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# TAX REFORM FOR A BALANCED ECONOMY

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**TAX REFORMS TO KICK-START LONG-TERM  
INVESTMENT & GROWTH**



The  
manufacturers'  
organisation

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## Summary

The next government must create the right environment for business to flourish if the UK is to pay its way and generate the necessary wealth to repay its debts. But the tax system has increasingly failed to reflect the needs of modern manufacturing. We urgently need a modern, more efficient, competitive tax system that actively helps to grow a diverse and dynamic manufacturing base.

### *A tax policy that supports manufacturing*

Manufacturing is different from other types of business - it requires greater investment in costly machines and R&D, has longer pay back periods and is exposed to subtle shifts in demand, costs and exchange rates. The tax system must reflect these differences if manufacturing and a balanced economy are to flourish.

- **Tax policy should encourage manufacturing investment**
  - *Modernise the antiquated capital allowances regime.* The UK tax system should recognise the true cost and shorter lives of modern machinery.
  - *Improve the tax regime for entrepreneurs and innovation.* The next government should create a more sustainable capital gains tax regime and make the R&D tax credit less costly to claim and reflect a wider range of costs.
- **Ensure manufacturing is not treated as a 'cash cow'**
  - *Prioritise a balanced economy, not narrow tax cuts.* Cutting the headline rate is crucial to the UK's long-term competitiveness. But paying for a tax cut for 50,000 companies while reducing capital allowances for 900,000 is not a sensible way to rebalance the economy.
  - *Environmental taxes should not penalise investment and production.* Environmental taxes should be used to encourage investment, not to fund tax cuts for non-capital intensive businesses or for families.

### *An internationally competitive tax system*

The UK must remain internationally competitive for tax purposes to ensure businesses have the funds to invest, our larger manufacturers remain headquartered here and to encourage inward investment.

- **Cut the headline rate, but over time.** A lower headline tax rate is welcome but not if it can only be achieved through a reduction in allowances for legitimate business costs which disproportionately hits manufacturing.
- **Shift towards a territorial regime.** The UK should continue the shift to a territorial system – which only taxes activity that occurs in the UK – and stop trying to tax every pound earned in a globalised economy.
- **Encourage long-term investment, not debt and consumption.** Raising the VAT rate to 20% would accelerate rebalancing and reduce the number of hard choices needed to repair the public finances.
- **Signal Britain is open for business again.** There should be a clear signal of intent that the 50p income tax rate is only temporary and it should be reduced as soon as possible.
- **Consider a carbon tax to encourage investment and sweep away the current clutter of environmental taxes.** Environmental taxes should encourage investment as well as reducing emissions.

### *Improving the operation of the tax system*

Because manufacturing differs from the rest of the economy, the tax system will only work better for manufacturers if HM Treasury and HMRC take the time to understand what makes modern manufacturing competitive.

- **Stop the legislative churn.** We must improve the quality of legislation and reduce the volume of changes, allow for meaningful scrutiny and restore trust in the process.
- **Seek broader engagement and more effective consultation with business.** HM Treasury and HMRC should engage earlier and consult more effectively with a wider range of businesses to understand their business and identify and address any unintended consequences.
- **Improve relationships with business.** HMT and HMRC should adopt a more trusting, risk-based approach to policy and administration, particularly towards SMEs.
- **Deliver simplification that actually reduces burdens on business.** The areas for simplification include VAT and the R&D tax credit.

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## Tax and a balanced economy

As we emerge from a period of significant economic and financial turbulence, the next government must decide where we go as an economy.

The decisions made in the first 100 days will have long-term implications: they will determine our ability to generate growth and prosperity, to fund much-needed infrastructure improvements and to create job opportunities across our society. The need for a more balanced economy with a strong manufacturing sector has never been clearer.

The next government must, therefore, put in place a strategy that ensures that we can pay our way in the world. And developing a modern, efficient tax system that helps to grow a diverse and dynamic manufacturing base must be a part of that strategy.

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*The UK tax system is tilted against manufacturing and stands in the way of growing a more balanced economy.*

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There have been some helpful changes to the regime in recent years, including the R&D tax credit, the drive to demonstrably reduce the administrative burdens and a new approach to working with large businesses.

But the benefits are piecemeal and for manufacturers, the tax system is close to breaking.

It encourages debt and consumption rather than long-term investment. It takes thirty years to reflect the cost of machines that are replaced in eight. It increasingly seeks to tax every pound of profit in globalised value chains. It forces companies to pay tens of thousands of pounds just to claim R&D tax credits.

It makes hiring the first employee in a new business almost prohibitively complex. It saddles manufacturers with rising costs, complexity, inconsistency and ultimately uncertainty around the direction of tax policy.

In sum, the tax regime is tilted against manufacturing and stands in the way of growing a more balanced economy.

Changes over the last 30 years have consistently penalised manufacturing relative to other sectors. Smaller, less mobile companies have little choice but to bear this burden in the UK, but larger, more mobile manufacturers

are beginning to be pushed abroad.

A modern, competitive tax system would not only recognise the significant costs of investing in modern machinery. It would enable small businesses to invest in growth. It would attract mobile multinational investment to the UK. And it would provide the predictability needed to minimise the tax risks to returns on those investments.

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Here, we set out how the next government should take a more strategic, deliberative and consultative approach to tax policy and administration. We suggest structural reforms to modernise the UK's tax regime. And we make proposals on how to develop an internationally competitive business tax environment that sends the right signals to would-be investors.

The simple, clear objective of our *Manifesto for Tax Reform* is to encourage a high-value, balanced economy.

## A tax system that supports modern manufacturing

The foundations of success are different in manufacturing than in other types of businesses. Its competitiveness requires greater investment in costly modern machines and R&D. It needs skilled engineers and managers to drive the business and invest over longer time scales. And its global reach increases risks around subtle shifts in demand, costs and exchange rates. To create the right environment for manufacturing to flourish the UK's tax system must reflect these differences.

### *Encouraging manufacturing investment*

In a high-labour cost economy, manufacturers remain competitive by exploiting innovation and advances in technology. Constraining manufacturers' ability to re-invest in capital equipment forces them to compete on cost of labour, a battle the UK cannot win.

The current system of capital allowances does just that because it fails to recognize the importance of capital investment, advances in technology and the short lives of modern machinery.

### *Constraining manufacturers' ability to re-invest in capital equipment forces them to compete on cost of labour; a battle the UK cannot win.*

Manufacturers replace their equipment every 7-8 years. Yet the current 20% rate of capital allowances only recognises that cost over 30 years. Pushing the level of capital allowances lower would simply compound the distortionary effects of an already inefficient system.

In buoyant times, this puts a hidden brake on the abilities of companies to re-invest; in a recovery it positively discourages the one thing the government must catalyse. Our priorities for reform include:

- **Extending the short-life asset regime.** Even though the capital allowance regime is far from perfect, radical reforms are likely to prove complex or costly.

A simple and practical proposal to recognise the true cost of modern machines with shorter lives would be to extend the time restriction on short-life asset election from four to eight years. This would allow a wider range of assets to be written off at the end of their useful economic lives.

The cost to the Exchequer would be zero in the first four years after the reform, £620 million in the fifth year, before steadily falling in cost over time. (*see*

*Annex A for further details*)

### *Pushing capital allowances lower than 20% would simply compound the distortions inherent to an already inefficient system.*

- **Improve the tax regime for entrepreneurs and innovation.** The lack of bank finance has increased the need to improve the tax regime for serial entrepreneurs and innovators.

**The capital gains tax regime** needs to be reformed yet again to create a sustainable regime that actually encourages long-term investment.

The basis of such reforms include minimising the incentives for tax avoidance and maximising incentives to make longer-term relatively riskier investments in growing businesses. This will include removing some of the overly restrictive measures around the Enterprise Investment Scheme and Venture Capital Trusts. (*see Annex D for further details*)

**The R&D tax credit** should be made more effective, firstly by reducing the costs associated with claiming the credit, and secondly by relaxing the rules on what qualifies as R&D for tax purposes. Rather than creating complexity by restricting eligibility, the R&D tax credit should reflect the wider range of development costs inherent to the complex and iterative nature of high-tech R&D. (*see also simplification priorities below*)

### *Prioritise a balanced economy, not narrow tax cuts*

The current Government funded a corporate tax rate cut in 2008 by reducing capital allowances and retrospectively taxing investments in modern factories. The Conservative Party are considering a similar approach to finance a 3p cut. Cutting the headline rate is crucial to the UK's long-term competitiveness. But cutting taxes for the 50,000 companies that pay the headline rate while raising the cost of investment for 900,000 companies that are due capital allowances each year would actively prevent rebalancing. As discussed in the next section, there are more efficient methods of financing a cut in the headline rate.

Similarly, the revenues of environmental taxes should be used to stimulate investment, not to fund tax cuts, for example on national insurance (as the current government did with Landfill Tax in 2001 and the Aggregates Levy in 2002) or to reduce taxes on families, as proposed by the Conservatives. Both approaches penalise manufacturing.

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## Restoring competitiveness

In a globalised economy where manufacturing investment is increasingly mobile, providing an internationally competitive business tax environment is essential to attracting and retaining investment in the UK.

The next government will have an opportunity to use tax reform to signal to UK-based businesses, entrepreneurs and mobile multinationals that they should choose the UK as the location for their next investment.

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*Over the next parliament, the balance of the tax burden should reinforce the shift to a more balanced economy.*

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This means removing old-fashioned features of the tax system that simply do not reflect modern business. It means shifting the burden of taxation away from productive, growing businesses. And it means providing the right signals to invest in the UK.

### *Structure of the tax system*

The UK needs a modern, simpler, more efficient tax system that encourages investment in modern machines and in global markets.

#### *(i) Cut the headline rate overtime*

While headline rates of tax are the most visible, the effective tax rates determine investment decisions.

- **Commit to cut the headline rate to 25p over the next five years.** Cutting the headline rate would boost the UK's international competitiveness, but only if it helps bring down the effective tax rate. Consequently, the 3p cut in the headline rate should not be financed by reducing capital allowances or cutting back on the R&D tax credit. Instead, the 3p cut could be paid for by not introducing the £1.3bn patent box, which would only benefit a handful of companies. And given the need to repair the public finances, the cut is not an immediate priority, but would be critical to maintaining the UK's competitiveness over the long-term.

#### *(ii) Attract international investment*

Much of the complexity surrounding corporate tax systems stems from problems in determining what should be taxed and where it should be taxed in a globalised economy. The simplest answer is to move towards a territorial corporation tax system:

- **Shift towards a territorial tax system.** Under such systems, only production and consumption that happens in the UK is taxed in the UK. Recent reforms are step in this direction and the next government should commit to continue the shift towards not taxing profits that are genuinely earned outside the UK.

Part of the move towards a territorial system should include consulting on restricting interest deductibility. But any changes would need an appropriate transition period, grandfathering arrangements and a proportionate reduction in the headline rate of corporation tax. (*see Annex B for further details*)

#### *(iii) Shift the balance of the tax burden*

Over the next parliament, the tax burden should be rebalanced to reinforce the shift to a more balanced economy. In particular, the tax reforms should reflect that our economic growth has relied for too long on too much debt, too much consumption and not enough manufacturing.

This is particularly true given the need to repair the public finances. Manufacturers know that they will shoulder some of the burden in the form of higher taxes. But given the need to rebalance the economy, the brunt of fiscal consolidation should not fall on manufacturers. We recommend:

- **Raising the VAT rate to 20%.** Raising the VAT rate would accelerate the rebalancing process by encouraging further savings, while weaning the economy off debt-fuelled consumption. The measure would raise £11.75bn which should then be used to mitigate the potentially savage cuts to government capital spending and mitigate the tax burden on productive sectors of the economy. (*see Annex C for further details*)

#### *(iv) Signal Britain is open for business again*

The UK needs to encourage broader, more balanced sources of growth. But the serial entrepreneurs and multinationals that could invest in growth and jobs in the UK are increasingly weary of the UK as place to invest in and grow businesses.

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*Serial entrepreneurs and multinationals are increasingly weary of the UK as place to invest in and grow businesses.*

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Taken together, the general drift in tax policy, coupled with changes to capital gains tax, pensions relief, personal allowances and the top rate of income tax, have cumulatively eroded the UK's ability to invest in growth.

In response to the 50p rate, for example, many serial entrepreneurs have begun to withdraw from the UK, while multinationals wanting to recruit high-quality managers in the UK are facing inflationary raises in after-tax salaries.

- **Make the 50p rate temporary.** By making clear the 50p rate is a temporary measure, the next government could provide a clear signal of intent that it is committed to restoring the competitiveness of the UK tax system. Coupled with CGT reform, this would be the first step in restoring the competitiveness and predictability of the UK's personal tax regime.

#### *(v) Investment in the environment*

Environmental taxes should be part of a broader package to encourage behavioural change and investment in clean technologies.

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*Rather than providing clear and effective incentives to change behaviours, the UK provides muddled measures that punish production and energy-intensive businesses; we need a more balanced approach to carbon abatement.*

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The focus for the next government must be on providing a coherent and transparent set of measures that stimulate investment in clean technologies as well as encourage a reduction in carbon emissions.

The current mix of overlapping and complex environmental measures fails to deliver the change needed. Rather than providing clear and effective incentives to change behaviours, the UK provides muddled measures that punish production and energy-intensive businesses.

Maintaining this status quo is therefore not an option. We need a more balanced approach to carbon abatement that provides transparent and stable long-term incentives to invest in clean technologies and energy supplies.

We believe that a well-designed carbon tax can play a significant role in achieving this and also address many of our concerns with the current approach, but only under the following conditions. (*see Annex E for further details*):

- **It's not just an additional cost.** A carbon tax should be used to rationalise the vast array of environmental measures to provide a smarter signal and influence behaviour.
- **Consult on whether the carbon tax should be levied upstream or downstream.** Consultation is needed on how, and if, a carbon tax could be integrated alongside existing downstream measures.
- **Protect the competitiveness of UK-based energy-intensive firms.** A carbon tax should avoid perverse outcomes for particular energy consumers, including the fuel poor and energy-intensive companies.
- **Revenues raised are used to develop clean technologies and energy supplies.** Manufacturers' are opposed to measures that are designed to raise general revenue and/or cut taxes for other businesses (as the current government did with NICs cuts) or for families (as the Conservative Party are proposing).

## A better tax system

Although reform is necessary, so too is caution. Haste in making changes could have lasting, damaging consequences for the competitiveness of the UK economy.

The next government must proceed slowly to identify the right priorities for reform and understand the consequences – intended and unintended – of their proposals.

*Haste in making changes to the tax system could have lasting, damaging consequences.*

*(i) Develop a more structured policy and consultative process*

A more deliberative policy development and consultation process will improve the quality of legislation, minimising unintended consequences and the need to rapidly reverse or change new measures. Central to this improved process is creating a transparent process which provides sufficient time to set out the broader policy and economic context for proposed changes, while also allowing time for genuine consultation and feedback on responses. The ultimate aim is to restore trust and credibility in the process

As well as allowing for meaningful consultation, a more structured process would slow the continual churn of policy changes that has led to poorly drafted and/or rushed legislation.

EEF fully endorse the Conservative Party proposals to create a more structured and consultative legislative process that allows for greater Parliamentary scrutiny to ensure legislation achieves the stated objectives. (*see Annex F for further details*)

*(ii) Seek earlier engagement and broader consultation with business*

A more transparent and structured policy and legislative process would allow HM Treasury (HMT) and HM Revenue and Customs (HMRC) to consult more widely and at earlier stages with business to understand their concerns about potential changes to the UK's tax regime. This would allow for redrafting of legislation to avoid any unintended consequences.

But rather than relying on the usual suspects that respond to consultations or sit on government forums, HM Treasury and HMRC should seek broader engagement

with businesses of all sizes, as well as inbound and outbound investors.

Broader engagement by government would require businesses and their representative bodies to have credible representation and views on taxation issues. Indeed this manifesto is an attempt by manufacturers to proactively meet this challenge.

Early and meaningful engagement with business also requires a greater understanding of what makes businesses such as modern manufacturers so successful. Frequent visits to businesses would help HM Treasury and HMRC to understand the capital investments, the long-investment cycles and the innovation required to be a competitive manufacturer in the UK.

### **Principles of taxation**

A clear and consistent tax strategy should be grounded in two fundamental principles: business competitiveness and predictability.

**Business competitiveness.** The tax system should deliver a balanced economy by creating the best possible location for manufacturing investment.

**Predictability.** No business can ever have complete certainty over their investments and markets, but the long-term nature of manufacturing investment exposes the sector to a range of risks. Manufacturers need predictability from the tax system to enable them to invest confidently for the long run.

While simplification of the tax system should be both an immediate and longer-term priority, it should not come at the cost of competitiveness or predictability, as is increasingly the case. Indeed, simplification and other principles such as fairness should enhance, not undermine, the competitiveness and predictability of the UK's tax regime.

A focus on competitiveness and predictability would help avoid retrospective legislation. The abolition of Industrial Building Allowances and the capital gains tax changes had a retrospective effect on existing investments. Given the long pay back periods typical in manufacturing such an approach discourages investment by increasing the risks involved.

*(iii) Improve relationships with business*

Despite the government's desire to actively develop a mixed and balanced economy, neither HMT nor HMRC have a thorough understanding of how manufacturing differs from other sectors. Neither do they understand how these differences are affected by tax policy and administration. This in turn has fed an often adversarial relationship between business and government on corporate taxation.

A new risk-based approach to large businesses has the potential to improve their relationships with HMRC. The benefits to both government and business of a targeted, risk-based approach are clear.

Smaller businesses have yet to benefit fully from a risk-based approach to enquiries. Although the government is committed to improving relationships and extending the risk-based approach to SMEs, the sheer number of and variations in smaller businesses understandably complicates government's efforts.

We believe that HMT and HMRC should adopt a more trusting, risk-based approach to policy and administration, particularly towards SMEs.

*(iv) A focused simplification agenda*

Simplification should enhance, not undermine, competitiveness and predictability. Yet, recent attempts at simplification have either been haphazard, leading to unintended consequences, or focused on anti-avoidance measures cloaked in the concept of fairness.

The next government should use an independent body of experts to identify and resolve – in consultation with business – a limited set of the most burdensome issues for simplification. Initial areas for simplification include: VAT and the R&D Tax Credit.

- **Consult on a single VAT rate.** According to a 2007 EEF survey, VAT requires the greatest compliance time for manufacturers. Likewise, an HMRC and KPMG review of administrative burdens found that VAT accounts for £1 billion, or 20% of the total of UK taxes. Research by the Institute of Fiscal Studies shows that much of this burden is due to differentiated rates.

EEF, therefore, would recommend broadening the base

of VAT if and only if it was part of an efficient and effective package of reform to overcome the significant distributional concerns. (*see Annex E for further details*)

- **Improve the effectiveness of R&D Tax Credit.** The modern R&D process requires proven technologies to be developed through a succession of prototypes to firstly prove the technology works, then prove its commercial application and finally to prove its scalability.

Too often, technological uncertainty is too narrowly interpreted and the additional R&D work necessary to successfully commercialise the technology does not qualify as R&D.

Specifically, we would recommend including the costs of developing pre-commercial products and scalable processes, of subcontracted R&D work and on part commercially and/or government funded R&D. Increasing the level of the tax credit and allowing a broader range of activities would bring the UK into line with other countries.

## Annex A – Capital allowances

### EEF's Short-life asset reform

The cost of capital investment is rising and investment cycles are shortening as new technologies render existing equipment obsolete. The faster the rate of this depreciation, the earlier manufacturers are forced to reinvest in new, more productive equipment. A report by Statistics Canada estimated that, from 1995–2001, the average depreciation rate for machinery and equipment, based on the declining balance method, was 27%. By contrast, the UK tax depreciation rate under the UK's capital allowance regime, again using the declining balanced method, is only 20% for most machinery and equipment.

In the intervening decade, modern machinery has become more productive by increasingly incorporating the latest technologies and software. Empirical and anecdotal evidence suggests that manufacturers are replacing their machinery and equipment, on average, every seven to eight years. Yet the UK's current rate of 20% means that manufacturers are only able to recoup their costs after 30 years, adding a premium to investing in the UK.

**Table A1 – Average rate of economic depreciation**

	1971–1990 <sup>(1)</sup>	1985–2001 <sup>(2)</sup>	1995–2001 <sup>(2)</sup>	UK regime <sup>(3)</sup>
<b>Industrial Sector</b>	12.3	-	-	-
<b>Machinery and equipment</b>	-	23.0	26.8	20.0
<b>Manufacturing buildings</b>	-	8.7	9.9	0.0

Source: (1) Institute of Fiscal Studies, (2) Statistics Canada and (3) HM Treasury

**Table A2 – Average service life of machinery and equipment, years**

	1985–1989 <sup>(1)</sup>	1995–2001 <sup>(1)</sup>	2005–2011 <sup>(2)</sup>
<b>Machinery and equipment</b>	12.3	9.8	7.3–7.8
<b>Manufacturing buildings</b>	35.6	27.9	20.2–21.8

Source: (1) Statistics Canada and (2) Statistics Canada & EEF

### Three options for introducing short-life asset reform:

1. *Fully retrospective – any investment eligible.* This option would provide the maximum benefit for manufacturers, but would entail added complexity and provide the highest cost to the exchequer.
2. *Partially retrospective – cap on eligibility of older investments.* A partial cap on older investments would limit the Exchequer cost, but increase complexity. Any cap would also be arbitrary: would the cap be set to minimise cost or maximise benefit to business? And how would the cap adjust over time?
3. *Only new investments qualify.* This option would be simpler to administer and still reflect the cost of investment.

EEF recommends option 3 as it improves efficiency, while minimising complexity. And because it applies only to *new* investments, the initial cost to the Exchequer would be in year 5 after introduction and would decline over time<sup>1</sup>.

#### Proposed change

The section to be amended is CAA 2001 s86 Short life asset pool. The proposed wording for sub-section 2b and 3 are as follows:

CAA2001 s86 (2b)

“The available qualifying expenditure in the pool is allocated to the main pool for the first chargeable period ending after the eight-year cut-off”

CAA2001 s86 (3)

“In this Chapter “the eight-year cut-off” means the eighth anniversary of the end of –”

**Table A3 Additional P&M capital allowance COST of EEF's Option 3 reform w/ 20% capital allowance rate, £millions**

	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
<b>Cost of 8-year cut off for short-life asset election on new investments (option 3 above)</b>	0	0	0	0	620	496	397

### An illustrative example

Consider a machine with a useful economic life of five years which is acquired for £1 million. After the end of year 5, it is disposed of for £100,000. Under the current regime, the machine is not eligible for the short life asset treatment. Therefore it is included in the main pool, with no balancing allowance unless the business stops trading. The total allowance given on this machine is £718k. Despite the machine having been sold, the remainder of the tax write-down value of £182k will be carried forward and claimed over time through the writing down allowance at a rate of 20% p.a. (reducing balance method). This defeats the purpose of the capital allowance legislation which is to let a taxpayer write off the cost (net of disposal proceeds) of an asset over the economic life of an asset: The balance of £182k will take over 20 years to be relieved.

#### Scenario A1 – With a 12.5% capital allowance level

	Main pool (000s)	Capital allowances (000s)
1 Cost	1,000	
2 Written down value after 5 years (12.5% reducing balance)	328	672
3 If disposed of in year 6		
4 Disposal proceeds (10% of initial value)	-100	
5 WDV eligible for WDA (2) - (4)	228	
6 WDA @ 12.5%	-46	46
7 WDV carried forward at end of year 6	182	
<b>8 Total capital allowances claimed over asset life</b>		<b>718</b>

If the machine is eligible for the short life asset treatment under EEF's proposal, it would be treated independently from the main pool, hence a balancing allowance arises. The total allowance given on this machine of £900k is higher than £718k as per Scenario 1 because the remainder of the tax write down value of £228k will be claimed as balancing allowances in the year of the disposal as opposed to being carried forward indefinitely as in Scenario 1.

#### Scenario A2 – With EEF's proposed extension to the Short Life Asset regime

	Main pool (000s)	Capital allowances (000s)
1 Cost	1,000	
2 Written down value after 5 years (12.5% reducing balance)	328	672
3 If disposed of in year 6		
4 Disposal proceeds (10% of initial value)	-100	
5 WDV eligible for WDA (2) - (4)	228	
6 Balancing allowance	-228	228
7 WDV carried forward at end of year 6	0	
<b>8 Total capital allowances claimed over asset life</b>		<b>900</b>

#### International treatment of useful economic lives

Country	Basis	Method	Recovery period
US*		AD	All assets: 3 – 20 years
			Manufacturing assets: 3 – 10 years
Ireland	Acquisition cost	SL	5 – 10 years
Germany*	Historical, acquisition or production costs	SL	10 – 16 years
France*	Initial cost or cost of manufacture	SL	Plant, machinery, equipment & tools: 10 – 20 years
Canada	Acquisition cost	AD	20 years
UK (20% capital allowance level)	Pooled costs	AD	30 years
Singapore			30 years
UK (potential – 12.5% rate)		AD	53 years

Source: US Congressional Research Service, PWC & EEF

## Annex B – A territorial tax system for the UK

The idea of a territorial system, aired by HMT during the summer of 2008, has potentially many advantages for UK manufacturers. The logic of such a system, and its theoretical benefit, is, undoubtedly, compelling although there are clearly significant issues would need to be resolved. Such detailed issues include compatibility with EU law, interest deductibility rules, appropriate transitional and grandfathering arrangements and a proportionate reduction in the headline rate of corporation tax.

Business needs certainty in order to make long term business decisions. Accordingly, it is crucial that business is presented with a clear “direction of travel” for a UK tax system. It is possible to move towards a new system in incremental steps provided business is confident of the ultimate goal.

### *Key elements of a territorial UK tax system*

Territoriality means taxing profits earned in the UK from UK activity and thus giving tax relief only for those expenses that relate to that activity. It also means not seeking to tax profits not so earned. Over and above the dividend exemption, territoriality implies abolishing, or at least severely limiting the Controlled Foreign Companies (CFC) system and also limiting interest deductibility to that related directly to UK trading profits.

On the basis that any change of the tax system should, in the first instance, be revenue neutral, the potential increase can be offset by reducing the UK corporation tax rate significantly. Moreover, the behavioural consequences are likely to allow a greater reduction in tax rate than, first level, neutrality would imply.

### *Designing a tax system*

There is a clear advantage in having a tax system that maximises the behaviours that we wish to see and, correspondingly, minimises undesirable behaviours (see Table B1). The key step in determining the design is therefore to determine the desirable behaviours and testing proposals against the potential reactions of the taxpayer.

**Table B1**

Desirable behaviours which strengthen the economy or add to the UK tax take	Undesirable behaviours which weaken the economy or subtract from the UK tax take
<ul style="list-style-type: none"> <li>• <i>Incremental UK business activity</i></li> <li>• <i>UK headquarters activity</i></li> <li>• <i>UK asset ownership</i></li> <li>• <i>Debt pushdown</i></li> <li>• <i>Overseas tax minimisation</i></li> <li>• <i>Secure debt-equity ratios</i></li> <li>• <i>Asset price stability</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Business activity export</i></li> <li>• <i>Overseas cash boxes</i></li> <li>• <i>Inversion</i></li> <li>• <i>Tax avoidance</i></li> </ul>

### *The current system*

Measured against these behaviours the current tax system fails. There would not be much disagreement over the view that our marginal tax rate is high, our CFC system onerous and our interest regime very generous. These are all key drivers of behaviour. Equally, the system meets none of the characteristics set out above. It is reasonable to suppose that a move to a suitably constructed territorial tax system, which removed the negative pressures, could significantly change behaviour with beneficial consequences for the UK economy, the taxpayer culture and the UK Exchequer.

It must also be remembered that this is not a zero-sum game for the UK and its taxpayers. UK taxpayers and HMRC can both be better off, if the system creates the desired behaviours.

## Annex C – VAT reform

### A 20% VAT rate

Although the political debate is focused on when the UK should repair the public finances, the most important question is how. Which taxes will go up, and by how much? And which spending budgets will be cut, and by how much?

The starting point for most analysis is the government’s assumptions in the 2009 Pre-Budget Report, which assumes two-thirds of the adjustment will come from spending cuts (and in particular deep capital spending cuts) and one-third from tax rises. The Institute of Fiscal Studies (IFS) calls for £13bn more in tightening by 2015/16 than planned for in the 2009 PBR. Similarly, PricewaterhouseCoopers (PWC) believe that an additional £20bn by 2012/13 is needed. EEF’s own forecasts and calculations suggest an additional £12bn could be needed by 2013/14.

To address this finance gap, EEF recommend a rise in the VAT rate to 20% from 01 January 2012. This would raise £2.8 billion in 2011/12 and £11.75 billion in 2012/13, according to HM Treasury figures. This additional tax revenue should then be used to mitigate the potentially savage cuts to government capital spending and mitigate the tax burden on productive sectors of the economy.

Raising the VAT rate to 20p, therefore, would accelerate the rebalancing process by shifting the burden of taxation away from taxes on productive businesses and raising the cost of debt-fuelled consumption.

### Consult on a flat rate VAT

EEF recommends that the next government should consult on removing or limiting the zero- and reduced- rates of VAT.

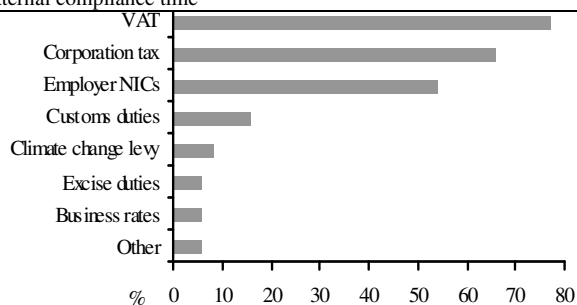
The alternative of taxing mobile and productive businesses and entrepreneurs would simply shackle growth or push it abroad. And the research by the IFS shows that, “it has been recognized for more than twenty years that the policy rationale for the zero-rating of food and children’s clothing is extremely weak.”<sup>iii</sup> Moreover, research by HMRC shows that VAT accounts for £1bn (20%) of the total administrative burden of UK taxes<sup>iii</sup>, a fact which EEF surveys shows is significantly adding to the compliance costs of UK manufacturers.<sup>iv</sup> Research by the IFS confirms our anecdotal evidence that differentiated VAT rates are a significant driver of the added administrative and compliance burdens.<sup>v</sup>

But broadening the VAT base would be highly regressive because higher VAT payments on, for example food, would represent a larger proportion of disposable income for families and individuals with low-incomes. The IFS suggest that revenue raised from such a measure would be enough to compensate those on lower incomes, while leaving sufficient revenues to help pay down the debt.

EEF, therefore, would recommend broadening the base of VAT if and only if it was part of an efficient and effective package of reform to overcome the significant distributional concerns.

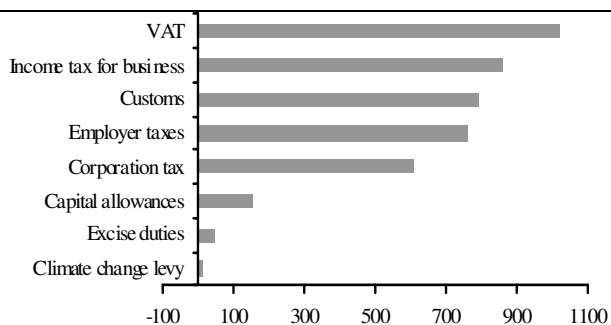
### VAT adds to administrative and compliance costs

Chart C1 - % citing tax as demanding greatest amount of internal & external compliance time



Source: EEF 2007 Tax Survey

Chart C2 - Estimated cost of administrative burden, £m



Source: HMRC

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## Annex D – Capital gains tax

### *A sustainable regime*

When a flat-rate capital gains tax rate of 18% was announced in the 2007 Pre-Budget Report, it reversed a decade of consistent messages on the purpose of the capital gains regime – to encourage long-term investment in business – and undermined the government’s credibility.

Despite the subsequent introduction of the Entrepreneurs’ Relief, the 18% rate was significantly lower than the 40p income tax rate, providing significant incentives for high-earners to artificially shift income into capital gains to avoid paying the higher rate. This incentive has been exacerbated by the sharp rise in the effective marginal rate for high earners following on from the 50p rate, restrictions in pension relief and removal of personal allowances.

The current regime, therefore, is unsustainable.

EEF’s has three priorities for reform:

1. *Close the gap between income tax and capital gains tax.* The wider the gap between the two, the greater the incentive for tax evasion – we need to avoid the pending cycle of avoidance and anti-avoidance measures.
2. *Provide incentives to invest in long-term productive assets.* Encouraging long-term investment in a balanced economy rather than short-term speculation should be a top economic priority for the next government.
3. *Implement a system that is designed to last.* Nothing is forever, but given the damage the 2007 change did to the UK’s reputation, this set of reforms need to be carefully managed, consulted on and understood before implementation. Choosing the wrong system that required yet further changes in 2-3 years time would confirm the UK as a tax basket case.

These priorities raise three questions for consultation:

1. *What is the appropriate relationship between income tax and capital gains tax?* The simplest option is aligning the two, while providing relief and/or incentives to hold business assets longer. However, the rationale for such a dramatic change from the current 18% rate should be carefully explained and consulted on.
2. *What is the best mechanism for encouraging investment in productive assets?* The previous capital gains regime used a relatively well-regarded business asset distinction to encourage investment in business, while the current Entrepreneurs’ Relief is designed to encourage serial entrepreneurship. Given the need to rebalance the economy, providing incentives to invest in long-term productive assets is clearly a priority. As part of the reforms to the capital gains tax regime, the next government should assess which – or another alternative – is the best method for meeting the policy aim.
3. *How should related schemes - such as the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) – fit with the new regime?* The EIS and VCTs are valuable mechanisms for channelling finance to small, growing business and they need to be made more efficient in any new capital gains tax regime.

## Annex E – Environmental taxes

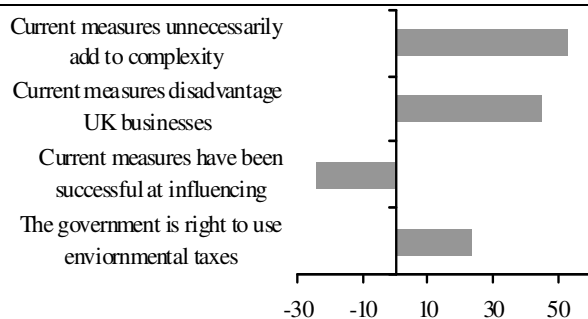
### *Transparent, smarter incentives*

The UK has set itself ambitious targets to reduce carbon emissions in the short, medium and long-term. This includes an EU mandate for member countries to reduce carbon emissions by 20% of their 1990 levels by 2020 and a UK target of an 80% reduction by 2050. Achieving the UK's goals will require action by business, the public sector, households and transport sectors, with the last two requiring increased effort, given their limited progress so far in reducing emissions.

#### Chart E1

##### *Role for taxes, but concern over current measures*

% balance of companies agreeing minus disagreeing with statements



Source: EEF 2007 Tax Survey

that current measures have been successful and so are concerned about the impact on competitiveness and the complexity associated with environmental taxation.

The UK's current mix of overlapping and complex environmental measures fail to provide clear and effective incentives to change behaviours. Instead these measures punish production and energy-intensive businesses.

Maintaining this status quo is not an option: we need a more balanced approach to carbon abatement. We favour an approach to carbon abatement that also provides transparent and stable long-term incentives to invest in clean technologies and energy supplies.

EEF's 2007 Taxation Survey shows that manufacturers believe that taxation has a role to play in addressing climate change (see Chart E1). Yet firms do not believe

A well-designed carbon tax can provide the incentives to change behaviour and invest in low carbon energy and technologies, but only under the following conditions:

1. *It's not just an additional cost.* We currently have a vast array of environmental measures. These include the Climate Change Levy, Climate Change Agreements, the Carbon Reduction Commitment, the Renewables Obligation, the Carbon Capture and Storage Levy and the Renewable Heat Incentive. A well-designed Carbon Tax, with the opportunity for all manufacturers to participate in Carbon Tax Agreements along the lines of Climate Change Agreements, would mean that manufacturers would not need to comply with the current combination of measures. It would also provide the finance and price signals to fund investment in low carbon energy and technologies without the need for measures such as the Carbon Capture and Storage Levy and the Renewable Heat Incentive.
2. *Consult on whether the carbon tax should be levied upstream or downstream.* An upstream tax on all fuels would minimise the administrative and compliance costs of implementing an economy-wide carbon tax. Yet, for many environmental measures – including critically the EU Emissions Trading System – the focus is downstream, affecting energy consumers. Careful consultation would be needed on how, and if, a carbon tax could be integrated alongside existing downstream measures.
3. *Protect the competitiveness of UK-based energy-intensive firms.* A carbon tax should provide incentives to invest in low carbon energy and technology while avoiding perverse outcomes for particular energy consumers, including the fuel poor and energy-intensive companies. Carbon Tax Agreements (similar to CCAs), for example, should be developed to ensure that carbon intensive sectors, that are unable to pass on the costs, are not exposed to carbon leakage.
4. *Revenues raised are used to develop clean technologies and energy supplies.* Manufacturers' appetite for environmental measures – including a carbon tax – is in part determined by how the revenues are used: they are opposed to measures that are designed to raise general revenue and/or cut taxes for other businesses (as the current government did with NICs cuts) or for families (as the Conservative Party are proposing). Because a tax is more predictable for users, it would be easier to predict revenues and budget for support for clean technologies.

## Annex F – A better legislative process

### *Improve quality through a slower, more deliberate process*

The UK has a code of practice on consultation but it is somewhat toothless. Consultation needs to be real, and there is always much cynicism about the extent to which even widely-expressed views are fairly considered. A proper consultative process needs to generate confidence in itself as well as aim for better tax law.

The key is allowing proper time for the whole process of consultation. This is well beyond the 12 week formula stipulated in the code. This would allow for detailed and wide-reaching consultation as there should be distinct phases of any consultation. Then it needs to be complemented by full and open reporting of consultees' views, with honest explanations of why particular routes are not being followed.

EEF endorse plans put forward by the Conservative Party as well as the Chartered Institute of Taxation (see table below) to improve the quality of tax legislation through a more structured, transparent and consultative process. The Conservative Party plans, in particular, to increase Parliamentary scrutiny and draw on expertise and experience of the House of Lords should be adopted regardless of which party forms the next government.

**Table F1 – Proposal for a more structured legislative process, by the Chartered Institute of Taxation**

Year 1	Budget year 1	Outline idea for change
	April year 1	Issue consultation document on idea and set out options
	July year 1	Gather responses to consultation document
	September year 1	Meetings & workshops with consultees on ideas
	PBR year 1	Report back on consultative responses and announce direction to be pursued
	November/December year 1	Issue second, more detailed consultation on proposed rules and first draft of legislation
Year 2	January/February year 2	Second round of meetings & workshops to discuss rules and draft legislation
	February year 2	Gather response to second consultation
	Budget year 2	Report back on second consultation, invite comment on remaining areas under discussion, announce new rules and consult on draft legislation
	Finance Bill year 2	Revise legislation as a result of final consultation
	Finance Bill debates	Bill Committee to call and/or examine witnesses regarding revised Finance Bill

Source: Chartered Institute of Taxation

<sup>i</sup> Introducing an eight-year limit for the SLA regime is cash-neutral for the Exchequer in net present value terms

<sup>ii</sup> Crawford, Keen and Smith (2008), Value-added tax and Excises. <http://www.ifs.org.uk/mirrleesreview/reports/indirect.pdf>

<sup>iii</sup> HMRC and KPMG (2006), Administrative Burdens – HMRC measurement project. <http://www.hmrc.gov.uk/better-regulation/kpmg1.pdf>

<sup>iv</sup> EEF (2007), Blurred Vision – the need for a clear strategy on corporation tax.

<sup>v</sup> Crawford, Keen and Smith (2008)