiest roads. However there would also be hurdles including very high set-up costs (as yet undefined) and low public acceptance.

The prospect of a tight spending round in 2007 limiting transport investment may give further impetus to user-charging systems such as road pricing. In Section 2 we outlined some of the shortfalls in transport spending and shortcomings in delivering promised infrastructure improvements. Although

Chart 10 Road usage still growing rapidly

% projected increase in traffic from 2000 levels (England)




Source: Department for Transport, *Transport White Paper*, 2004

transport spending has increased significantly it is still under 1% of GDP, short of the 1.4% originally intended. The UK's long-term spending on roads as a percentage of GDP is below the European annual average of 1%. However, transport experts also indicate that it will not be possible simply to spend and build our way out of congestion problems.

Business must be a key part of any consensus on distance-based road charging. According to a 2000 KPMG survey of EU transport costs, transport is 78% of total logistic costs, and for nearly 80% of companies roads are the most important transport mode. Roads carry 81% of goods moved by weight, are crucial to delivery of many services, and carry employees to and from work. The growth in the use of roads is also associated with changes to supply chain management in manufacturing such as just-in-time delivery. However, the low quality of overall infrastructure is one of the most problematic factors for doing business in the UK according to the World Economic Forum's annual *Global Competitiveness Report*.

Estimates of congestion costs range from approximately £15 billion at 1998 prices, according to the Institute for Transport Studies at the University of Leeds, to around £20 billion according to the CBI. The cost of road transport relative to other EU countries is also high. In 2003, according to the EU Road Federation, the UK collected almost £60 billion in road-related taxes, with only Germany and Italy among EU countries raising more. UK rates of fuel excise tax are the highest in the EU15 by a considerable margin. Unleaded and diesel excise rates were each €742 per 1,000 litres in the UK compared with an EU15 average of €506 for unleaded fuel and €361 for diesel. Despite these already high tax costs, fears of the future costs of congestion are generating increasing interest in road user-charging.

## What difference would charging make?

The economic rationale for road user-charging stems from the assumption that road users do not consider the full costs to society of making individual journeys. Motoring taxes such as fuel taxes and vehicle excise duty impose additional costs on vehicle use. However, the price signals they send are blunt and may not influence actual road use. Better regulating the demand for road use should alleviate congestion, in effect delivering an improvement in transport infrastructure. User-charging, if designed correctly, might have a more direct impact on individual behaviour through sending a much clearer price signal to users.

Depending on how any scheme was designed, there may be scope for some individual businesses reducing their transport costs, for example by changing the time of day at which travel is made. The balance of impacts across different businesses is likely to depend on the flexibility with which they can plan their transport use.

A side benefit of road pricing could be reduced carbon emissions. Free-flowing traffic emits less carbon and could be a cost-effective means to reduce emissions. However, if road pricing led to a significant fall in total traffic, this would be a more costly way to reduce emissions given the wider implications for economic activity. Efforts to encourage the purchase of fuel-efficient cars through vehicle excise duty (VED) and company car taxation tax advantages have been reasonably successful, but if these taxes are removed it is not clear whether these low carbon incentives would be replicated in road user-charging pricing structures.

EEF is still consulting members on this issue, but a range of possible impacts on employers can be predicted:

- investment location decisions may be influenced by the need to be close to suppliers and employees in order to minimise travel costs;
- employees may require greater flexibility to plan their travel times;
- there may be employee/employer privacy issues arising from technology used in company cars to measure distance and location; and
- unpredictability caused by congestion should be eased and this may help supply chains and lean manufacturing practices work more effectively, ultimately reducing costs from delays and planning for uncertainty.

## Numerous guarantees would be required

There are a number of concerns associated with any move to road user-charging that would need to be satisfactorily addressed. There is already dissatisfaction with the high level of existing motoring taxation and with the slow progress in delivering promised transport infrastructure improvements. Any move to a road user-charging approach would be a dramatic change and would need to be accompanied by tangible evidence of improvements in the government's effort to address the full range of transport problems. There would also need to be a number of clarifications and assurances on the objective, scope and implementation of any scheme.

A crucial issue is how revenues from any road user-charging scheme would be spent. There are a number of possibilities:

- Make the scheme revenue-neutral. Offset revenues against reductions or abolition of current road taxes – e.g. fuel duty and VED. An important issue with this or any attempt to 'recycle' revenue back through cuts in other taxes (e.g. NICs) is to ensure that those paying the new tax benefit directly from the reductions in existing taxes. This has proved difficult with existing environmental levies.
- Use the revenue to fund additional transport policies and infrastructure. Under this scenario the scheme would probably not be financially neutral for road users and might represent an additional tax.
- Redirect the revenues to non-transport-related public services. This is probably the least desirable option from a business perspective, as it would constitute additional taxation with no clear link to spending on additional measures to improve congestion or transport infrastructure.

The approach on revenue would be influenced by the objective of any road user-charging scheme. If explicit targets of the scheme go beyond easing congestion to include revenue raising for funding additional transport spending and contributing to environmental targets, there will be more pressure to move away from a revenue-neutral scheme towards one that raises additional revenue and/or reduces overall road use. This seems to have been the experience with the recent increase in the London congestion zone charge, driven in part by revenue targets.

There is also a range of complicated administrative and cost issues that would need to be resolved. The government's feasibility study could not put a figure on the cost, other than to flag up that it would be a very large number. There is a risk that infrastructural set-up and enforcement costs might be passed on to road users. If charging is to be both fair and to influence individual behaviour there are also complicated issues surrounding pricing structures. These include varying charges for different vehicle types, roads, regions, uses and times.

Further information and clarification from government would also be required on the following:

- **The costs of the scheme** and how these would be apportioned between government and different categories of road users.
- **The explicit objective(s) of the scheme** – for example, reduced congestion, environmental benefits and/or revenue raising.
- **The intended use of revenues** – for example, fully offsetting reductions/abolition of other motoring taxes, reinvestment in transport infrastructure or general public spending.
- **Evidence of improvements.** Proof that reinvestment of revenues in transport would be accompanied by significant improvements in delivery of transport infrastructure, and by

enhanced measures to address the full range of transport problems. Evidence would be needed that further increases in spending would be met from economic growth and more efficient spending of existing tax revenues rather than by raising additional revenues from the scheme.

- **Willingness to address business needs** through the design of charging structures, including minimising any additional cost burden on business, avoiding regional competitive distortions, and special consideration for small business needs and for those who have already adopted environmentally friendly transport practices.

# Appendix: The UK's tax system

## Overview

The UK tax system is complex and constantly changing. The UK has a largely unitary tax system with central government collecting over 75% of tax revenue. The UK system is increasingly used to deliver public policy objectives. Social security benefits are delivered through it, as are a selection of taxes and incentives to encourage or discourage certain behaviours to benefit the wider public good (such as increasing R&D or reducing pollution).

Corporation tax uses a 'schedular' approach rather than the accounts-based approach. This allows different streams of income to be clearly distinguished and taxed differently – e.g. capital versus income profits and trading versus investment activities. This is a 'bottom-up' approach to designing tax rules and creates additional complexity, as companies often have to calculate transactions differently for their company accounts and their tax accounts.

A 'partial imputation' approach is used in the UK to minimise double taxation on dividend payments that have already been taxed as corporate income. Tax relief on dividend income is given to shareholders in recognition that corporation tax has already been paid. Tax-paying shareholders receive a credit against their income tax liability to reflect this.

Generally, in the UK, tax rates on savings (e.g. income from interest, dividends and rents) tend to be lower than on income (labour and corporate profits). Returns from capital tend to be taxed more lightly than returns from labour income.

In 2003/04 the government collected almost £400 billion in taxes. Corporation tax on profits and rates on business property made up nearly 12% of this revenue. However once the full range of taxes relevant to business are included, business paid considerably more – in total £134 billion in tax in 2003/04. This is approximately one-third of total tax revenue. Chart A1 shows a breakdown of different taxes as a percentage of the total tax take.

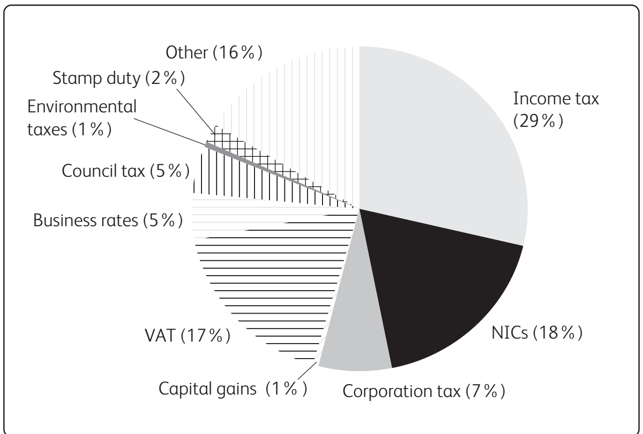
## Corporation tax

Starting from a corporation tax rate of 52% in 1980 the UK has cut corporation tax rates and they now stand at 30% for large companies and 19% for SMEs. Since the current government came to power in 1997, the rate for large companies has been reduced by 3% and for SMEs by 4%.

Accompanying the initial reductions in corporation tax rates in the 1980s were corresponding measures to broaden the tax base and sustain revenues, for example by making the system of capital allowances less generous. Under the capital allowances system expenditure on plant and machinery is written down at a

Chart A1 Business is an important source of tax revenue

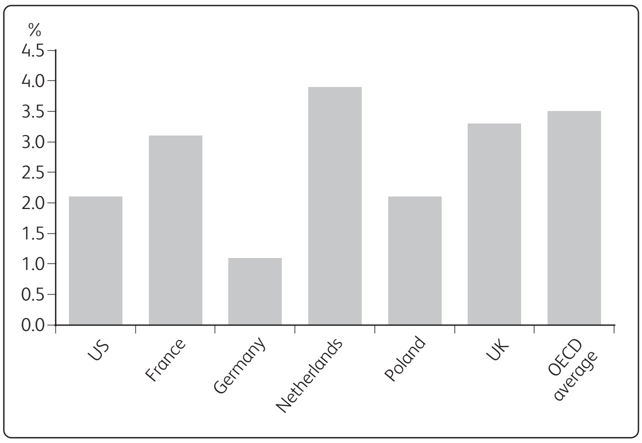
Different taxes as % of total tax revenue, 2003/04




Source: HM Treasury, *Budget 2005*

Chart A2 UK corporation tax revenues high compared with competitors

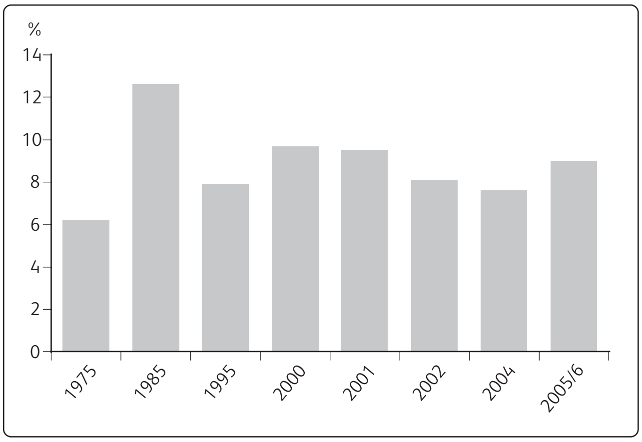
Average taxes on corporate income as a % of GDP during 2000–2002




Source: EEF and OECD, *Revenue Statistics 2004*

Chart A3 Corp. tax expected to contribute more to total tax take

Taxes on corporate income as a % of total taxation




Sources: OECD, *Revenue Statistics 2004* and HM Treasury, *Budget 2005*

25% declining balance, although SMEs have a first-year rate of 40%.

Although headline tax rates in the UK remain competitive, the UK is still more reliant on corporation tax revenues to fund government spending than many other key developed country competitors, including the US, as shown in Chart A2. In the case of France and Germany, their lighter reliance on corporation tax may reflect weaker economic performance and greater reliance on income taxation.

The share of corporation tax on profits compared with national income has fluctuated over time, as shown in Chart A3. Corporation tax revenues initially fell following cuts to corporation tax rates in the late 1990s. However, they have rebounded, exceeding expectations in the year to January 2005 at a growth rate of around 17%. Revenues have benefited from a recovery in corporate profits in the financial sector and new anti-avoidance measures. The government forecasts that these higher revenues are achievable in the near future, although a number of independent commentators dispute this.

## Input taxes

A feature of the UK tax system is a greater reliance on input taxes – i.e. those taxes levied on costs regardless of the level of income or profitability. For business these taxes are levied on production inputs such as labour and raw materials. They are generally less efficient than taxation on profits as they may distort production decisions and create anomalies between different sectors with different cost bases.

Manufacturing in particular feels the impacts of these taxes due to difficulties in passing on cost increases to customers. One justification for the increase in input taxes has been to tax 'bads' and reward 'goods'. For example, the climate change levy put up the cost of energy as a way of discouraging a 'bad' activity – pollution – while the revenue raised was used to reduce the rate of employer's national insurance contributions, encouraging a 'good' activity – employment. Leaving aside the debate of whether this is the most effective way to address the issue of climate change, the impact on most manufacturers was unfavourable, given that they tend to be intensive users of energy but less intensive users of labour.

Input taxes on business activity in the UK include:

- **Employer's national insurance contributions** are an additional labour cost. Increases may eventually be shifted from employer to employee through wage adjustments, although low inflation, tight labour markets and skill shortages suggest that this adjustment may take a long time.
- **Insurance premium tax** is a compulsory tax on gross insurance premiums, the cost of which has significantly increased over recent years. For example, the EEF's employer liability insurance survey shows that, in 2005, 38% of manufacturing companies faced an increase in their premiums, following on from an average increase in their premiums of 30% in 2004 and of 40% during 2002/03.
- **Business rates** are levied on officially estimated market rents for business property and fall particularly heavily on property-intensive sectors.
- **Landfill tax** is levied per tonne of landfill waste to encourage better waste management practices, such as recycling. Revenues are transferred back to business through funding assistance to improve waste management practices. However, it is questionable whether this is effectively targeted at those companies paying the most in the tax.

- **Climate change levy** is charged for each kilowatt-hour of energy used. This is offset by a reduction of 0.3 % in employer NICs, which disproportionately benefits companies with large numbers of employees and low energy bills.
- **Stamp duties** are charged on the value of share transactions, land and property transfers, and can penalise investments in these assets.
- **Other input taxes** include the aggregates levy on extraction of sand, gravel and other natural aggregate materials, fuel excise tax, vehicle excise duties and air passenger duty. Regulatory fees arising from compliance with government regulations are a related cost on business.

Environmental taxes are summarised in Table A1.

## Table A1 Environmental taxes in the UK

| | Rationale | Description | Impact and questions |
|---|---|---|---|
| **Landfill tax** | Encourage better waste management – e.g. recycling | £18 a tonne for landfill waste rising to £35 a tonne over time<br>Tax credit for donations from landfill operators to local environmental projects<br>Revenues used to fund waste management programmes (the BREW programme in England) | Landfill volumes falling, but fly tipping increasing<br>Are funds accurately directed back to companies through waste programmes?<br>Capital allowances for buying waste technology under consideration |
| **Aggregates levy** | Reduce quarry output, encourage use of alternative materials | £1.60 a tonne<br>0.1 % cut in employer NICs and a sustainability project fund compensate for the levy | Aggregates sales falling and recycled aggregates increasing<br>Criticisms of complexity and unintended environmental harm |
| **Climate change levy** | Encourage energy efficiency and reduce carbon emissions by making energy use more expensive | Rates vary according to energy source – e.g. 0.43p/kWh for electricity<br>A 0.3 % cut in employer NICs and Carbon Trust energy-efficient projects to compensate for the levy<br>Energy-intensive companies get an 80 % discount on the levy for meeting energy targets | Concerns over competitiveness, revenue neutrality and environmental effectiveness |
| **Fuel duties** | To reflect true costs of fuel and road use and encourage alternative fuel markets | Basic rate 48.3p/litre and varied rates – e.g. a 20p/litre differential to favour biodiesel<br>Enhanced capital allowances to be introduced for biofuel plants and a 'renewable transport fuels obligation' under investigation | The UK has amongst the highest fuel costs in Europe<br>Alternative taxes being considered, such as road user-charging as fuel duties are costly but don't influence congestion |
| **Company car, fuel tax and vehicle excise duty** | To encourage purchase of more carbon-friendly cars | Taxable benefits of a company car and VED are linked to car emission levels | Positive response seen in car purchasing decisions<br>Capital allowance rules for cars may also be linked to emissions |
| **Air passenger duty** | Tickets taxed to reflect high carbon emissions from air travel | Levied at between £10 and £40 a ticket | Aviation may be covered by emissions trading schemes in future |

# About EEF

EEF, the manufacturers' organisation, has a membership of 6,000 manufacturing, engineering and technology-based businesses and represents the interests of manufacturing at all levels of government. Comprising 11 Regional Associations, the Engineering Construction Industries Association (ECIA) and UK Steel, EEF is one of the UK's leading providers of business services in employment relations and employment law, health, safety and environment, manufacturing performance, education and skills, and information and research.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ISBN 1-903461-63-4

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