Pointmaker

10 POINTS FOR GROWTH

CHARLIE ELPHICKE MP

SUMMARY

- The long-term growth prospects of the UK economy will be determined by the expansion of the productive private sector and the re-skilling of its work force.
- Higher economic growth today would make this transition much easier.
- The Coalition has moved swiftly to improve the UK growth rate. This paper sets out 10 policies which are intended to add to the Government's Growth Review, to create a pro-business framework, to provide an economic stimulus for the private sector and to recognise the importance of both big and small enterprises.
- Measures to support larger businesses include:
  - reducing the main rate of corporation tax to 19%;
  - reforms to make the UK the corporate headquarters centre of Europe;
  - abolition of stamp duty on share transactions.
- Measures to support for smaller businesses include:
  - reform of UKTI;
  - float the smaller business growth fund on the London Stock Exchange;
  - lower capital gains tax rate for business assets or expansion of Entrepreneur's Relief;
  - expanding specific reliefs for entrepreneurs and small business investors.
- The following regulatory reforms are also recommended:
  - extension of the New Enterprise Allowance;
  - the creation of Transition Enterprise Zones;
  - less stringent Employment Law.

SUPPORT FOR LARGER BUSINESSES

Half of all private sector turnover is generated by larger businesses.[1] These types of businesses tend to be the most internationally mobile; moving in and out of jurisdictions on the basis of the tax and regulatory regime on offer. Indeed, Figure 1 shows that larger businesses are employing 1 million fewer people in the UK now than in 2001/02.

Recruitment and retention of these companies within the UK should be a cornerstone of any growth strategy. If the UK's competitiveness can be improved, substantial investment and employment could be generated.

Point one: lower corporation tax

A World Economic Forum report concluded that tax rates and tax regulations are among the most problematic factors for doing business in the UK, ranking the UK 95th out of 139 countries for the "effect and extent of taxation". The UK's corporation tax rate is the 12th highest out of 31 OECD nations[2] (higher than the Slovak Republic and Chile). Even worse, a Cato Institute[3] report found that the UK's effective tax rate on new investment for business is 27.9% (the 11th highest of the 83 countries considered), compared to an OECD average of just 18.6%.[4]

The UK's effective new investment tax rate is now higher than Germany (23.8%), Switzerland (17.6%) and Ireland (10.9%). This deters inward business investment.

The Coalition has pledged to reduce the main rate of corporation tax by 1% each year to 24%

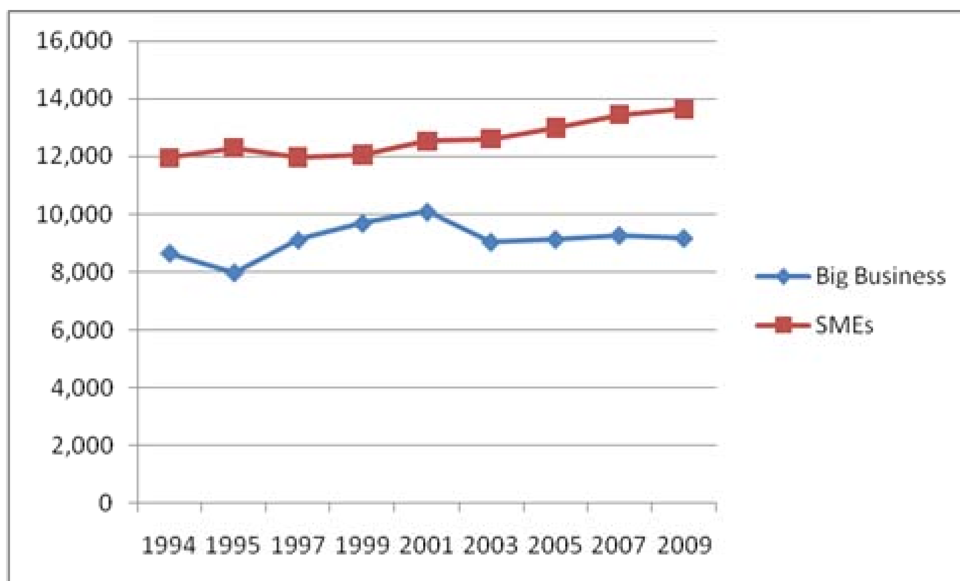
1 Those with 250 employees or more.

2 See www.oecd.org/dataoecd/26/56/33717459.xls

3 New Estimates of Effective Corporate Tax Rates on Business Investment (Cato Institute 2011) – see http://www.cato.org/pubs/tbb/tbb_64.pdf

4 Note that the effective tax rate can be a more revealing indicator of the tax burden than the headline rate as tax reliefs and exemptions can make the latter figure misleading.

FIGURE 1 – COMPARATIVE EMPLOYMENT OF LARGE BUSINESSES AND SMEs (THOUSANDS)



Source: BIS Economics and Statistics: http://stats.bis.gov.uk/ed/sme/

by the end of the current Parliament. While this is certainly a step in the right direction, the UK's rate will still be relatively high. Reducing the corporation tax rate further to 18% or 19% by the end of the Parliament would make a much greater difference in attracting inward investment – with the UK then among the five lowest business tax rates of OECD countries.

According to HM Treasury, the "static" cost of reducing corporation tax by 1% is approximately £800 million. But international evidence suggests that the dynamic effect of a lower business tax rate will mean the reduction is self-financing: increasing tax revenues and Foreign Direct Investment (FDI) capital inflows[5]. When Ireland reduced its corporation tax rate from 38% to 12.5%, corporation tax revenues *increased* by 24.3% a year, with a net FDI inflow of US$92.7 billion. Similarly, Australia's reduction of corporation tax from 36% to 30% saw a 16.6% increase in revenues each year and FDI inflows of US$44.4 billion.

By contrast, while the UK business tax rate was static at 30%, annual revenue growth was just 1.7% and FDI outflows amounted to US$404.1 billion. The US business tax rate was static at 40% and tax revenues rose 0.2% per annum, while FDI outflows were US$50.2 billion.

Point two: make the UK the corporate centre of Europe

Many European countries encourage businesses to headquarter in their jurisdictions. This is economically valuable as with the corporate headquarters comes financial management, HR and top end management functions, not to mention quotations on the UK stock markets. These generally create well paid, highly skilled jobs.

5 See C Elphicke and W Norton, *The Case for reducing business taxes*, CPS, 2006.

The UK is missing out on this opportunity because it lacks a tax regime that is sympathetic to multinationals choosing the UK as a place to headquarter operations in Europe. In contrast Luxembourg, the Netherlands, Ireland and Switzerland have all benefited from policies that attract multinationals to their countries.

What is needed? In simple terms, a tax rule that says foreign profits or interest payments brought into the UK by a subsidiary business will not be taxed in the UK, nor will they be deemed to be brought into the UK and taxed if held overseas. This is known as a "participation exemption", and would be most attractive to US multinationals. Positive moves have been made by the Coalition in this direction already. Further development of this area has rich potential.

Some will say that it is too late and that the UK has missed the boat. But this business is highly mobile. The UK has the attraction of a shared language, a legal system familiar to US investors, world-leading financial services and – in London – a highly attractive city to live in. Tax law changes of this nature have the potential to make the UK the corporate as well as the financial services centre of Europe.

Point three: support for the City of London share markets

A complimentary reform to the above proposal would be to encourage multinationals to seek a listing on the UK stock exchange.

The UK stock exchange is subject to growing competition and is finding it increasingly hard to compete effectively in a globalised world. Much of the reason for this is the stamp duty levy on shares traded in the UK markets, which both discourages companies from seeking a listing and makes accessing growth-inducing finance measurably more expensive.

The annual revenue to the Exchequer from stamp duty on shares currently amounts to £3 billion.[6] But the London Stock Exchange estimates that the economic stimulus from the abolition of stamp taxes would increase GDP by as much as 0.78% (or £12 billion at current prices), and make equity capital for UK business around 9% less expensive,[7] encouraging investment. The result would therefore be to entirely replace the lost revenues from stamp taxes[8].

However, since these are dynamic effects and the UK public finances are so fragile, this is a reform that could be announced now to take effect in three years time or, potentially more attractively, be phased in over three years.[9] Business behaviour is dictated by forward planning, meaning that the economic and revenue benefits of the economic activity should be in place by the time the revenues from stamp taxes fall away.

This reform would send out a clear message to larger international businesses that the UK is seeking and welcoming investment from overseas and committed to expanding and deepening the UK stock markets.

A similar, if less urgent, issue is that it is currently not possible for shares listed on AIM to be put into Individual Savings Accounts (ISAs). The AIM market has changed greatly since the late 1990s and it would be constructive to allow AIM company shares to be in ISAs so as to widen the investment pool. The case is made by smaller quoted companies because it would widen the availability of capital to businesses that are typically smaller in nature and faster growing.[10]

SUPPORT FOR SMALLER BUSINESSES

Small and medium sized enterprises account for around 60% of the UK's private sector jobs, and have been – so far – remarkably resilient in the face of the economic downturn. But small business owners constantly complain that their businesses are over-regulated and burdened by swathes of bureaucracy.

Point four: helping smaller businesses expand overseas

A recent OECD report into high growth businesses[11] recommended that an effective method to help SMEs to grow is to:

> "Promote innovation and internationalisation activities of new and small firms for their potential role as factors of enterprise growth, particularly when combined with other factors such as ambition to growth."

Given the growth trend of the emerging economies, it is highly likely to be the case that businesses trading with high growth countries will themselves grow more quickly: outpacing those trading domestically or with the (low growth) EU. Figure 2 sets out the expected relative size of G7 and E7 economies in the coming decades.

6 www.hmrc.gov.uk/stats/stamp_duty/table15-1-0910.pdf The relevant figure is the total 'Stocks and shares and other liable securities' figure for 2009-10.

7 KPMG, *Building a sustainable recovery,* 2010.

8 Ibid.

9 i.e. the rate would be 0.4% in year 1, 0.25% in year 2, 0.1% in year 3 and zero in year 4 onwards.

10 See Quoted Companies Alliance 2011 Budget Representations.

11 See OECD, *High-Growth Enterprises: What Governments Can Do to Make a Difference,* 2010.

Improving trading links with emerging economies is therefore important to the UK's future economic success, as the Prime Minister has indeed recognised.[12] Yet the tendency is for government delegations to include predominantly larger businesses.[13] Smaller businesses tend not to be considered, yet hold much intellectual capital and are sources of much innovation.

The evidence from a recent survey indicates that less than a quarter of smaller businesses export overseas.[14] Most that do are exporting to the EEA, US or Canada, while less than 15% of those exporting sell to China, India, Brazil or Russia. This means only around 5% of smaller businesses are exporting to the world's key growth markets. Meanwhile, less than one third of smaller businesses were aware of trade missions and UK Trade & Investments (UKTI), with only 6% having used it, while just 22% were aware of the Exports Credit Guarantee Department (ECGD). Only 1% had made use of it.

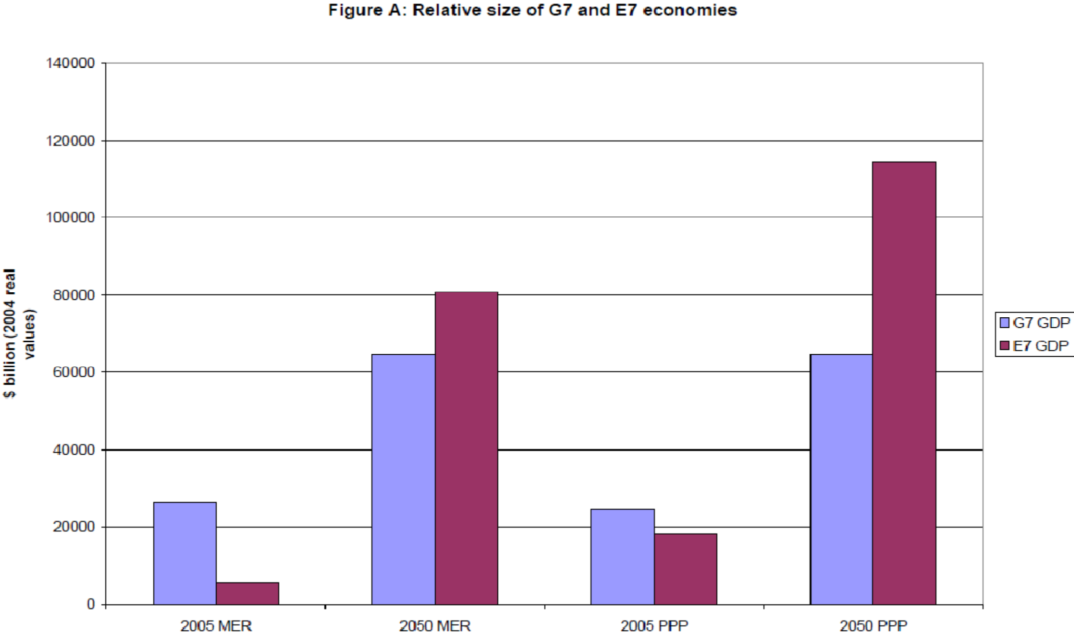
Given that the stated purpose of UKTI and ECGD is to assist business in just these areas, the evidence indicates that these organisations are not succeeding in their mission. This is underlined by small businesses saying they are most put off exporting by currency fluctuations, bureaucracy, getting paid, the ability to find customers and logistics of how to get goods and services to the overseas market.

12 The Prime Minister led a trade delegation to India in July 2010 and China in November 2010.

13 See e.g. http://www.telegraph.co.uk/finance/china-business/8116566/British-trade-mission-to-China-the-delegates.html for the Chinese trade delegation membership.

14 FSB, *Small businesses are exporting, but stifled by red tape,* 2010.

FIGURE 2 – COMPARISON OF G7 AND E7 PROJECTED GDP



Source: PWC, *The World in 2050,* 2006.

What can be done to help small businesses? The push clearly needs to be based around the availability of finance and credit security, clear promotion of help available tailored to small businesses, help with currency hedging, navigating red tape, finding customers and export logistics. All these items fall neatly into the province of UKTI and ECGD.

UKTI has a broadly sound strategy, placing special emphasis on China and India, and identifying 16 high growth markets (such as Brazil). But its results have been less impressive. The survey showed that just over one third of small businesses that made use of UKTI found it "very useful", while less than 20% found trade missions "very useful" and only 14% found the export credit guarantee department "very useful".

The Government's recent White Paper on boosting international trade[15] recognises that more needs to be done. But, rather worryingly, it appears to consider the UKTI a success for smaller businesses despite the survey evidence above. In reality, fundamental reform of both UKTI and ECGD is required. With just 2,225 staff in total, UKTI's 2007 annual report indicates that the resources allocated are very low. Serious consideration should be given to increasing trade missions in the US and Canada to build on existing small business exports to those nations, whilst doubling the size of trade missions in fast growth countries like India, China and Brazil, to foster small business trading links.

Similar reforms are needed for ECGD. The awareness and usage of ECGD as well as the reported satisfaction levels are a serious cause for concern, particularly when trade finance has been restricted as a result of the financial crisis. The Department for Business White Paper speaks of co-locating ECGD with UKTI. This is welcome, yet they should probably be merged altogether given the obvious overlap of functions. A greater, more explicit involvement by business groups is needed to help get the approach right; and promote exports to their members.

Point five: small business finance and liquidity

A substantial new £2.5 billion growth fund aimed at small business was recently announced by the Chancellor of the Exchequer in the "Project Merlin" settlement,[16] as well as a commitment on the part of banks to lend £10 billion more a year to small businesses.

The need for this is underlined by the latest Bank of England lending trends[17] report, which showed just how difficult it has been for small businesses to seek finance.

Much therefore is now being done by the Government to get debt liquidity to smaller businesses. It will be essential to monitor follow through on the part of the banks and to make sure that lending is made on affordable terms. It is also important that any increase in debt finance for SMEs is directed to innovative companies in a position to expand, rather than in propping up existing companies which are unviable in the long term.[18]

There is evidence that smaller businesses have serious difficulty raising equity finance. The businesses affected are invariably unquoted

15 See www.bis.gov.uk/assets/biscore/international-trade-investment-and-development/docs/t/11-717-trade-investment-for-growth.pdf

16 www.hm-treasury.gov.uk/press_17_11.htm

17 See www.bankofengland.co.uk/publications/other/monetary/TrendsJanuary11.pdf

18 See OECD, op. cit.

and normally seek between £250,000 and £15 million[19] and cannot tap equity capital markets in the way larger, quoted businesses do. This is why the £2.5 billion Growth Fund is such a positive step in the right direction.

But more might be considered. For example, the fund could be floated on the London Stock Exchange. This would allow pension funds and private investors greater exposure to UK smaller business investment and returns. It is also possible to introduce limited gearing from the money markets, creating a fund of between £5 billion and £10 billion. That kind of money, targeted at equity and intermediate finance in smaller businesses, could make a real difference in terms of bridging the "equity gap".

It will be essential for such a fund to be invested by professional fund managers rather than by government. Awards should be made on solid growth-orientated business models.

[19] See e.g. Department of Business, *The supply of equity finance to SMEs: Revisiting the Equity Gap*, 2009.

Point six: lower capital gains tax for investors or expand Entrepreneurs Relief

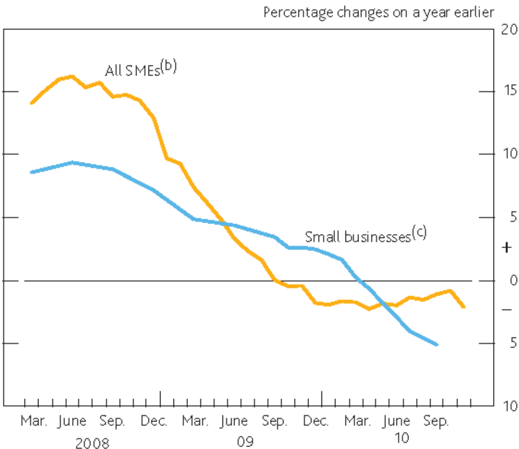
The system of capital gains tax taper relief introduced by the previous Government was effective in encouraging entrepreneurship. Its abolition was controversial.[20]

The old system broadly divided the treatment of assets between business and non-business assets. Business assets were taxed at a lower rate of just 10% (subject to being held for at least two years.) This meant that investors providing capital to a business paid almost no tax on their gains. In the dying days of the Labour Government, the distinction between business and non business assets was abolished and a uniform rate of 18% capital gains tax was imposed,[21] while the current Government has

[20] See e.g. www.ft.com/cms/s/0/749a1d24-cd27-11dc-9b2b-000077b07658.html#axzz1FBqDUuhb – in fact, there were many measures that could have ensured private equity paid a fair share of tax not involving the abolition of taper relief (e.g. longer holding period or the extension of deemed earnings rules).

[21] Budget, 2008.

FIGURE 3 – LENDING TO SMALL AND MEDIUM-SIZED BUSINESSES



Source: Bank of England, *Trends in Lending,* January 2011.

raised the rate of capital gains tax to 28%.[22] The same rate of capital gains tax is therefore payable whether the asset is a second home or a manufacturing facility employing hundreds of people, with no recognition of the economic benefits of the latter.

A lower rate of capital gains tax for investors should be re-introduced. This can be done on a revenue neutral basis: lowering tax on business assets to 10% for assets held for at least three years and compensating with increases on the tax rates on non-business assets. In this way the capital gains tax regime could be highly targeted to favour investments in businesses that will create employment and generate growth.

If the 10% tax regime for business assets cannot be reintroduced across the board, an alternative would be to expand Entrepreneurs' Relief. This enables investors to benefit from a capital gains tax relief such that tax will be paid only at the rate of 10% on the first £5 million of gains on the sale of shares or business assets in a trading business – and hence encourages serial entrepreneurship. However, this relief is available for sales of investments after just 12 months and has been criticised on the grounds of encouraging speculation above longer-term investment.[23] It also only applies where investors own over 5% of the business *and* are employees.

The relief could be expanded to apply to those who are *either* employees *or* those who own over 5% of the relevant business. This would provide a tax incentive for wider share participation by employees holding less than 5% in smaller businesses. It would also do more to encourage investment by business angels, further widening the available investment capital.

[22] Emergency Budget 2010.

[23] E.g. Quoted Companies Alliance 2011 Budget Representations.

Point seven: expand specific reliefs for entrepreneurs and smaller business investors

The Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) provide tax incentives to invest in smaller businesses. However, they are limited to companies that have 50 employees or less. This discourages business expansion due to the loss of the beneficial tax status and makes it relatively more difficult for larger small businesses (who might be better place to take on more workers) to access the tax advantaged capital.

A further problem is the unnecessary complexity of the rules. For example, investors cannot sit on the boards of the companies they invest in due to "connected party" rules – depriving businesses of potentially strong expert guidance from business angels and others who have a stake in the success of the venture.

Blame for this complexity has been placed by the UK Government on the EU state aid rules. However, EU state aid rules are less restrictive when it comes to SMEs. The EU rules provide that SMEs are enterprises having up to 250 employees or a turnover of €50 million and a balance sheet total of €43 million.[24] The EU provides a block exemption for state aid provided for "SME investment and employment".[25] In addition, the thrust of EU policy is clear in its support for SME investment and as such it should be possible to gain agreement for derogation to the benefit of investment in British SMEs. It is therefore to be hoped that Ministers will take better advantage of the opportunities that the EU regulations present and extend the benefit of the EIS and VCT rules to all small businesses falling within the EU definition.

[24] EU Council Recommendation 2003/361/EC.

[25] Commission Regulation (EC) No 800/2008.

REGULATORY REFORM

Point eight: encourage new start ups for all, not just the unemployed

Previous OECD studies on growth suggest that enterprise creation is an important factor in growth prospects.[26] Moreover, the expansion of the private sector is necessary as the public sector is planned to contract over the course of this Parliament. It is therefore important to remove as many barriers as possible to new enterprise creation.

The Coalition has announced a New Enterprise Allowance.[27] This will provide £2,000 to unemployed people who wish to start a business (and assist with business mentoring and guidance) from April 2011. The stated aim is to aid the establishment of 10,000 new small businesses over the next year.

Business groups have expressed concern.[28] The allowance will only apply to new enterprises established by the unemployed. This leaves out those who are employed but who could be better placed to set up a successful new enterprise (such as skilled people who may be in middle management and want to strike out on their own).

The New Enterprise Allowance scheme should therefore be widened to make it easier for anyone to set up a new business. The following measures would also make a substantial difference:

- Cutting back on non-compete clauses. In parts of the US, such clauses are unenforceable or restricted.[29] Releasing people from being bound in by such clauses in their employment contracts will make it easier for them to set up in business without fear of being pursued by their former employer. The OECD describes measures of this type as "reducing the regulatory restraints on competition".

- Direct incentives. Many people fear setting up in business due to a lack of capital and a concern about the cost of tax, regulation and employment law. An incentive scheme could include a cash start-up grant or loan (e.g. the £2,000 under the New Enterprise Allowance, or perhaps more for promising ideas) and a two year holiday from corporation tax, employer's National Insurance, lighter employment law and similar provisions. This could make a huge difference, encouraging more people to take the chance of setting up a new enterprise.

Point nine: transitional enterprise zones

The Coalition's plan to set up 10 new Enterprise Zones in the UK is at least partly inspired by the 'Enterprise Zones' set up in the 1980s.

The original Enterprise Zone policy was designed not solely for national economic growth purposes, but to regenerate tightly targeted local areas – both physically and economically. In theory, supply-side policies such as tax incentives, reduced bureaucracy and public-sector infrastructure renewal were applied to attract private-sector resources, to develop property and to increase business activity. The aim was to encourage new start-ups and attract

[26] E.g. OECD, *Fostering Entrepreneurship and firm creation as a driver of growth in a global economy*, 2004.

[27] See www.businesslink.gov.uk for details.

[28] See www.guardian.co.uk/money/2011/jan/05/new-enterprise-allowance-expanded

[29] E.g. California – California Business and Professions Code Section 16600.

inward investment within a ten-year time-frame, leaving an area regenerated with improved employment and economic prospects.

Today's problems are different from those of the 1980s. The Coalition will clearly target its Enterprise Zones in areas of greatest need. But there is also a strong case for the establishment of temporary Enterprise Zones to assist with smooth industrial or market transition. These might be called "Transition Enterprise Zones" and would be aimed at maintaining, for a short, limited time, an existing cluster of high labour skills and infrastructure in an industry that is in structural transition rather than dying or uncompetitive.

A prime example of a candidate for a Transition Enterprise Zone could be the Pfizer site at Sandwich in Kent. The pharmaceutical industry model is moving from large research sites to smaller businesses known as "contract research organisations" in collaboration with universities. This has seen the withdrawal of pharmaceutical companies in recent times from sites as diverse as Charnwood in Leicestershire; Harlow in Essex and now Sandwich in Kent. A Transition Enterprise Zone would help manage the transition and avoid the effective loss of up to date research laboratories and a highly skilled labour pool.

It is essential that such Transition Zones should be regarded as temporary measures only, designed to give an existing and viable cluster the time to identify and encourage alternative investors.

Point ten: simplify employment law

Small businesses can feel strangled by the weight of employment law.[30] Many are discouraged from expanding until absolutely necessary for fear of the costs that may fall on them if a hire goes wrong.[31]

The latest industrial tribunal statistics[32] show that there were 236,000 claims made to Employment Tribunals in 2009/10 (up from 151,000 in the previous year). The CBI calculated the cumulative cost of employment law[33] between 1998 and 2009 at £70 billion – which it says is equivalent to the employment costs for more than 215,000 people in full-time jobs paid at average earnings throughout the period.

The Government has recently announced a consultation on increasing the period of employment protection from the current one year to two.[34] This will provide small businesses with some relief from the burdens of labour law, but there are other reforms worth considering.

First, the maximum award an industrial tribunal can make is too high at £68,400.[35] The Labour Government increased the maximum level from £12,000 (at a time when average earnings were £14,888[36]) to £50,000 in 1999, and this has been uprated by inflation ever since. It would be more appropriate for the maximum compensation level to be equal to average

30 See www.smallbusiness.co.uk/channels/legal-advice/news/1297838/employee-law-a-burden-for-smes.thtml

31 www.fsb.org.uk/news.aspx?REC=4335&re=news.asp

32 www.justice.gov.uk/publications/docs/tribs-et-eat-annual-stats-april09-march10.pdf

33 www.cbi.org.uk/ndbs/positiondoc.nsf/1f08ec61711f29768025672a0055f7a8/E42F96B0AB675A48802575F300373D14/$file/20090706-cbi-jobs-for-the-future.pdf

34 Department for Business, *Resolving workplace disputes: a consultation*, 2011.

35 www.legislation.gov.uk/uksi/2010/2926/schedule/made

36 www.statistics.gov.uk/downloads/theme_labour/ASHE_1999/1999_all_employees.pdf

earnings – £25,900 as at April 2010.[37] At that level, the fear factor for employers that a huge award could be made against them would be reduced. The current number of tribunal awards greater than average annual earnings is only just over 5% anyway, so few would lose out in practice. But the boost in confidence to employers would be substantial.

A second reform is the introduction of a cap or a minimum length of service requirement for cases of discrimination in the workplace. The current regime of having no cap and no minimum length of service for such claims stirs fear on the part of all employers.[38]

A more effective system of ensuring a more balanced approach to employment protection could be enforcement by public fines. Poor employers would be exposed, fined, named and shamed as they should be. The wider body of employers would no longer be subjected to the nagging concern that they might be subject to spurious uncapped claims. Such a reform could also do much to boost the employment prospects of vulnerable groups, which must surely be the most just and desirable outcome of any reform.

Nearly half of all employers have reported a rise in weak and vexatious claims.[39] In almost a third of claims employers now settle even though they are advised they will win. There are practical ways the Industrial Tribunal system could dispose of such claims more quickly. Pre-trial reviews and more effective case management are possible under current law, yet rarely used. Requiring a deposit where a pre-trial review deems a claim weak, alongside greater use of cost orders, would help reduce the number of such claims.

CONCLUSION

Given the shocking state of the public finances, the only realistic option is for Britain to grow her economy through expansion of the private sector. The measures set out in this paper aim to increase the structural growth rate of the UK. Increased inward investment, encouragement for smaller businesses and a reduction of the regulations that hold back growth lie at the heart of these proposals.

Inward investment would be attracted through a lower rate of corporation tax, reforms to make the UK an attractive location for corporate headquarters and reforms to make the London equity markets more competitive.

Small businesses would be encouraged by the expansion of the business growth fund, the reform of Britain's export assistance and measures to incentivise business investment.

Regulatory reform through the extension of the New Enterprise Allowance to encourage new enterprises to be formed, the creation of Transitional Enterprise Zones and the reform of employment law to encourage the creation of more jobs would also help increase the growth rate of the UK.

If Britain grows faster, there will be more jobs and money for all. The pro business, pro jobs, pro money reforms in this paper seek to seize this opportunity to make our country and countrymen richer and more successful. A nation able to compete more effectively at a time of great change in the global economy.

[37] www.statistics.gov.uk/pdfdir/ashe1210.pdf

[38] www.cbi.org.uk/ndbs/press.nsf/0363c1f07c6ca12a8025671c00381cc7/d4b109e12bfc7c2a802577bb0055dcbf/$FILE/CBI%20HN%20ETS%20Oct%2010.pdf

[39] www.cbi.org.uk/ndbs/press.nsf/0363c1f07c6ca12a8025671c00381cc7/d4b109e12bfc7c2a802577bb0055dcbf/$FILE/CBI%20HN%20ETS%20Oct%2010.pdf

THE AUTHOR

Charlie Elphicke is MP for Dover and Deal and is a Research Fellow of the CPS. Before his election in 2010, he was a tax partner at a leading global law firm and was a member of the Corporation Tax Sub Committee of the Law Society's Revenue Law Committee. He is the author of numerous policy papers on tax, pensions and regulation.

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