Centre for Policy Studies

Pointmaker

HOW TO CUT CORPORATION TAX

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SUMMARY

- The main rate of Corporation Tax has gradually been falling in the UK, from 52% in 1982 to 26% now. The Coalition has said that this rate will continue to fall by one percentage point a year for the next three years so that it will be 23% in 2014.

- This halving of the rate of Corporation Tax has been accompanied by an ***increase*** in the revenue it has generated for the Treasury. In 1982-83, it yielded revenues equivalent to 2.0% of GDP. In this financial year, the Treasury expects Corporation Tax to yield 2.8% of GDP (or £43.2 billion).

- A further substantial and immediate cut in Corporation Tax now – to 20% – could do much to boost growth. It would encourage new investment by businesses (as it would improve net returns) and would send a strong signal that the Coalition is taking the supply-side measures necessary to restore growth. It would also represent a major simplification of the tax system.

- The recent evidence suggests that such a cut in the rate of Corporation Tax should ***not*** necessarily lead to a fall in revenues. However, given the weak state of the public finances, the static costs of a cut to 20% should be noted. Depending on the approach used, this might involve a loss of revenue to the Treasury of between £4 billion (according to the Treasury ready reckoner) and £8.5 billion (on a straight line basis).

- This theoretical fall in revenue could easily be matched by, for example, abolition of higher rate tax relief on pensions.

- This cut in the rate of Corporation Tax would afford a great opportunity to announce a programme of tax simplification

- A deeper cut may be desirable in due course. This would, however, require detailed planning to reduce opportunities for tax avoidance. This could probably best be done by introducing a "Further Corporation Tax" so that when dividends were paid by a company, the effective tax rate would remain at 20%.

- Business owners would then have a further significant incentive to reinvest profits, thereby creating a virtuous cycle of higher investment and higher profits.

INTRODUCTION

Corporation Tax is a tax on the taxable profits of companies and some other organisations. "Profits" include trading profits and investment profits (although dividend income is normally exempt) and capital gains.

In the current financial year, Corporation Tax is charged at a standard rate of 26%. There is a lower rate for smaller companies of 20%; and numerous exemptions, reliefs and special rules. While simple in principle, the application of Corporation Tax, and its interaction with other taxes, is anything but simple.

The standard rate of Corporation Tax has been falling for some time. Most recently, it was cut from 28% to 26% in the 2011 Budget.[1]

This is continuing a long-term trend. The standard rate of Corporation Tax was charged at 52% in 1982. The downward trend in UK rates is reflective of an international trend, which has seen the average OECD rate fall from 48% to 26% from 1981 to 2010 (see Chart 1 below), with the relaxation of capital controls having led to significant tax rate competition.[2]

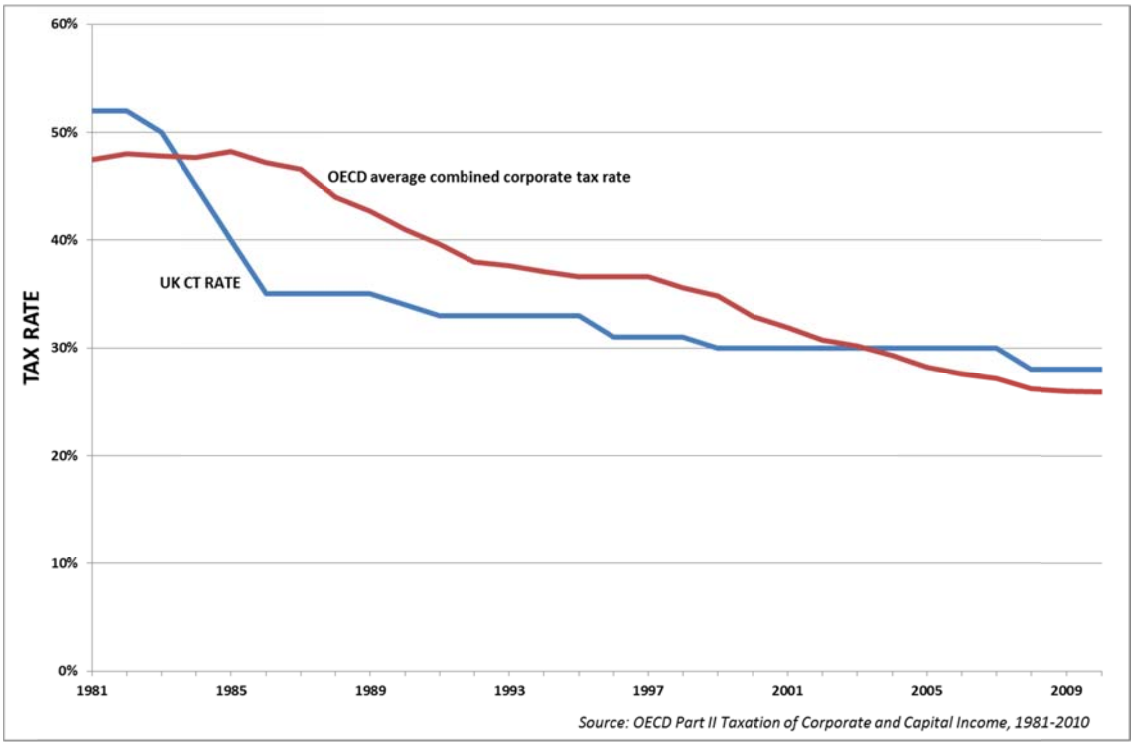
For much of this period, the UK took the lead in lowering rates, but since 2004 the OECD average combined rate has been below the main UK rate (while the UK rate is now 26%, one can expect the OECD rate to have fallen further since 2010). This perhaps helps to explain the Coalition's declared aim "to create the most competitive tax system in the G20."[3]

1 HM Treasury, Budget 2011 http://cdn.hm-treasury.gov.uk/2011budget_complete.pdf

2 M Devereux, B Lockwood, M Redoano, "Do countries compete over corporate tax rates?" *Journal of Public Economics*, 2008.

3 HM Treasury, Autumn Statement, 2011.

CHART 1: CORPORATION TAX RATES FELL FASTER IN THE OECD THAN IN THE UK



The 2011 Budget saw a commitment to cut the main rate of Corporation Tax to 23% by 2014 – which would be the lowest rate in the G7.[4]

Corporation Tax is an important source of revenue for the Treasury: in the financial year 2011-12, HM Treasury expects Corporation Tax to yield £43.2 billion. This is equivalent to 7.8% of all tax revenues and 2.8% of GDP.

WHY SHOULD WE CUT CORPORATION TAX NOW?

The UK is facing the possibility of a double dip recession. Demand in the economy is weak. Business confidence is low. Politicians of all parties are looking for ways to encourage growth. Bold steps should be considered.

Households are still too indebted to expect consumers to lead in the rescue of the economy. But many companies have cash available, and there is much potential for new private investment in such areas as infrastructure, healthcare, advanced engineering, building work and many other sectors.

Companies with growth potential will of course evaluate their after tax rate of return from any investment. But they also need the confidence to invest. A substantial cut in Corporation Tax would not only improve returns, but also provide a much needed boost to business optimism.

The Coalition's action on reducing the main rate of Corporation Tax has been welcomed by business.[5] However, research from the Cato Institute has shown that the UK still has relatively high effective tax rates on new capital investment, taking into account statutory rates, depreciation deductions, inventory allowances, and interest deductions, as well as other taxes that affect it. They calculate that the UK's effective tax on new capital investment in 2010 was 27.9%, compared to an 18.6% OECD average.[6]

There is also plenty of research evidence to suggest that reducing corporation tax significantly increases investment and boosts wages. A recent working paper by Djankov et al for example, finds that "a 10 percentage point increase in the effective corporate tax rate reduces the investment to GDP ratio by about two percentage points",[7] while previous CPS reports have highlighted the huge boosts to Foreign Direct Investment in both Ireland and Australia following large rate cuts – which occurred at the same time as increased tax revenues.[8]

It is also clear from Chart 2 overleaf that previous cuts in the main rate of Corporation Tax here have not necessarily lead to falling revenue for Treasury. In 1982-83, Corporation Tax was charged at 52% and yielded revenues equivalent to 2.0% of GDP; in 2011-12, the rate had halved to 26% yet the yield had increased to the equivalent of 2.8% of GDP.

There is some evidence that the upward trend in revenues has been in part due to the growth of the corporate sector as a share of GDP.

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4 HM Treasury, *Corporate Tax Reform: delivering a more competitive system*, November 2010.

5 CBI response to Treasury's road map on Corporation Tax February 2011. See www.cbi.org.uk/media/1039452/cbi_response_to_ct_road_map.pdf

6 D Chen and J Mintz, *New Estimates of Effective Corporate Tax Rates on Business Investment*, Cato Institute, 2011. See www.cato.org/pubs/tbb/tbb_64.pdf

7 S Djankov, T Ganser, C McLiesh, R Ramalho, A Shleifer, "The effect of corporate taxes on investment and entrepreneurship", NBER, 2007. www.nber.org/confer/2007/pef07/shleifer.pdf

8 See C Elphicke and W Norton, *The Case For Reducing Business Taxes*, CPS, 2006.

In the opinion of academic experts, this was driven mainly "by a combination and expansion of and improved profitability in the financial sector," but also due to the shift in the UK economy from manufacturing to services.[9] But despite the economic downturn since 2008, revenues still remain above 8% in terms of their share of total tax revenue and remain higher as a proportion of GDP than in the early 1980s.

A SHARP CUT RATHER THAN A PHASED REDUCTION

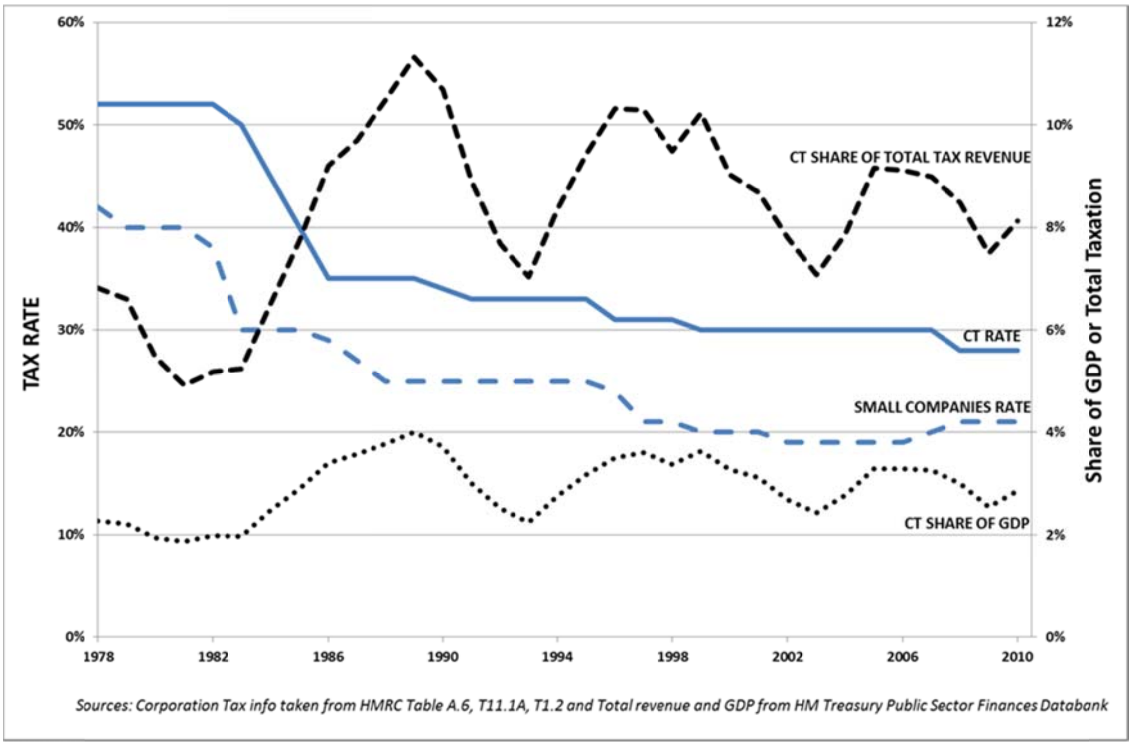
The continuing reductions in Corporation Tax will help business, and will help attract overseas investment. However, it is unlikely that this salami slicing approach to the issue maximises the impact of such a beneficial move on the business community.

A cut in the rate to 20% from the beginning of the 2012/13 financial year would be a quantum leap towards encouraging the enterprise economy which this country needs. It would be a wake-up call to business, both domestic and international. It would also be a significant simplification of the tax system (see below).

Chart 2 suggests that the dynamic effects of such a cut in the standard rate would not significantly affect Treasury revenues. However, those who insist on a static approach would calculate on a *pro rata* basis that an immediate cut from 25% (the rate planned for 2012/13) to 20% would represent a fall of around £8.5 billion in Treasury revenues.

9 M Devereux, R Griffith and A Klemm, "Why has the UK Corporation Tax raised so much revenue?" *Fiscal Studies*, December 2004.

CHART 2: A COMPARISON OF THE TAX RATE AND YIELD OF CORPORATION TAX



More realistically, the Treasury estimates that each percentage fall in Corporation Tax would lead to an £800 million fall in revenue.[10] According to this approach, a cut from 25% (the rate planned for 2012/13) to 20% would represent a fall in Treasury receipts of £4 billion from Corporation Tax.[11] This is equivalent to less than 1% of total government revenue.

Despite the appalling state of the public finances, these sums are not unaffordable given the potential such a cut would have in stimulating business confidence and growth. Those who needed a matching cut in spending could consider some combination of capping upfront tax relief for pension contributions by higher and additional rate taxpayers to the standard rate of tax (saving £7 billion); or abolishing contracting out of S2P (saving £3.5 billion) and ending the 25% tax-free lump sum entitlement from pensions (saving a further £2.5 billion).

TAX SIMPLIFICATION

Having the same rates for the standard rate of Income Tax and Corporation Tax would be a major simplification and would in itself have an energising effect on all those who despair at the current complexity of business taxation.

Perhaps the most common difficulty cited in connection with achieving tax simplification is that it creates winners and losers. While the winners may quietly accept their advantage, the losers can be vociferous. The best time to simplify, therefore, is when tax rates are being reduced generally, so that the losers from simplification have their pain eased.

Reducing Corporation Tax, and perhaps also business taxes on the self-employed, would represent a golden opportunity to substantially simplify the tax code for business.

The strategy for such simplification is clear. There is currently an artificially fragmented tax base for UK business. One needs separate rules and calculations for different sources of income, and for capital gains, and for capital allowances. On top of that are complex rules for aggregating the results of these calculations, and for how profits and losses can be offset. The first step for any serious reform is simply to define the tax base as the business profits. Until that Rubicon is crossed all other efforts at tax simplification will merely be tinkering.

This proposal was recommended by George Osborne's Tax Reform Commission and also by the more recent report of the CBI Tax Task Force. More detail concerning how to simplify business tax is in Annex 1.

TAX ON DIVIDENDS

Dividends currently carry a tax credit which is equal to 1/9 of the amount of the net dividend. Three special rates of income tax, either 10%, 32.5% or 42.5%, are then applied for basic rate, higher rate taxpayers and additional rate taxpayers respectively to the grossed up dividends.

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10 The impact would be lower in the first two years of any change as there is a lagging effect. See www.hmrc.gov.uk/stats/tax_expenditures/table1-6.pdf. Note that this table shows the revenue gained from each percentage point increase in tax. However discussions with Treasury officials have confirmed that they estimate that a decrease in the tax rate has an equal impact on reducing revenue.

11 Note that even "loss" would be at least partly offset by increases in revenues from other taxes. For example, if the lower rate of Corporation Tax encouraged a company to set up a subsidiary in the UK, then that would lead to higher income tax receipts, VAT, business rates and so on,

All this is highly complicated and confusing. The tax credit should be changed to correspond to the basic rate of income tax, which would also equal the rate of Corporation Tax under the proposal in this paper.

Thus, where a company earns a profit of £100, it would pay tax of £20 and could then pay a dividend of £80. The dividend should carry a tax credit of £20. Shareholders would have grossed up income of £100 for tax purposes, and the tax credit would satisfy the liability to tax on the grossed up income of £100 for the basic rate taxpayer, the 40% taxpayer would be liable to a further £20 tax, and the 50% taxpayer would be liable to a further £30 tax.

It will be noted that this proposal for dividends would go a long way to satisfy the need for neutrality in the tax system. It would not matter whether shareholders earned the profits directly, or incorporated a company to earn the profits and pay out a dividend. HMRC would collect the same aggregate amount of tax either way, leaving aside the issue of NICs which is addressed below.

More detail concerning the reform of dividend tax is in Annex 2.

SMALL COMPANIES RATE

It is not proposed to change the current small companies rate of 20%. In future, all companies would therefore pay the same rate of tax.

This would achieve simplification. It is also important not to create tax incentives for small businesses to incorporate for tax reasons only, when having a company conduct the business is otherwise inappropriate or unnecessary.

That is what happened to reforms of Corporation Tax when Gordon Brown was Chancellor. In April 2000, a new starting rate of Corporation Tax of 10% was introduced for companies having profits of less than £10,000. In 2002 this rate was reduced to 0%.

This created a huge incentive for businesses to incorporate – and many tens of thousands did so. A company with initial profits of £15,000 could pay a salary of £5,000 to its owner/director without him or her having any liability to income tax or NICs (because £5,000 would be below the relevant thresholds). The company would pay no Corporation Tax on the profit remaining of £10,000. This could be paid as a dividend tax free to a basic rate taxpayer (because of the tax credit attached to the dividend). In 2002/03 this translated into a tax saving of over £3,500 for an individual who chose to incorporate compared with an employee with the same gross income.

Because of this avoidance, the starting rate of tax was then abolished from April 2006, with the result that many of these businesses would now prefer to disincorporate – ironically it is often the tax cost that now prevents them from doing this.

The proposal in this paper would not give rise to such tax driven incentives to incorporate.

NATIONAL INSURANCE CONTRIBUTIONS

National Insurance Contributions remain a complicating factor.

A self-employed individual pays NICs at the rate of 9%. For this reason, the aggregate bill would be more for a self-employed man earning profits directly than if he used a company to earn the profits and then pay himself a dividend. The desire for tax neutrality would be thwarted to some extent, even where the rate of Corporation Tax becomes equal to the basic rate on Income Tax.

Consider the difference between:

- a company earning the profits and paying a dividend to its shareholder, who works in the business; and,
- a company paying a salary plus employer's NICs of an amount equal to those profits.

Employer NICs and employee NICs are normally charged at the rate of 13.8% and 12% respectively on salary paid. The total tax liability of the second route is just over twice the liability of having the company pay out a dividend instead of paying salary for a basic rate taxpayer.[12]

The problem of people setting up companies to contract out their own services is the source of the notorious "IR 35" issue, which HMRC has tried to tackle with highly complex law which is uncertain in its application. Cutting Corporation Tax to 20% does not exacerbate these problems because they mainly apply to small companies, and no change is proposed to small company taxation. But the point would become pertinent if it were decided to reduce Corporation Tax rates further (see below).

REFORM OF NATIONAL INSURANCE CONTRIBUTIONS

HM Treasury has conducted a public consultation on merging the operation of income tax and NICs. "Merging the operation" means for example levying income tax and NICs in the same way on income and benefits, and for the same charging periods, and on the same basis for separate employments, and so on. However HM Treasury has said they do not want to abolish NICs entirely, because they want to retain the contributory principle.

The contributory principle has however become more and more compromised over the years, and very many people are no worse off, or can even be better off, claiming means-tested benefits rather than contributory benefits. One could say that the whole National Insurance System is in a mess.

The Government has started a further review process, which is likely to be lengthy, on merging the operation of income tax and NICs; but the outcome of this process is not clear. While it remains the Government's intention to retain NICs as a separate charge it is possible that the NIC system will not survive the scrutiny that will now come to bear on it. If the separate NIC levy does survive, however, it may emerge from the reform process as effectively an earned income surcharge.

These points will need to be considered if even deeper cuts in Corporation Tax are to be made. The danger is that this would lead to strong incentives for incorporation as the tax system would then encourage businessmen to cut their tax bills, save NICs, and transfer investments into companies to reduce the tax bills on passive investment income.

HOW TO CUT CORPORATION TAX FURTHER

While an immediate cut in the rate of Corporation Tax is both feasible and economically desirable, further cuts will take more time. This is because it will be necessary to plan ahead to deal with tax avoidance issues.

Deeper cuts should be done in a way that not only reduces tax on business profits but also preserves neutrality as far as possible. In particular it is important that large numbers of

[12] Ignoring thresholds, NICs of 13.8% would be due, which means that only £87.90 can be paid out as salary (because £87.9 + 13.8% of £87.90 = £100). Employees NICs payable at the rate of 12% on the £87.90 (= £10.50) and basic rate tax of 20% of £ 87.90 (= £17.60) would also be deducted from the £87.90 salary, meaning that the employee would only receive £87.90 – £28.10 = £59.80.

people did not set up companies purely for tax reasons when a company would not otherwise be appropriate. The following examples of how this can be achieved are based on reducing the Corporation Tax rate to 15% so that when the company earns £100 profit, it would only pay tax of £15.

- Unincorporated businesses could be given the choice of electing into a system whereby profits were taxed only at 15% until such time as they were withdrawn for personal expenditure. The self-employed person who wishes to make such an election would of course need to maintain a separate business bank account into which all business receipts were collected, and to identify amounts withdrawn for personal purposes on which further tax would become due. In this way one would mirror to some extent the position for companies, where a low rate would apply until such time as a dividend is paid and more tax may become due from the shareholder.
- Alternatively, a company could be charged a "further corporation tax" when paying a dividend. That is, if the company were paying a dividend of £80, the company should pay further Corporation Tax of £5. Thus the total of £20 Corporation Tax paid would correspond to the £20 tax credit on the dividend, as above.[13]

The second option has numerous benefits:

- The business owner would have a significant tax incentive to re-invest profits into his company. The extra tax only becomes payable on the dividend when the funds are paid out by the company to be available for personal expenditure instead of remaining invested for business purposes.
- Leaving aside NICs, neutrality is preserved.
- There would be little tax avoidance reason to incorporate a company.

HOW WOULD TAX ON PASSIVE INCOME BE AFFECTED BY DEEPER CORPORATION TAX CUTS?

Suppose an individual is not in business but in receipt of passive investment income. He might clearly be tempted to incorporate a company to receive the passive income in order to take advantage of the low Corporation Tax rates. There are at least three possible approaches to this matter.

One is to apply a higher rate of tax to the profits of close investment holding companies.

This approach is adopted in Ireland, for example. The main rate, which is 12.5%, applies to the trading income of companies. It is low compared to international standards and its longevity (it was introduced in 2003) has ensured widespread confidence among international enterprises in the value of investing in Ireland. But a higher rate of 25% applies to non-trading income such as interest and rental income, and to profits from so-called "exempted trades", including land-dealing, income from working minerals, and petroleum activities.

A second alternative is to bring back the rules for close company apportionment (which were abolished in 1989) so as to deem passive

[13] Germany had a higher rate of Corporation Tax on undistributed profits until 2000 – ie the opposite of what is proposed here. But Germany has a classic system of company tax: there is not tax credit on dividends, and so this arrangement sufficed to equalise the aggregate tax paid whether or not profits were distributed. Their approach does not therefore contradict the approach suggested here.

investment income of the company to be distributed to shareholders. Tax is then paid on that basis.

A third solution is to introduce a savings regime for individuals which would mean that setting up a company has no or limited benefits in comparison. This may be the simplest and the best solution. A lifetime individual savings account would be appropriate for this purpose.

LIFETIME INDIVIDUAL SAVINGS ACCOUNTS ("LISAS")

It is quite clear that many or perhaps most people are not saving enough. According to a World Bank report last year the UK has the fifth lowest savings rate in Europe. Far too many people will arrive at pension age without adequate income and dependent on state support. But pension schemes look less attractive than ever, and people have lost confidence in them.

One attractive solution to this problem is to expand the ISA regime into an "LISA" regime – income and gains on savings and investments can accumulate tax free within a LISA until withdrawn for expenditure. Such a scheme could make a big impact on the level of savings, and it would certainly ensure that it was never worthwhile to set up a company simply to take advantage of low Corporation Tax rates on investment income.

CONCLUSION

Corporation Tax should be cut forthwith to 20%. But tax legislation needs a joined up approach – as mentioned above such a cut would also represent a golden opportunity to announce simplification at the same time. NICs are a major obstacle. Further, possible changes to NICs, or possible future reductions in Corporation Tax, all need to be planned for and anticipated in order to ensure that the tax system operates sensibly.

ANNEX 1: SIMPLIFYING BUSINESS TAXATION

At present the UK has one of the most complex codes in the developed world for taxing business.

If we wished we could move to having one of the simplest codes.

It is often said that our tax is so complicated because we have a proliferation of reliefs. These reliefs are then exploited, and a cycle ensues of anti-avoidance measures followed by yet more tax planning to get round these new rules.

While there is of course some truth in this, a detailed examination of the tax code reveals that the underlying cause of complexity is that we have a fragmented and unsatisfactory tax base.

The tax code contains:

- separate rules for income, unnecessarily sub-divided into different sources (particularly the division between trading and other income),
- separate rules for calculating capital gains;
- a separate system for providing capital allowances for some assets.

The rules for these systems do not marry together well.

Further, the rules are needlessly different for companies and individuals.

We have become so used to this segmented approach to the tax computation that it has become difficult to see the extent to which it is artificial and unnecessary. Overseas jurisdictions do not approach the problem of taxing business profits in this way.

The tax base should simply be the aggregate business profits pooled together "in one bucket", and those profits should be determined by reference to their accounts. For small and uncomplicated businesses this would simply mean taxing all profits on an accruals basis – i.e. taxing profits when they have been earned.

Adjustments to accounting profit will always of course be appropriate for tax purposes, but very few adjustments would be required for small and uncomplicated businesses. (Examples of such tax adjustments would be to deny relief for expenses not incurred for business purposes, or conversely to provide accelerated relief for capital expenditure up to a prescribed limit through the annual investment allowance.)

More tax law will be required for businesses which are for involved, say, with sophisticated financial instruments, or have overseas aspects, or are operated within a group of companies, or which indulge in tax avoidance.

But even allowing for adjustments the aggregate tax code could be made far shorter and simpler than at present. Anti-avoidance rules could be very much clarified and simplified. A preliminary exercise has been done which suggests for example that tax law for assets which are not trading stock could be reduced by between 80% and 90%

The requirements of GAAP could be relaxed to some extent in order to work out the profits of a small business, but this should not result in a step change in tax treatment as a business grows in size. A short tax code could be published which would be sufficient for small businesses, although more rules in the complete code might become relevant as they became larger and more complicated.

Tax law for incorporated and unincorporated businesses should be the same, with only isolated exceptions.

The approach outlined above should be further developed, costed, explained and consulted on. If sufficient simplification and rationalisation can be shown to be achievable it is very likely that taxpayers will be attracted by this approach.

Example of how the accounts based approach is better

Tax law can be very ill-adapted to modern commerce.

For example, there is a possible charge to capital gains tax where there is a "disposal" of an asset. There is no general definition of the word "disposal" in tax legislation, and "disposal" is normally taken to have its ordinary dictionary meaning of "transferring" or "alienating" or "getting rid" of something.

In modern commercial transactions, however, there is a spectrum of possibilities for dealings in an asset. These range from a simple sale to the financing of an asset which may, as a legal matter, be owned by the financier, but the risk and reward in the asset falls on a different person who is using the asset. Finance leasing and hire purchase contracts are treated quite differently under existing tax law, even though their financial effects may be very similar. Sales with rights or obligations to repurchase, limited recourse financings, sales where the seller retains some risk in the value of the asset, effective sales achieved through the making of a derivative contract rather than a disposal of the asset itself etc. also need to be addressed in the tax code. In the face of these possibilities, the concept of "disposal" in capital gains legislation can appear somewhat crude.

The corresponding accounting question is whether an asset should be "derecognised". The asset should cease to be recognised when all significant benefits and risks relating to the asset have been transferred. A "disposal" therefore occurs when the asset is derecognised.

The accountants' analysis of when an asset is to be derecognised is therefore more sophisticated than the tax concept of disposal. It reflects the commercial position, and this illustrates how profits which are determined by reference to accounting principles are more satisfactory as a tax base than old fashioned tax rules.

ANNEX 2: DIVIDEND TAXATION

Dividends currently carry a tax credit which is equal to 1/9 of the amount of the net dividend. There are three special rates of income tax on dividends, the dividend ordinary rate of 10% for basic rate taxpayers, the dividend upper rate of 32.5% for higher rate taxpayers, and the dividend additional rate of 42.5% for those who are liable to pay the top rate of 50% income tax – these rates are applied to the grossed up amount of the net dividend and the tax credit.

Thus if a company pays a net dividend of £90, the tax credit attaching to it will be £10, and a basic rate taxpayer will have a liability of £10 on the grossed up dividend which is satisfied by the tax credit, so that there is no further tax to pay on the dividend.

A higher rate tax payer will have a tax liability of £32.50, less the £10 tax credit, which is £22.50. An additional rate taxpayer will have a tax liability of £42.50, less the £10 tax credit, which is £32.50.

It will be noted that almost the same economic consequences could be achieved much more clearly and simply be having a tax credit of 1/4 of the amount of the dividend, and simply applying the usual basic, higher and additional rates of tax to the grossed up dividend. Thus a dividend of £80 would have a tax credit of £20 attached, and the grossed up dividend would be £100. (This was the rule until the change in April 1999, see below). The tax credit of £20 on the grossed up dividend of £100 would satisfy the tax liability of a basic rate taxpayer, who would have no further tax to pay on the dividend. A higher rate (40%) taxpayer would have a further £20 to pay, after deducting the £20 credit from his total £40 liability. An additional rate (50%) taxpayer would have a further £30 to pay, after deducting the £20 credit from his total £50 liability.

The tax rates on the net dividends under both existing and proposed regimes would be nil for basic rate taxpayers, 25% for higher rate taxpayers and either 36.1% (with a 1/9 tax credit and the existing special dividend tax rates) or 37.5% (if we returned to a 1/4 tax credit, without special dividend tax rates) for additional rate taxpayers.

The extra complication was introduced in April 1999 and it seems likely that the main or only reason for doing this was to reduce the amount of the dividend tax credit refunded to non-UK shareholders under double tax treaties. (In other words it was considered acceptable for the UK tax authority to artificially manipulate a reduction in its treaty obligations to overseas third parties, whilst the same tax authority frowns heavily on any artificial manipulation by tax payers to reduce their own obligations).

ANNEX 3: NATIONAL INSURANCE CONTRIBUTIONS

The Treasury has summarised the contributory principle as follows: "Individuals should pay NICs while in work in order to receive financial support while out of work, whether through illness or unemployment or in retirement".

This may appear at first sight to be relatively straightforward. But there are plenty of anomalies, at both the individual level and the aggregate level.

Anomaly one: who is "in work"?

As a preliminary point it is often hard to decide which individuals are "in work" and what is their "earned income" on which NICs are due. For example an owner of a company can pay himself dividends or salary. It is hard to decide how much is due to him in his capacity as "worker" or in his capacity as "investor". Perhaps one portfolio investor is very passive, but another spends a long time actively researching and analysing alternatives so as to increase his return – is the second investor therefore "working" for his income? A partner in a business may be working hard, or working little, or hardly doing anything. Indeed a self-employed business man can invest in personnel or equipment so as to reduce (perhaps to nil) the work that he needs to do himself. At what point does his income become "unearned" in a substantive sense?

The attempt to define the boundary between "earnings" and other income, and to charge NICs on "earnings" inevitably creates distortions and unfairness because no clear boundary exists.

Anomaly two: many categories of people are exempt from NICs but receive NICs credits

Under the contributory principle those in work (assuming these can be identified) should pay NICs in order to get financial support while out of work. But there is a long and complicated list of categories of people who do not pay at all but nevertheless receive NIC credits. This includes for example people on Jobseeker's Allowance, or people on maternity leave or paternity leave, or students, or people aged 60 to 65. There are many further limited categories eg for people on jury service, or people wrongly imprisoned.

Anyone in a job with earnings above the Lower Earnings Limit but below the Primary Threshold is also given NIC credits, even though their actual liability to pay is nil.

Anomaly three: little connection between the amount paid and the benefit received

For those who actually pay NICs, there is no real connection between the amount paid and the amount of benefit received. For example, A earns £100,000 a week and pays NICs accordingly but is entitled to the same contributory benefits as B, earning £200 a week. People who already have 30 qualifying years' earnings are entitled to receive a full pension. But if they continue to work and pay NICs it does nothing for their pension entitlement. Such examples clearly demonstrate that the system has ceased to operate as an insurance scheme but as a tax, particularly since NICs became earnings related in the 1960s. Indeed NICs are treated in practice by the Treasury simply as a tax.

Anomaly four: not all income from NICs is used for benefits
About £20 billion of NICs collected (which is about 20% of the total) are paid direct to the National Health Service without being paid into the National Insurance Fund. This is distortionary, because everyone can benefit from the Health Service, whether they have paid NICs or not.

Anomaly five: NICs are pooled, not accumulated on an individual basis
The remaining £80 billion collected through NICs is paid into the National Insurance Fund. However, amounts are not accumulated in any individual's account. There is no actuarially-based calculation (as would be done in the case of a normal insurance policy). Broadly speaking, aggregate amounts paid in equate to aggregate amounts paid out of the Fund, although in fact the Fund retains more money than official guidelines advise. Most people now retired will have begun paying NICs into the Fund at a time when the number of pensioners was half what it is now. Those individuals will therefore only have paid approximately half the cost of the pension now being provided to them. This fact alone is sufficient to demonstrate that the system is unfair and distortionary;

Anomaly six: the Fund is at the mercy of arbitrary adjustments
The Fund is at the mercy of arbitrary adjustments. For example, employers' NICs have been reduced (by about £13 billion up to 2005/6 alone) to compensate them for paying green taxes. This reduction has clearly impacted on the amount available to pay contributory benefits, and yet there is no logic behind the adjustment.

Anomaly seven: contributory benefits are often less generous than their non-contributory counterparts
But perhaps the biggest problem of all with the contributory principle is that you don't need to pay or even be credited with NICs in order to receive financial support while out of work. Indeed contributory benefits are typically less generous than their non-contributory counterpart:-

For example, income-based JSA is an automatic passport to health benefits, such as free prescriptions, and education benefits, such as free school meals, and maximum housing and council tax benefits. Contribution-based JSA carries no automatic right to any of these benefits, and is normally limited to 183 days;

It is no wonder then that the amounts paid out in income-based JSA dwarf the amounts paid out in contribution based JSA (about eight times as much) The contributory benefit is not worth claiming for those who qualify for the income based equivalent. Pension credit, which requires no contribution record, is (and will remain under proposals being considered by Government)) greater than or equal to the state pension;

Less than 45% of benefit expenditure by Government is now on contributory benefits. By far the biggest of which isthe state pension. And this overstates the extent to which benefits are granted in return for NICs actually paid, because of the system for conferring National Insurance credits.

The NIC system is a mess. The basic problem, as can be seen from the above, is that there is no satisfactory relationship between the payment of NICs and the receipt of benefits. There are other key issues, such as what constitutes the earnings tax base for NICs. But fundamentally the problem is that too many people who need benefits have not paid sufficient NICs or been granted enough NIC credits. This problem was serious even in 1948, when it prevented many of Beveridge's original recommendations being implemented – but now it is much worse.

Given the absence of a genuine relationship between NICs paid and benefits received it is not possible to reform the system satisfactorily with detailed changes. There is no clear rationale for deciding who should pay NICs and how much. Therefore it is not possible to determine where avoidance is taking place by reference to underlying principles.

Recent major reports have been unanimous that full integration of tax and NICs should be the goal – For example, Steve Webb (in 1992), Andrew Dilnot (in 1995), the Chartered Institute of Taxation (1998), the British Chambers of Commerce (2004), and the Mirrlees Review (2011) all came to broadly the same conclusion. The most recent major report that rejected integration was published as far back as 1986 in a Government Green Paper, but changes since then have served at least to some extent to undermine its conclusions.[14]

The nettle needs to be grasped. For the most part benefits in future should either be means tested (such as the new universal credit) or universal (such as the Health Service, education, and, it is submitted, a universal pension). There is no space for a satisfactory and substantive state-based National Insurance system in the middle.

There is actually a clear argument that we would then have a much better "contributory system" than before – one would make one's contribution to qualify for benefits by paying due tax under an integrated system, in which all income is taxed in the same way, if It is submitted that the current problems of distortion, complexity and unfairness can only be resolved on this basis. In particular, the problem of how to tax dividends or remuneration paid by companies can only be properly solved through full integration.

14 In particular there is no longer a group of people who at that time earned more than the upper earnings limit for NIC purposes but less than the higher rate threshold for tax purposes who would have to pay more tax under an integrated system. This gap (referred to as the "elephant trap" at the time) no longer exists. Further the contributory system has clearly been weakened since that time by other changes. If desired benefits payable only to employees (such as maternity pay) could be funded by a simple payroll tax on employers. The current NIC system is not required for such purposes.

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