



Tax – the weighty burden 2011

IoD POLICY PAPER





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by Richard Baron

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Tax – the weighty burden 2011

1 Summary

- The overall tax burden on businesses is a lot higher than the corporation tax rates of 20 and 26 per cent. Typical SMEs suffer burdens of between 32 and 43 per cent.
- A high burden can deter people from starting or expanding businesses, can deter capital from coming to the UK and can make it hard to raise the funds that are needed for investment in order to develop businesses.
- We can take into account corporation tax, employers' national insurance, business rates, road fuel duty, climate change levy and stamp duty land tax. Other taxes also bear on businesses, but the data that would be needed to identify the business burden are not available. We concentrate on incorporated businesses.
- Three examples are given: a micro business, a small business and a medium-sized business.
- A business can expect to have to pay four or five months' worth of profits to the state each year. The position has improved slightly since last year, but not enough to make life significantly easier for businesses.
- The promised reductions in the main rate of corporation tax, down to 23 per cent by 2014, will benefit medium-sized businesses significantly, but will make no difference to micro or small businesses. And even the benefit to medium-sized businesses will be less than one would expect, because many other tax burdens will remain unchanged.
- A reduction in the rate of corporation tax to 15 per cent, or a reduction in the rate of employers' national insurance to 10 per cent, would have a much greater effect, and would benefit businesses of all sizes.

2 What tax does to business

Last June, the IoD published a report that assessed the tax burden on business.¹ It will be an annual report, and this is the second edition. Each year, we will measure whether the burden is rising or falling, identify the reasons for the change, and make policy recommendations.

We have chosen to concentrate on the overall tax burden on business. This overall burden, which goes well beyond corporation tax, is of great significance for our future prosperity. The burden on business is rather ill-defined, but if we measure it in the same way each year, we can make valid comparisons and get a good idea of whether things are getting better or worse.

¹ *Tax – the weighty burden*. Institute of Directors, 2010.

One way to see the impact of taxation on prosperity is to consider the impact on business decisions.

- It is voluntary to start or expand a business. If people considering such a move see that too high a proportion of the rewards for their efforts will be taken in tax, they will not bother. Businesses that would have been viable and that would have had real prospects will not be created, and businesses with the scope to expand will not do so.
- Capital can be invested in the UK or elsewhere. It will tend to go where it can achieve the best post-tax returns. The point applies both to capital that originates in the UK, and to capital that originates elsewhere and that might or might not be invested in the UK. If capital is diverted elsewhere, the UK's economy and employment levels will suffer.
- The profits of a business are typically not wholly distributed to investors. Substantial amounts are kept back for re-investment in the business. If the tax burden on businesses is too great, directors will have to decide against making new investments. That will ultimately damage the prospects for the business. It is no answer to say that fresh capital can be raised from outside the business, because it is far cheaper and more straightforward to obtain finance from retained profits than it is to raise fresh capital externally.

We therefore concentrate on the taxes that will strike decision-makers as diverting returns away from their uses in rewarding investors or in building up businesses. This definition is not perfect. No usable definition of a tax burden on a particular group will ever be perfect. But it will still give a reasonable measure of the burden. The taxes are listed in section 3.2 below.

We do not call for the tax burden on business to be shifted elsewhere. We should reduce the tax burden for everyone, not reduce it for some and increase it for others. But a concentration on reducing the burden for businesses has the potential to help far more people than their owners. It will help businesses to expand, increasing employment opportunities and the likelihood of pay rises. Increased economic growth will also increase the tax base, making it easier to finance the public sector without increasing tax rates.

3 The size of the burden

3.1 The state's share

It is vital to be aware of the total tax burden, and not just its most obvious components. When we add up income tax, national insurance, corporation tax, VAT, excise duties and all the rest, we come to see that we pay a great deal of tax without noticing. But noticed or not, it is still a burden. If we think that the price of the public services that we can see is only the taxes of which we are constantly aware, we delude ourselves. And if we only notice those taxes, we seriously under-estimate the burden on those who work in the private sector to create jobs and wealth.

One way to make the total tax burden easy to grasp is to ask how much we work for the state, rather than for ourselves. The question is answered by looking at the proportion of the year during which we effectively work for the state.

This approach has been used by the Adam Smith Institute, which computes Tax Freedom Day for the UK each year. This is the day on which we stop working for the state and start working for ourselves. It typically falls in May or, in the worst years, in June. In 2011, it falls on 30 May.² This means that for the first 149 days of the year, up to 29 May, we work for the state. That is, the proportion of our work that is for the state is 149/365, or about 41 per cent. The concept was originally developed in the United States, and is now computed for that country by the Tax Foundation.

Our concern here is not to replicate the work of the Adam Smith Institute, but to make a similar computation that specifically relates to the tax burden on businesses. A business's profits are earned throughout the year. Some are taken by the state in taxes, while the rest are available to re-invest in the business or to reward those who have risked their capital in order to fund the business. If the business is owner-managed, profits can also be used to reward owners for their (usually considerable) efforts in running the businesses, to the extent that they do not take their rewards in salaries that are deducted in computing profits.

As with individuals, we can compute the proportion of a business's profits that the state takes in taxes, and translate that into a proportion of the year during which profits are being generated for the state, rather than for the business and its owners. (Profits that go to reward the owners are subject to additional taxation when the profits are paid to them, and when they spend the money.) We can then translate that proportion into a date which marks the end of the state's proportion of the year. The later the date, the more overbearing the state.

3.2 The method

The taxes

The taxes that we will take into account are as follows.

- Corporation tax
- Employers' national insurance
- Business rates
- Fuel duty on business transport
- Climate change levy on fuel and power for business purposes
- Stamp duty land tax on purchases of business property.

This is not a comprehensive list. Non-recoverable VAT, for example, is omitted, because data that would allow it to be quantified are not published, but it is still a burden on business, for example by leading to increased bank charges. We have omitted insurance premium tax on premia that are paid for business purposes, because there are no published data to divide the total burden of the tax between business insurance policies and private policies. Vehicle excise duty and air passenger duty are also omitted because it is not possible to divide the revenues

² <http://www.adamsmith.org/tax-freedom-day/>

into business and non-business amounts. These omissions mean that we underestimate the tax burden on business. But the list does include the other main tax burdens. It is also exactly the same list as we used in 2010.

The businesses

We focus on incorporated businesses. The proprietors of unincorporated businesses must pay income tax and class 4 national insurance contributions on their profits, instead of corporation tax. These impositions can be either a greater or lesser burden than corporation tax and the tax on dividends received by individuals, depending on personal circumstances. But given that most businesses can be incorporated if their owners so choose, and that many have to be incorporated in order to make it feasible to attract outside equity capital, a focus on incorporated businesses gives a reasonable measure of the tax burden. It also saves us from having to make assumptions about the personal circumstances of proprietors.

Rather than giving a single overall average, we have prepared calculations for examples of micro, small and medium-sized businesses. The vast majority of businesses fall into these categories. Large businesses are also vital to the economy, employing a great many people and paying vast amounts of tax, but there are far fewer of them, and the statistics that are published for the economy as a whole make it hard to present a picture of a typical large business.

The basis of calculation

We take the profits of each type of business before imposition of the taxes in question, and then see what proportion of those profits is taken in those taxes. That proportion can then be taken to represent a fraction of the year, the fraction during which the business generates profits in order to pay taxes rather than for the benefit of itself or its owners. The year taken is the calendar year, which is the period to which most of us relate most easily. Tax rates are generally set for the period from April to March, but it is straightforward to make apportionments in order to translate to calendar years.

Since all of the taxes in question, apart from corporation tax, are deducted in computing accounting profits, those amounts must be added back to compute a true pre-tax profit. Those amounts must then be included in the tax burden to be compared with that pre-tax profit, along with corporation tax. But the corporation tax burden must be computed on the profit without these add-backs, because they are deductible expenses for corporation tax purposes.

The presentation of the figures does, however, start with profits for corporation tax purposes. We then work back to profits before all taxes. The reason is that we want to start with profit figures that are broadly comparable to the figures that are shown in accounts. Profits are shown in accounts after deducting the taxes that we have considered, other than corporation tax.

3.3 The results for 2011

The results by type of business are as follows. All amounts are in pounds except for the numbers of employees and the ratios, days and dates at the end. Details of the calculations are given in the appendix.

	Micro	Small	Medium
Employees	5	20	100
Total salaries	129,500	518,000	2,590,000
Profits for corporation tax purposes	105,000	275,000	1,400,000
Corporation tax	21,263	55,688	369,438
Employers' national insurance	12,975	51,900	259,500
Business rates	2,841	17,180	85,900
Road fuel duty	2,535	10,140	50,700
Climate change levy	120	480	2,400
Stamp duty land tax	325	1,300	6,500
Total taxes excluding corporation tax	18,796	81,000	405,000
Profits before taxes	123,796	356,000	1,805,000
Total taxes including corporation tax	40,059	136,688	774,438
Taxes/profits before taxes	0.324	0.384	0.429
Tax days in the year	118	140	157
Date by which taxes paid	28 April	20 May	6 June
Date in 2010	1 May	22 May	10 June

3.4 The comparison with 2010

- The position of micro businesses has improved, but not dramatically. The most noticeable effects come from the reduction in the small profits rate of corporation tax from 21 to 20 per cent, and the enhancement to business rates relief for smaller businesses.
- The tax burden on small businesses has also lightened somewhat. The reduction in the small profits rate of corporation tax from 21 to 20 per cent explains this. But the burden of business rates and road fuel duty is rising. These are costs that do not rise and fall in line with profits, and companies

in difficulty feel the pinch. The fact that business rates only rise in line with inflation is small comfort.

- The improvement for medium-sized businesses has been greater, although they also started from a worse position than small businesses. Here we see the benefit of the surprise 2 per cent reduction in the main rate of corporation tax in this year's Budget. As with smaller businesses, burdens that do not change in line with profits remain a significant issue.

4 The way forward

4.1 The need for action

The burden of taxation on businesses is still far greater than corporation tax rates would suggest. The ratio of taxes to profits before taxes ranges from 32 to 43 per cent, as against corporation tax rates of 20 and 26 per cent (21 and 28 per cent in the first three months of 2011). It is clear that we have a serious problem, even though the computations have been made only for a few businesses, so that we are not entitled to conclude that they represent the average burden on business.

The immediate message to the Government is a negative one. Do not add any more tax burdens, under the mistaken impression that because corporation tax rates are reasonable, the tax burden is reasonable.

Another important point is that the total tax burden increases dramatically as the size of business increases. A key policy objective is to facilitate the growth of successful businesses. But a tax burden that grows in percentage terms along with the business, potentially to quite horrific levels, is a major obstacle to growth. Profits that are needed to finance growth, by providing extra working capital or by paying for new premises or equipment, are snatched away by the state instead. Policy-makers need to bear this in mind when contemplating any changes to the taxation of business. A growth policy can all too easily be undermined by the unintended, but still very real, adverse effects of a tax policy.

The obvious positive step to take is to reduce the burden, and thereby reduce the proportion of the year in which a business earns profits for the state rather than for itself. The place to start is the two burdens that are by far the heaviest, corporation tax and employers' national insurance. We can first assess the difference that the very welcome reduction in the main rate of corporation tax that has already been promised will make, and then see what more could be done, as and when fiscal conditions allow.

4.2 The promised reduction in the main corporation tax rate

By 2014, the main corporation tax rate will be 23 per cent, while the small profits rate will on current plans remain at 20 per cent. Only companies with profits of over £300,000 a year will benefit from this reduction. So our micro and small businesses will be unaffected (although they will be slightly better off in 2012 and later years than in 2011, because the small profits rate will be 20 per cent for the whole year, instead of 21 per cent for the first three months and 20 per cent for the last nine).

If a main rate of 23 per cent and a small profits rate of 20 per cent had applied throughout 2011, our medium-sized business's taxes would have been 40.2 per cent of profits before taxes. The business would have taken 147 days to pay all of its taxes, that is, up to 27 May. Corporation tax would have been £321,250 instead of £369,438, a fall in that tax burden of 13 per cent, but the fact that corporation tax is only one tax burden among many means that the percentage fall in the overall tax burden would be only 6 per cent.

4.3 Possible further reductions in corporation tax rates

Suppose that the corporation tax rate, on businesses of all sizes, could be reduced to 15 per cent. The IoD's view is that this is the right target, and that it is achievable within the next decade. A rate of 15 per cent would put the UK out ahead of the pack of other countries, helping our international competitiveness. It would also make a real difference to businesses of all sizes. The benefit to large and medium sized businesses would be particularly dramatic, which is not surprising because they currently pay corporation tax at the main rate (with marginal relief if their profits are below £1.5m). The new figures would be as follows.

	Micro	Small	Medium
Corporation tax	15,750	41,250	210,000
Total taxes excluding corporation tax	18,796	81,000	405,000
Profits before taxes	123,796	356,000	1,805,000
Total taxes including corporation tax	34,546	122,250	615,000
Taxes/profits before taxes	0.279	0.343	0.341
Tax days in the year	102	125	124
Date by which taxes paid	12 April	5 May	4 May
Actual 2011 date	28 April	20 May	6 June

4.4 Possible reductions in national insurance rates

Employers' national insurance is a heavy burden on employment. It has also been increased over the years. The Government that took office in 2010 let the last rise decided upon by its predecessor stand, increasing the main rate from 12.8 to 13.8 per cent, but negated the impact for employers of moderately-paid staff, and reduced the impact for employers of highly-paid staff, by increasing the amount of each employee's earnings on which contributions are not paid from £5,715 to £7,072 a year.

Suppose that the rate were reduced to 10 per cent, while keeping the amount on which contributions are not paid at £7,072 a year. Significant reductions in the

overall burden would then be achieved. With corporation tax rates of 20 and 23 per cent, as planned by the Government, the results would be as follows. (Note that the saving in national insurance has to be added to profits for corporation tax purposes, so that the total profits before taxes remain the same. By definition, those profits should not be directly affected by changes in tax rates. The beneficial effect of lower tax rates on profits is indirect, through the facilitation of investment and the encouragement of enterprise.)

	Micro	Small	Medium
Employees	5	20	100
Total salaries	129,500	518,000	2,590,000
Profits for corporation tax purposes	108,560	289,240	1,471,200
Corporation tax	21,712	57,848	338,160
Employers' national insurance	9,415	37,660	188,300
Business rates	2,841	17,180	85,900
Road fuel duty	2,535	10,140	50,700
Climate change levy	120	480	2,400
Stamp duty land tax	325	1,300	6,500
Total taxes excluding corporation tax	15,236	66,760	333,800
Profits before taxes	123,796	356,000	1,805,000
Total taxes including corporation tax	36,948	124,608	671,960
Taxes/profits before taxes	0.298	0.350	0.372
Tax days in the year	109	128	136
Date by which taxes paid	19 April	8 May	16 May
Actual 2011 date	28 April	20 May	6 June

4.5 Choosing an option

It is clear that significant reductions in the rates of either corporation tax or national insurance could bring considerable benefits. But these data are not enough to make a choice between these two leading options. Many other considerations would need to be taken into account. Furthermore, the examples of companies that are given here are merely examples, not mathematically average businesses.

It is, however, clear that the tax burden on business is far higher than corporation tax rates would suggest. We need a steady programme of tax rate reductions,

going much further than what has already been promised and stretching well beyond the end of the current Parliament.

Appendix: details of the calculations

Total salaries are computed using national median full-time earnings of £25,900 a year (Office for National Statistics, *2010 Annual Survey of Hours and Earnings*, page 3). Use of the median rather than the mean may under-state the total, and hence the burden of national insurance, but the median is more likely than the mean to give an appropriate figure for a typical business. Use of the figure for the year to April 2010 will also tend to under-state the total, and therefore the burden, but unfortunately no more recent figure is available. Amounts of employers' national insurance are computed by applying the rate to (total salaries – (employees x threshold for paying contributions)). We first apportion the salaries, and then apply the rates for 2010-11 to 3/12 of them and the rates for 2011-12 to 9/12 of them.

Profit figures are rounded versions of those used in 2010, so as to give a sound basis for comparison. The figures were established in 2010 by using data on the corporation tax paid in previous years by companies at given percentiles in the distribution. Those percentiles were taken from data on the numbers of people employed in companies of different sizes. One could repeat the same style of computation, but that would give a misleading picture of what might have changed from 2010 to 2011, because the data on tax payments by percentile come from 2007-08 and 2008-09.

Corporation tax figures are the computed by applying 2011 corporation tax rates to these profits, time-apportioning profits between the first three months of the year and the last nine months.

The business rates figures are computed as follows.

- Take the number of employees in the company as a proportion of the number of employees in the UK, and apply that proportion to the total revenue from business rates in the calendar year 2010. The reason for proceeding in this way is that both the number of employees and the revenue from business rates are published for businesses as a whole, not distinguishing between incorporated and unincorporated businesses. This approach should not lead to any great inaccuracy in the portrayal of typical businesses, given that there is no particular reason to think that the ratio of business rates to employees would differ significantly between incorporated and unincorporated businesses. And the fact that the figure for employees includes employees in the public sector means that there is no need to adjust the total business rates to exclude amounts that relate to public-sector buildings.
- The number of employees is taken as 29.2m (*Labour Market Statistics*, National Statistics, April 2010).
- The revenue from business rates in 2010 is computed as three twelfths of the 2010-11 revenue plus nine twelfths of the 2011-12 revenue. The figures are

£23.8bn (2010-11 estimate) and £25.5bn (2011-12 projection) (*Budget 2011*, HM Treasury, page 92), giving a figure for 2011 of £25.075bn.

- The figure that this produces for the micro business is £4,295, which would imply a rateable value under the 2010 valuation of $£4,295/0.428 = £10,035$, using a time-weighted average of the standard multipliers for 2010-11 (0.414) and 2011-12 (0.433). This would be small enough to lead to small business rate relief. The figure for the micro business has therefore been computed on a rateable value of £10,035, as $£10,035 \times 0.421 \times (0.02 \times (10,035 - 6,000)/120) = £2,841$. (0.421 is a time-weighted average of the small business multipliers of 0.407 and 0.426. The formula has 0.02, in place of 0.05 + 0.01, to reflect the temporary enhancement to small business relief that is due to run up to October 2012.)

Data on road fuel duty are not available in sufficient detail to allow us to identify the amounts paid by businesses. But we do have figures for duty on petrol and for duty on diesel. The latest available figures, for 2010-11, are £11.8bn for petrol and £14.8bn for diesel (*Hydrocarbon Oils Bulletin*, HMRC, April 2011). Both businesses and private motorists use both petrol and diesel, but the great majority of diesel and a substantial proportion of petrol will be used by businesses. We can therefore take the figure for duty on diesel, £14.8bn, as the minimum plausible burden on businesses.

We can then derive the figures for typical businesses by applying the fraction (employees in the business/total employees), as was done for business rates. And as with business rates, the fact that the total of employees includes public-sector employees means that there is no need to adjust the total revenue figure for amounts that fall on the public sector.

Fuel and power bills include climate change levy. The levy is not charged on fuel and power for domestic use, so we can allocate the entire amount that it raises to business. The amount for 2010 is £0.7bn (*Budget 2011*, HM Treasury, page 92). As with business rates, this total can be allocated in line with numbers of employees, and as with business rates, the inclusion of public-sector employees in the total means that there is no need to adjust for the fact that some of the levy will fall on the public sector.

It is said that all revenue from the climate change levy is recycled to business through a 0.3 per cent reduction in employers' national insurance and through support for energy efficiency and for low-carbon technologies (HMRC website). But we should not make any allowance for this, because the burden of national insurance has been computed on the basis of the rates in force, thereby taking account of any notional reduction, and because other support amounts to government spending, while our focus is on the tax burden.

Stamp duty land tax is payable when land and buildings change hands. Many businesses rent their properties, so that their landlords actually pay stamp duty land tax, but the cost inevitably filters through to businesses through increased rents. It is therefore not necessary for a business to move from one property to another, in order for it to suffer the burden of the tax.

Stamp duty land tax on non-residential properties amounted to £1,595m in 2009-10 (HMRC table 15.4, updated September 2010). The actual or estimated total revenues from stamp duty land tax for 2009-10, 2010-11 and 2011-12 are £4.9bn, £6.0bn and £5.8bn respectively (*Budget 2011*, HM Treasury, page 92). Given that we seek the burden for 2011, we should take the figure for 2009-10 and adjust it in proportion to the projected revenue from all stamp duties for later years. This computation gives a total for 2011 of:

$$£1,595m \times (0.25 \times 6.0/4.9 + 0.75 \times 5.8/4.9) = £1,904m$$

As with business rates, this total can be allocated in line with numbers of employees, and as with business rates, the inclusion of public-sector employees in the total means that there is no need to adjust for the fact that some of the burden will fall on the public sector.

