



House of Commons
Treasury Committee

Principles of tax policy

Eighth Report of Session 2010–11

Volume I: Report, together with formal minutes, oral and written evidence

Additional written evidence is contained in Volume II, available on the Committee website at www.parliament.uk/treascom

*Ordered by the House of Commons
to be printed 9 March 2011*

HC 753

Published on 15 March 2011
by authority of the House of Commons
London: The Stationery Office Limited
£13.50

The Treasury Committee

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1 Introduction

1. In June 2010, the Government published *Tax policy making: a new approach*. In the introduction the Exchequer Secretary wrote:

I want a new approach to tax policy making; a more considered approach. Consultation on policy design and scrutiny of draft legislative proposals should be the cornerstones of this approach. The Government will always need to maintain flexibility to make changes to the tax system. But in doing so, it should be transparent about its objectives and open to scrutiny on its proposals.

The Government set out a new approach to tax policy:

the Government is committed to a new approach to tax policy making, designed to support its ambition for a more predictable, stable and simple tax system:

- to increase predictability, the Government will provide taxpayers with clarity on its approach and certainty on the future direction of the tax system;
- to increase stability, the Government will slow down the rate of change to the tax code, focusing on fewer and better developed proposals supported by improved processes for changing tax law; and
- to increase simplicity, the Government has confirmed its intention to create an independent Office of Tax Simplification.

1.6 It is also important that the Government is held to account in the development of tax policy:

- when the Government makes changes to the tax code, it will ensure there is sufficient opportunity for policy and legislation to be properly scrutinised;
- to support good scrutiny, the Government will be more transparent about the rationale and impact of tax policy changes; and
- to maintain integrity of the tax code, the Government will evaluate the impact of significant changes after implementation.

The rest of the document set out changes to improve the tax policy making process and, in particular, the preparation of new proposals.

2. The Government's policy changes are welcome, but while they give significantly more clarity about the way in which tax policy and legislation will be dealt with in future, they could do more to set out the principles underlying that policy. To this end, we announced an inquiry to investigate these principles, asking:

- What are the key principles which should underlie tax policy?
- How can tax policy best support growth?

- To what extent should the tax system be structured to support other specific policy goals?
- How much account should be taken of the ease and efficiency with which a particular tax can be imposed and collected?
- Are there aspects of the current tax system which are particularly distorting?

3. Our work is based on extensive written evidence, which is remarkable for the degree of common ground on basic principles. It is also based on two sessions of oral evidence. The first was drawn from the authors of the Mirrlees Review of Tax Policy, conducted by the Institute for Fiscal Studies.¹ The second contained a number of tax practitioners.² We are grateful to all those who gave evidence, both oral and written. We are also extremely grateful to the ICAEW, and especially grateful to Anita Monteith,³ Tax Manager of the ICAEW Tax Faculty, who acted as Specialist Adviser on this inquiry and worked extremely closely with Committee staff in preparing this Report.

4. This is a preliminary report. It is the first time the Treasury Committee has examined the overall structure of the tax system. Not everybody will agree with the approach we have taken. In particular, some will want to add further principles, but in this Report we have endeavoured to create some common ground with the intention of stimulating greater stability in policy making, leading to incremental reform over a number of Budgets. We will also require the Treasury to explain the rationale for its approach to taxation in more detail and, among other things, to assess its coherence against increasingly accepted principles.

5. There is nothing new in seeking an overarching principle or principles for tax policy. For over two hundred years there have been attempts to define a set of fundamental principles, providing rules by which to assess objectively and apolitically, new tax policy proposals.⁴

1 Professor Richard Blundell, of the Institute for Fiscal Studies (IFS), and University College London, Professor Stephen Bond, Oxford University, Stuart Adam of the IFS and Paul Johnson, of the IFS and Frontier Economics

2 Francesca Lagerberg, of Grant Thornton, John Preston, of PricewaterhouseCoopers, Andrew Hubbard, of RSM Tenon and Past President, Chartered Institute of Taxation, and John Dickie, Director of Strategy and Policy, London First

3 Anita Monteith declared that she is a member of the Office of Tax Simplification SME Committee.

4 The most pragmatic may be that of Jean-Baptiste Colbert, the Controller-General of Finances of France under Louis XIV:

The art of taxation consists in so plucking the goose so as to obtain the largest amount of feathers with the least possible amount of hissing.

The most frequently quoted by our witnesses was that of Adam Smith:

The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.

The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person.

Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.

Every tax ought to be contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state.

Smith's principles have been the subject of debate ever since; Malthus added the long term stability of the economy.

6. In 1999 the ICAEW produced ten tenets for a better tax system. These tenets have been extremely influential. However, they look at the tax system as a whole, rather than focussing, as we do, on tax policy. (Our sub-committee is currently inquiring into the administration of HMRC). In summary, the ICAEW's tenets are:

The tax system should be:

1. **Statutory**
2. **Certain**
3. **Simple**
4. **Easy to collect and to calculate**
5. **Properly targeted**
6. **Constant**
7. **Subject to proper consultation**
8. **Regularly reviewed**
9. **Fair and reasonable**
10. **Competitive**

7. There is a wealth of information on tax matters. The OECD has regularly reviewed tax policy, both as a whole and through studies of individual issues. For the last six years the World Bank and PwC have produced an annual report on the ease with which tax can be paid in different countries around the world.⁵ In 2010, the Organisation for Economic Cooperation and Development (OECD) in Paris and the Institute for Fiscal Studies in London each published important reports on the fundamentals of tax policy.⁶

8. If determining tax policy were easy, this inquiry would not be necessary. Tax reform needs political backing. Our aim, as a cross party committee, has been to produce a number of tax policy principles which are common ground across the House. We will consider the measures contained in future budgets against these principles.

Pace of change

9. The tax system is the product of history, as Christopher Wales, a consultant and former member of the Council of Economic Advisers of HM Treasury, told us:

5 See <http://www.doingbusiness.org/reports/special-reports/paying-taxes-2011>

6 OECD(2010) *Tax Policy Reform and Economic Growth*, OECD Publishing, <http://dx.doi.org/10.1787/9789264091085-en>
The Mirrlees Review, *Tax by Design*, see www.ifs.org.uk/mirrleesReview

The UK tax system, as it stands today, reflects the economic, social and legal history of our country. If legislators were to start afresh, it would be constructed somewhat differently. Society changes and the economy changes.

and:

Largely because of its origins and history, the tax system today is riddled with instances where principles are in conflict. Anyone seeking to derive the principles that underpin the system today from the legislation would struggle to establish any principle from what we have on the statute book that is not contradicted somewhere in another piece of legislation.⁷

Over the long term, there may be a case for substantial changes to the tax system. As society and the economy change, the tax system should change to reflect them.

10. Several radical changes have been mooted. In its work on the financial crisis, the Committee in the last Parliament noted Lord Turner's point that the different tax treatment of debt and equity was among the factors which led to financial instability. However, Lord Turner was not sure that the United Kingdom could make a radical break to such an entrenched system.⁸

11. In this inquiry, we received many submissions advocating radical change to the tax system, such as the imposition of a land value tax. The supporters of such a tax consider that it would tax economic rent rather than economic activity and would meet the OECD criterion that recurrent taxes on immovable property were the least harmful tax.⁹ However, as the CBI notes, "the OECD acknowledges that it is politically difficult for governments to shift the tax base onto property."¹⁰ The ICAEW warned "Our initial conclusion is that, even if such a move was desirable economically and let alone whether it would be politically acceptable, it would involve a major rebalancing of the UK tax system which would take time to achieve and risks introducing considerable distortions and behavioural changes."¹¹

12. Not only are there political difficulties: practical matters, such as the way in which such values would be assessed and the extent to which such a tax should take account of the current or the potential use of land, would also need careful consideration. We also note concerns that "While such a tax system would avoid distortions in economic behaviour, it would be highly unlikely to yield sufficient revenues to fund socially useful expenditure without producing substantial inequity."¹²

7 Ev w133 [note: references to 'Ev wXX' are references to written evidence published in the volume of additional written evidence published on the Committee's website]

8 Ninth Report of Session 2008–09, *Too important to fail, too important to ignore*, HC 261-I, para 12

9 *Tax Policy Reform and Economic Growth*, p 10

10 Ev w107

11 Ev w89

12 OECD 2001, *Tax Policy Studies No. 6, Tax and the Economy: A Comparative Assessment of OECD Countries*, p 17, see also OECD (2010), *Tax Policy Reform and Economic Growth*, pp 51-2, 92-94

13. While we attempt to construct some principles to guide policy makers, we recognise that sudden wholesale reform is likely, in some areas of the tax system, to be impracticable. The principles we and others set out can shape the system over the long term. We welcome the fact that tax policy making is currently the subject of considerable analysis and scrutiny, particularly by practitioners. If this can be sustained, there is a reasonable prospect of gradual improvement to the tax system.

2 The principles of tax policy

14. Oliver Wendell Holmes considered tax as the price we pay for a civilised society. Modern governments and societies depend on taxation. As the recent World Bank/PwC report on *Paying Taxes*, said:

Taxes are essential. In most economies the tax system is the primary source of funding for a wide range of social and economic programmes. How much revenue these economies need to raise through taxes will depend on several factors, including the government's capacity to raise revenue in other ways, such as rents on natural resources.¹³

The OECD reports that tax revenue as a percentage of GDP in OECD member states in 2008 ranged from 21 per cent in Mexico to 48.2 per cent in Denmark. The political debate around the structure and incidence of taxation can obscure the broad agreement that a significant proportion of GDP has to be devoted to taxation in order to sustain necessary services. It is notable that even in Mexico, a comparatively low tax country, over a fifth of GDP was taken in taxes.¹⁴

Establishing the principles

15. In its written evidence to this inquiry, HM Treasury said

Defining a sound basis for tax policy making is critical - taxation affects the decision making processes of business, households and individuals, reaching into all aspects of life and the economy.¹⁵

16. Tax policy covers a whole range of matters from where tax should fall and what it should aim to achieve, to the legislative framework for tax, its administration and complexity. As a 2001 OECD study put it:

Three features of taxation are especially important. *First*, so long as taxation affects incentives it may alter economic behaviour of consumers, producers or workers in ways that reduce economic efficiency. These effects should be taken into account when the costs and benefits of public expenditure to be funded are being assessed. *Second*, the distribution of taxation's impact across the population raises issues of equity, or fairness, which must be given substantial weight even if it entails costs in terms of economic efficiency. *Third*, the practical enforceability of tax rules and the costs arising from compliance are important considerations, the more so since these are both affected by, and have implications for, the efficiency and public perceptions of the fairness of tax systems.¹⁶

13 PwC and World Bank, *Paying Taxes 2011, The global picture*, p 7

14 OECD Revenue statistics, comparative tables

15 Ev w95

16 OECD 2001, Tax Policy Studies No. 6, Tax and the Economy: A Comparative Assessment of OECD Countries, p 17

17. Although these aspects of tax policy are linked, it is possible to distinguish between what can be seen as “basic” principles and “procedural” principles. The two basic principles raised by almost all of our witnesses were the fairness of taxation and its effects on economic performance. The “procedural principles” were given various names, but can be described as certainty, stability and practicability.

18. There is a further overarching principle, which is coherence with the rest of the tax system. In a mature tax environment, radical change cannot be made quickly without having an impact on other parts of the system. For example, while income tax has been charged on individuals since independent taxation was introduced in the 1980s, tax credits are awarded on the basis of family income. This creates complexity in the system for a particularly vulnerable sector. In our inquiry into the Comprehensive Spending Review, we noted similar problems created by the clawback of Child Benefit from higher rate tax payers.

19. In this Report, we discuss the principles separately, but the distinction between basic and procedural principles is fundamental. A tax system which is theoretically structured to promote growth, that is, which has the basic principles right, will not succeed if businesses are faced with constant change, or if the inefficiency of collection outweighs any benefits. And taxes can reduce growth, even if they are stable, clearly targeted, and efficiently collected, for example where the system contains incentives which distort economic activities. The coherence of the system affects the basic principles of both fairness and growth—a system which is riddled with anomalies will not be considered fair and will impair economic performance. It also matters for the procedural principles of certainty, stability and practicability, since incoherence will make them harder to achieve.

3 The basic principles

Fairness and economic welfare

20. There was a consensus among our witnesses that tax should be “fair”. Fairness is complex and people will accept that some of their tax will go to finance services they themselves do not require or even disagree with. However a system in which taxation is perceived to be unfair overall can result in increased levels of avoidance or evasion. In extreme cases, a perception of unfairness can lead to loss of legitimacy.

21. There is little consensus about the detail of what constitutes fairness. There are supporters of the view that simple flat rate taxes would reduce evasion, increase tax take and result in lower rates for all. By contrast, there are those who argue for greater progressivity in tax rates. As Christopher Wales said:

Fairness might be a good principle to underpin the system but what does it mean? It is a loose concept, to which we all might subscribe, but capable of many different interpretations.

22. This ambiguity was demonstrated in much of the evidence. It is generally accepted that distributional and fairness objectives may lead to some loss of economic performance. As Professor Blundell pointed out:

The idea generally is to increase welfare and that doesn’t line up precisely with GDP. There are distributional fairness objectives and other considerations.

How welfare should be maximised is and will remain the stuff of legitimate political debate and controversy.

23. A tax system which is felt to be fundamentally unfair will quickly lose political support. However, judgements about the fairness of policy details are politically contested and a major way in which parties distinguish themselves from one another. This can obscure the fact there is a significant amount of consensus on fairness. The differences are often matters of degree and emphasis. For example, although there are arguments about the extent to which taxation should redistribute resources directly, there is general support for some redistribution.

Growth

24. As our terms of reference indicate, we take it as axiomatic that, insofar as possible, tax policy should support growth. In a much quoted study, the OECD found:

A country’s rate of economic growth depends on many factors including the rate of economic growth of its main trading partners, the country’s innovative capacity, the availability of venture capital, the amount and type of investment, the degree of entrepreneurship, the skills level and the mobility of the workforce, the flexibility of the labour market, the degree to which individuals have an incentive as well as an

opportunity to participate in the labour market, the labour costs for employers of hiring workers, the availability of qualified workers, the administrative burden on businesses, product market regulations, the economic infrastructure as well as the legal certainty and the confidence level of consumers and businesses.

The tax system plays a crucial role as it is likely to impinge on many of these factors. The level of the taxes that are raised, the tax mix, the quality of the tax administration, the complexity of the tax rules and the tax compliance costs, the certainty and predictability for households and businesses of the taxes that have to be paid, the network of tax treaties as well as the specific design characteristics of individual taxes including the availability of tax incentives and the broadness of the different tax bases can have an impact on the country's rate of economic growth.¹⁷

25. As the Mirrlees Review work on *The economics of tax design* points out, taxation is likely to reduce economic efficiency by distorting price signals:

In an idealised world, price signals would ensure that private choices led—via Adam Smith's famous 'invisible hand'—to the best outcome for society. Taxes disrupt these signals by driving a wedge between the price paid by the buyer and the price received by the seller. For example, income tax means that an employer pays more for an hour of work than the employee receives for it, while VAT means that a retailer receives less for a product she sells than her customer pays for it. By increasing prices and reducing quantities bought and sold, taxes impose losses on consumers and producers alike. The sum of these costs almost always exceeds the revenue that the taxes raise—and the extent to which they do so is the deadweight loss or social cost of the tax.¹⁸

26. Taxation can also distort behaviour. The CBI pointed out that a "tax neutral" system in which those in similar situations were taxed similarly would not distort choices and behaviour, while "A non-neutral system creates incentives to reduce tax payments by changing behaviour—the behavioural response. This may be either a deliberate policy choice, such as in the case of taxing polluting industries more heavily, or incidental to the revenue collection objective." Behavioural responses can reduce economic activity, even when such reductions are not intended. The consultancy *Transforming communities* told us that the VAT system, in which businesses which reach the VAT threshold are subject to VAT on all their transactions, including those previously below the threshold meant that:

Many businesses will evade paying VAT either illegally through hiding income and expenditure or legally by stopping their trade in quiet periods such as is seen with businesses dependent on seasonal tourism but who could afford to operate in the quieter periods if there were no VAT.¹⁹

17 OECD (2010), *Tax Policy Reform and Economic Growth*

18 *The economic approach to tax design*, <http://www.ifs.org.uk/mirrleesreview/design/ch2.pdf>, p 9

19 Ev w70

27. Tax structures may also mean that time and effort is diverted into finding ways to avoid tax. As the OECD points out “An increase in the standard VAT rate may increase informal-sector trade and cross-border shopping, and an increase in the top PIT rate will reduce work incentives and might provide self-employed businesses with a tax-induced incentive to incorporate.”²⁰

28. There are complex trade-offs. The economic potential lost through taxation may be offset by the fact that tax revenues are used to buy goods (such as education or transport systems) which may themselves increase a country’s growth potential. However, in setting taxes, Governments should be alert to the effects that tax will have on economic growth.

Using taxes to change behaviour

29. Some witnesses considered that economic efficiency should not be the main consideration in tax design. The TUC told us:

Tax is not an option within a developed economy; it is an integral part of it. A developed economy is always a mixed economy; the state and private sector do, without exception, interact in such economies to create the environment in which personal, social, political and societal goals are met. This point is stressed: economic growth is an element in achieving these goals, but it is not the sole way in which they are achieved. As such any policy on growth has to respect other purposes for taxation as well.²¹

However, the CBI warned that:

even if a policy aim is thought to be worth pursuing, the question should always be asked whether the tax system is the most efficient method of delivery. The tax system is often a blunt and indirect tool, and, additionally, using the tax system in this way inevitably increases complexity.²²

The BBA agreed that “fiscal policy is too imprecise a lever to successfully or predictably drive a particular behavioural response. Furthermore, the use of tax incentives and disincentives may result in unintentional consequences, such as an adverse effect on economic growth.”

30. ACCA, the Association of Chartered Certified Accountants, pointed to problems in attempting to resolve market failures through the tax system:

44. Growth is best supported by simplicity and removing the drain on productive time imposed by unnecessary bureaucracy and complexity.

20 OECD (2010), *Tax Policy Reform and Economic Growth*, p 54

21 Ev w112

22 Ev w109

45. Using (reductions in) tax to subsidise particular business sectors or activities is of debatable efficiency. Differential taxation introduces complexity to the system, which acts as a drag on all taxpayers [...]

46. However in order to effectively deal with the market inefficiencies they must first be valued. Policy makers must then establish the level of tax incentive required to offset that inefficiency. The disconnect between problem and solution leads to further inefficiencies and potential market distortions.²³

31. Although there is a consensus that neutrality is a desirable end of the tax system, there is also controversy over the circumstances in which neutrality should be compromised. We agree with HM Treasury that:

24. The main aim of the tax system is to raise revenue. [...].

25. The tax system can be used to support wider objectives, but if tax policy is used to support these objectives it should be judged as representing the best value for money with respect to alternatives such as regulation or spending.²⁴

We also note the CBI's warning that even when taxation has been chosen as a policy instrument for changing behaviour:

The haste with which some tax policies with a behavioural objective are developed, however, may mean that insufficient consideration is given to the principles of good tax policy.²⁵

32. Governments of different parties will have different views of what constitutes welfare and different policies to pursue it. The use of taxation should not be ruled out as a means to that end. However, the indiscriminate use of taxation to achieve wider policy goals may increase the complexity of the system and be counterproductive. Governments should be wary about using tax policy as a substitute for direct policy measures, doing so only after careful analysis shows it to be the most effective tool.

Competitiveness

33. The UK needs to be a competitive place to do business, to attract investment and encourage growth in the economy. Tax policy can be used to help generate such a competitive environment. In his evidence, John Preston of PwC said “[...] competitiveness is key, but it’s what comes out of all of the other principles.” The United Kingdom is an open international economy and its tax system cannot be considered in isolation. The CBI placed particular emphasis on the need for competitiveness:

In the current economic climate, it is particularly important that taxation policy is undertaken in a way which supports, or, where possible, does not inhibit, economic growth. This means that tax competitiveness is also a critical principle.

23 Ev w62

24 Ev w97

25 Ev w109

The competitiveness of corporate taxation influences not only the decisions of internationally mobile companies to locate and/or remain in the UK, but also the incremental investment choices made by international groups with operations in the UK. As well as affecting the stability and breadth of the tax base, multinationals tend to have higher rates of productivity and produce positive spillover effects in the countries in which they operate. Therefore, an uncompetitive corporate tax system can have negative implications for both tax revenues and economic growth.²⁶

34. Competitiveness is not simply about the rates at which taxes are levied. In its written submission to us, the Chartered Institute of Taxation (CIOT) told us competitiveness:

[...] means far more than tax rates that are comparable (or lower) than our competitors. It means that the system must deliver the certainty referred to above and operate in a business-friendly way. In recent years there has been a growing perception that the UK's tax system has become less competitive with uncertainty probably being at least as important a factor than simple tax rates.²⁷

In its evidence, HM Treasury emphasises this point.

The Government's priority is returning the UK economy to balanced, sustainable growth. An economically efficient tax system that is both competitive and stable helps minimise distortions and provides businesses with the confidence to invest and expand. The tax system should also consider the international mobility of capital and labour in the context of a highly competitive global economy.²⁸

35. The scope for tax arbitrage has grown substantially over the last quarter of a century. Globalisation is likely to increase it further. A tax system which is not competitive by international standards will not support growth. Competitiveness is not a simple matter of tax rates, although they have a bearing, but of the stability of the system as a whole.

26 Ev w106

27 Ev w130, para 3.4

28 Ev w96

4 Procedural principles

36. Tax rates may be the subject of political controversy, but there was a remarkable degree of consensus among our witnesses about the importance of other matters in making an effective and even fair, tax policy. These can be described as “procedural” principles. Our witnesses gave them a variety of different labels: for the purposes of this report we shall describe them as:

- Certainty
- Stability
- Practicability

They are not glamorous and not necessarily easy to achieve. The tax system cannot be entirely static. It needs to evolve to reflect changing economic circumstances. It has to respond to international agreements. Government has a legitimate interest in reducing tax avoidance, and may need to change the rules to do this. However, taken as a guide, we believe these principles could improve the tax system appreciably.

Certainty

37. Certainty stems from two things—the clarity of the underlying law, and the confidence that the law will be interpreted and applied in a consistent manner. Clear and certain tax laws contribute to both the fundamental principles of fairness and growth. Taxpayers who can understand the rules and who know that others who share their circumstances will be similarly taxed are more likely see the system as fair. The more certainty there is, the less effort individuals and companies will have to divert to establishing how the tax system will affect them, and the less likely it is that taxpayers and the revenue authority will become involved in disputes about the tax effects of transactions and need to resort to the appeals system.²⁹

38. Unfortunately, even the apparently simple principle that individuals and companies should be able to have a clear idea of the taxes for which they are liable is hard to achieve. There are a number of barriers to certainty:

- lack of legal clarity;
- complexity in the tax system;
- poorly targeted legislation

Legal clarity

39. The law relating to tax can simply be unclear. This arises in two ways:

- ambiguity about the detail or application of particular measures;
- the language used in tax legislation.

Ambiguity

40. There has been a tendency in recent years for tax law to be written broadly and to be supplemented by copious amounts of HMRC guidance. While HMRC is charged with administering and collecting tax, it should not be left with the task of interpreting tax policy where there is uncertainty in the legislation. Guidance is helpful to taxpayers, providing information about HMRC's likely stance on a particular issue, but it does not determine the law. Moreover, as the CIOT told us, a need for extensive guidance can indicate a problem with the underlying law.³⁰

41. Many of our witnesses called for all tax law to be made by statute and for improvements in the lawmaking process to ensure that such legislation was properly scrutinised. Currently, the House of Commons sets out the main rate of tax and the structure of the tax system in primary legislation (the annual Finance Acts). More detailed provision can be made by secondary legislation, considered in varying degrees by the House of Commons. Some powers to make directions have been delegated to the Commissioners of the Revenue.

42. Where necessary, HMRC has some power to make extra statutory concessions. However, the extent to which it has discretion to do so was limited by the *Wilkinson* judgment in 2005. In that case a widower claimed that he should have been given the tax allowance granted to widows; among the reasons for rejecting that case, Lord Hoffman considered that although the Commissioners of the Revenue could make extra statutory concessions “construing the power so widely as to enable the commissioners to concede, by extra-statutory concession, an allowance which Parliament could have granted but did not grant, and on grounds not of pragmatism in the collection of tax but of general equity between men and women” was beyond their powers. However, Lord Hoffman was clear that some extra statutory concessions were legitimate:

This discretion enables the commissioners to formulate policy in the interstices of the tax legislation, dealing pragmatically with minor or transitory anomalies, cases of hardship at the margins or cases in which a statutory rule is difficult to formulate or its enactment would take up a disproportionate amount of Parliamentary time.³¹

Legal clarity is important, but the statutes may require interpretation. In theory, certainty could be achieved by giving HMRC greater powers to interpret the law, and giving it power to make binding guidance, or a wider range of non statutory concessions. This would not be acceptable. HMRC's powers should be limited and

30 Ev w129

31 House of Lords, Judgments - Regina v. Her Majesty's Commissioners of Inland Revenue (Respondents) ex parte Wilkinson (FC) (Appellant)

should be subject to reasonable challenge in the courts. The public interest in ensuring that HMRC is not sole arbiter of the law overrides the interest in certainty.

43. **However, although tax law should have a statutory basis, we do not consider it realistic to expect that all tax law will be made by primary legislation, or to rule out the use of Commissioners' directions, or the use of extra statutory concessions, providing they are limited to formulating policy in the interstices of the tax legislation, dealing pragmatically with minor or transitory anomalies, cases of hardship at the margins or cases in which a statutory rule is difficult to formulate.** Even the British tradition of legislative drafting, which is far more precise than that in many other jurisdictions, cannot be expected to cover all the ways in which the law could be applied. Moreover, some provisions, such as double taxation reliefs, are inherently suitable for secondary legislation. **However, if details are to be left to secondary legislation, or to directions, scrutiny is important.** We deal with this in Chapter 5.

Clear drafting

44. Tax law is often written in a style which makes it difficult for tax professionals to work with and impossible for a layman to understand. Tax may be simplified by using words which are more appropriate to the policy and which can be understood more easily. The Tax Law Rewrite (TLR) project which has rewritten much of the UK's direct tax legislation in a more accessible style, has attempted to contribute to this.

45. However, while the tax profession has welcomed the TLR's outputs and made positive comment on the usability of the legislation it has produced, it has certainly not made the underlying tax law appreciably easier for the layman to navigate. Nor, as the Institute of Directors pointed out, has it clarified the underlying tax policy.³²

46. **We support measures to improve the drafting of tax legislation. However, clarity of language will not help the taxpayer establish his or her situation with certainty if the underlying policy is unnecessarily complex.**

Complexity

47. The more complex a tax system is, the harder it is to administer and the harder it is for taxpayers to assess their own liability. Complexity can be caused by a number of things:

- the use of tax policy to achieve wider goals than simply maximising revenue;
- seeing the system as a series of discrete tax measures, rather than assessing it as a whole, which leads to an accretion of measures, rather than their re-shaping;
- the introduction of measures to reduce tax avoidance.

48. The ICAEW warned that:

32 *How competitive is the UK tax system?* IOD policy paper, 2010

The tax system should be designed to raise revenue efficiently to fund spending requirements. Using the tax system to support other policy goals is at best problematic and may result in unexpected behavioural changes and prejudice revenue flows.³³

It recommended the use of sunset clauses to ensure that such uses of the tax system were at least regularly reviewed.

49. When asked how to simplify tax, John Preston said

[...]if we're talking about policy, the best way of the simplifying the tax system is to try to only tax the same base once. So you don't try and apply lots of multiple taxes to the same type of income. An obvious example, which is controversial, is PAYE and national insurance, where you're applying different taxes to the same basic base and that obviously hugely complicates the process.³⁴

The Government established the Office of Tax Simplification on 20 July 2010. "Michael Jack and John Whiting have been appointed as the Chair and Tax Director to lead the Office on an interim basis, and will work on a part time, unpaid basis. They are supported by a small secretariat including tax experts from HM Revenue & Customs and HM Treasury and external secondees from the tax and legal professions."³⁵ The aim of the office is:

to provide independent advice to the Chancellor on simplifying the UK tax system, with the objective of reducing compliance burdens on both businesses and individual taxpayers.³⁶

Its preliminary reviews have identified over 1000 tax reliefs and allowances. The OTS final review of tax reliefs looked in detail at 155 of those reliefs and recommended that 54 remain unchanged, 37 be looked at in more detail, 17 be simplified and 47 be abolished. They also recommended wider work on specific parts of the tax system. The Chancellor is expected to respond to this work in the Budget. The OTS is also working on a small business tax simplification review." It is clear that this work is long overdue. **We welcome the establishment of the Office of Tax Simplification. This has been established for the life of the current Parliament. Whether this body or something similar could make a further contribution in the next Parliament will be assessed by this Committee and others when its current projects are completed, and the Chancellor has responded. In principle, higher quality work from HM Treasury and HM Revenue and Customs in this field should render such a permanent body unnecessary. If and when the benefits of the Office of Tax Simplification are clear, its resources should be reviewed.**

33 Ev w87

34 Q 109

35 <http://www.hm-treasury.gov.uk/ots.htm>

36 Office of Tax Simplification Framework Document

Targeting

50. Poorly targeted policies can also create uncertainty for the tax payer. Our witnesses gave the rules for taxing non-domiciles as an example of such difficulties. Previously, non-UK domiciled individuals were taxed only on income which was generated in, or remitted to, the UK. In 2008, this was changed so that non-UK domiciled individuals were taxed on their world wide income whether it was remitted to the UK or not. The remittance basis for non-UK income could be retained only if they made a payment of £30,000. John Dickie of London First said ‘The Government have estimated that they have raised, I think, £162 million in tax from non-domiciles paying the levy, which is 5,400 people paying it in its first year, which is below the original estimate [...].’³⁷

51. Andrew Hubbard, of RSM Tenon, and the past President of the Chartered Institute of Taxation, told us:

I think that there are 500,000 non-domiciles, probably more than that, but the vast majority of those people who are non-domiciled have no overseas income; they’re your cliché Polish plumber, all those sorts of people. People that are second generation or third generation people who are non-domiciled who may not even know it. Their tax status under the old rules wasn’t affected by the fact they were non-domiciles, because all their income was in the UK. One of the issues that comes out of this is that if you’re going to tax non-domiciles then you have to have in your mind an entire picture of what you mean by non-domiciles because the rules as they were drafted, I think, have been drafted very much in the target of high-earning international-type non-domiciles, rather than those in the UK who may have very small amounts of income abroad, or go abroad for a few weeks to help on the family farm over the summer.

Those people are non-domiciles and I think one of the issues around trying to define policy in all of this is to say, “Okay, when we talk about non-domiciles or a group of people, what do we mean? Who do we have in the target?” And I think that that has been potentially why we’ve had so many difficulties in that, because the mindset of who we’re dealing with is not necessarily rooted in reality.³⁸

52. One of the difficulties is that there is no authoritative figure for the number of non-domiciles resident in the UK nor for the sources of their income. The policy may be proportionate to the high earning wealthy individuals who are often highlighted in the media, but it is not simple in relation to the modest circumstances of the vast majority of non-domiciled residents in the UK who may be unaware that their small amounts of overseas income should be declared, and should be taxed—or dealt with under double taxation relief provisions. That there are exemptions for some cases does not help when individuals are not even aware that they may be caught by the rules.

37 Q 95

38 Q 103

53. The charge on non-domiciled individuals is only one example of a tax whose imposition may have had unforeseen consequences. For example, the Finance Act 2004 introduced rules intended to clamp down on the avoidance of inheritance tax. Someone who gave away an asset but who later benefits from that asset may now be subject to an income tax charge. The intention was to close a loophole relating to inheritance tax; imposing a potential charge which can affect a wider population leads to unwelcome complexity. The likelihood is that many people do not realise they are caught, still less that they should be paying income tax in consequence. **Tax policy must be clearly targeted, so that taxpayers can have certainty about which rules apply to them.**

Measures to reduce the incentives for tax avoidance and to clamp down on evasion

54. There is a distinction between tax avoidance, which is perfectly legal, and tax evasion, which is not. Lord Tomlin's comment that "Every man is entitled if he can to order his affairs so that the tax attaching thereto is less than it otherwise would be" has been cited frequently in defence of legal tax avoidance. In a complex system, people will use provisions in the tax system which allow for tax planning, and it is unreasonable to expect them or their advisers not to do so.

55. None would disagree that some at least of the complexity of the UK tax system is due to an 'arms race' between HMRC and the taxpayer and is provoked by attempts to secure the tax base from creative tax avoidance structures. Individuals and firms should be able to undertake legitimate tax planning. However, where specialist advisers are deployed on unusual and creative schemes, tax planning can be deemed to move beyond legitimate avoidance.

56. UK tax law is specifically targeted rather than purposive. This fits with the UK legal tradition and ensures that HMRC's decisions can be challenged in the courts. However, the search for legal certainty in such a system leads to ever more complex and lengthy legislation. This has led to the introduction of a system of targeted anti-avoidance legislation, in which more general provisions are used to target areas of perceived abuse. For example, Budget 2007 announced a rule that "Where a person has entered into arrangements, and a main purpose of those arrangements is to gain a tax advantage by creating an artificial capital loss, any resulting loss will not be an allowable loss for the purposes of capital gains tax, income tax or corporation tax."³⁹

57. Such targeted legislation was generally seen to be working, but was not without problems. the IMA told us

[...] as part of the development of taxation policy, all areas should be consulted upon, including anti-avoidance policy. Anti-avoidance policy has greatly exacerbated unpredictability in the development and application of tax policy in recent years. The

39 Budget 2007, BN30, 21 March 2007, Capital Gains Tax: a Targeted Anti-Avoidance Rule

manner in which highly complex anti-avoidance legislation is introduced has been problematic, with many changes being made piecemeal and without notice.⁴⁰

58. The Government is now considering a more general anti-avoidance rule. We note that a study group of lawyers has been set up under the Chairmanship of Graham Aaronson QC, to look into the scope for having a General Anti-Avoidance Rule (GAAR) in the UK tax system. Francesca Lagerberg of Grant Thornton reflected many of the concerns expressed by the accounting profession in relation to the GAAR:

The wording of the GAAR obviously is crucial. If you put it too broadly businesses will have huge uncertainty about the tax implications of what they're doing. Do it too narrowly and it might not hit the mark.⁴¹

59. The CIOT said

As most taxes will inevitably not be simple, there must be scope for the taxpayer to confirm their position. This is a key issue for businesses planning investment: we need to have more opportunities for rulings where there is genuine uncertainty.⁴²

Such a stance suggests that if a GAAR is introduced it may be desirable for HMRC to give clearance for certain arrangements in advance. While this would increase certainty for the taxpayers and companies concerned, it might increase HMRC's power effectively to make tax law. It could also increase costs to all involved. Accordingly, **the way in which any GAAR might be framed and implemented needs careful consideration and full consultation. While there may be advantages to a General Anti-Avoidance Rule, taxpayers need a safe harbour to operate effectively without the undue uncertainty over their tax liability which an ill thought through or impracticable GAAR might bring.**

Stability

60. Tax policy is only one of the factors on which businesses and individuals make their decisions, but lack of stability and clarity about the direction of travel in tax policy will, over time, undermine the competitiveness of a tax system and make it impossible for businesses to plan. If tax policy is to support growth, then the direction of travel of tax policy should be clear.⁴³

61. To give one example, the abolition of industrial and agricultural buildings allowances affected many businesses which had invested in property on the basis that they would be entitled to full relief for their expenditure over a 25 year period. This change of policy was criticised by the Chartered Institute of Taxation:

40 Ev w52

41 Q 112

42 Ev w129, para 2.2

43 Ev 23, para 2.1

Whether or not the withdrawal of industrial buildings allowances was necessary, doing so over a four year period when investors had anticipated a 25 year writing down period did not enhance the UK's business tax environment.⁴⁴

62. A further illustration was the sudden introduction of a zero starting rate of corporation tax in 2002 for the first £10,000 of a company's profits. This caused a flood of small business incorporations, as self employed individuals incorporated to reduce their tax. The annual rate of private company incorporations increased from 225,000 to over 325,000 in 2002-03. This rate of new incorporations continued for several years. There followed a huge backlog in VAT registrations as HMRC struggled to cope with the demand to register these new companies. In 2004, in an attempt to prevent the perceived abuse of the corporate zero rate, the non-corporate distribution rate was introduced. Francesca Lagerberg explained that this:

lasted for 18 months. It was quite penal and very hard to operate and it was removed because it just didn't operate.⁴⁵

Eventually, in 2006 the zero starting rate of corporation tax was abolished. There are still many thousands of small businesses operating through companies, coping with the additional administration this brings, although they would have lower administrative burdens if they operated as sole traders or partnerships.

63. Sudden and unexpected changes to tax policy are harmful to business and to the Exchequer and should be avoided unless there are exceptional reasons requiring immediate intervention. Tax policy has to change in response to changing circumstances. It is important that business has early warning of policy changes, except in cases where the tax base is at risk.

64. Successive governments have attempted to increase the advance notice taxpayers have of change. In 1997 the previous Government moved the Budget back to the spring (where it had been before 1993) and introduced the Pre-Budget Report to encourage debate on the proposals planned for the Budget. This has recently been taken further, so that draft Finance Bill 2011 clauses have already been published for consultation. As Francesca Lagerberg said "[...] we have Finance Bills coming out in draft three months ahead. That's fantastically useful for getting good consultation."⁴⁶

65. Greater stability in tax policy, secured by advance notice and better consultation, should also assist in securing the certainty which so many of our witnesses thought was essential in a good tax system.

Practicability

66. HM Treasury states in its written evidence

44 Ev w129, para 3.3

45 Q 88

46 *Ibid.*

Value for Money: the tax system should be cost effective. Costs of compliance and collection should be kept to a minimum.

The costs of administering the tax system are not only those incurred by government in collecting taxes, but also those incurred by business and individuals in complying with them. These costs should be taken into account when developing policy.⁴⁷

67. Despite this claim, one of the discussion papers leading up to the Mirrlees Review begins:

Most of modern tax theory, [...] completely ignores administration and enforcement. The policy formation process is not much better, too often addressing implementation only after reform has been determined, rather than as an integral part of the decision-making process.⁴⁸

68. PwC told us:

5.1 Our latest annual Paying Taxes study carried out with the World Bank indicates that while the UK does comparatively well on the ease of paying taxes (16th out of 183) for a small to medium sized case study company when compared with other economies around the world, the UK ranking has slipped as others have improved their systems, either with lower total tax rates or improved administrative procedures. Globally, on average over the last five years the overall total tax rate for the case study company has fallen by 5%, the time taken to comply with tax rules has fallen by almost a week, and the number of tax payments has fallen by almost four. The UK system has not kept pace to date with these changes. Our experience (including our Enterprising UK survey last year) suggests that the compliance burden for businesses is something on which they are increasingly focusing, whether as a payer of taxes or collector of tax at source.⁴⁹

The study referred to found that a small business would need to spend 110 hours a year to deal with tax.

69. The Forum of Private Business considered that the cost of compliance was an unnecessary burden on small business and the complication of the UK system diverted time and money from running the business.⁵⁰ They drew attention to survey work which suggested that the cost of tax compliance for small businesses was over £1.8bn per year.⁵¹ We note that the FPB considered that small businesses appeared willing to pay more tax if it meant the system was less onerous, or supported growth more efficiently:

47 Ev w96

48 IFS, *Dimensions of Tax Design*, p1103

49 Q 26

50 Ev 27

51 Forum of Private Business (FPB), *The cost of compliance on micro, small and medium-sized business employers*, <http://www.fpb.org/images/PDFs/referendum/FPB%20Referendum%20188%20report.pdf>

In our recent research (January 2011) on tax and budgets, we asked SMEs whether they would support a radical tax simplification programme even if it meant paying more tax (see figure 1). As the results show, only 23% of those surveyed said that they would not support simplification under any circumstance if it meant they would pay more tax. Small firms support simplification because they feel that the rewards, such as reduction in red tape, less time spent on completing tax forms and more predictable tax for business planning, would allow them to grow their business and would outweigh paying additional tax.⁵²

The Unquoted Companies Group complained that:

The ease and efficiency of the system needs to be improved. The implications of the way in which the system works at the present time can probably best be demonstrated by reference to:

- Compliance costs—an ever increasing drain on valuable resources that would otherwise be available for investment.
- Impact on senior management time—any business would recognise the benefits of freeing up time so that senior management are able to deal with important issues which will deliver sustainable commercial activity. Time spent dealing with the tax system is time away from running the business and this especially affects family-run businesses.
- State apparatus—the growth of an impersonal and difficult to navigate bureaucracy.⁵³

Our Sub-Committee is currently inquiring into the administration of HMRC, and will pursue these points further.

70. Some tax policy is based on inadequate information about cost, both the administrative cost to the business and the full cost to the economy. Both need to be much better estimated and, with respect to business costs, fully quantified. This will require effort both by HMRC and the business community and those who represent them. It is essential for better long run reform of the tax system. Impact assessments frequently fail to include much of the costs which rule changes would place on businesses. The impact assessment in support of the recent attempt at dealing with the problem of perceived income shifting within small family owned businesses failed to take full account of the costs which would be involved in valuing the work contributed by the different family members.

71. Similarly, the impact assessment which accompanies the current proposals for taxing furnished holiday lets is likely to have understated the number of businesses affected because it does not reflect those businesses which will have included this income within a related trading activity, such as farming.

52 Ev w28

53 Ev w94

72. Such lack of attention to whether a policy is practicable not only increases the overall cost of the tax system to the public purse, but directly affects individual taxpayers. The practicability of withdrawing the personal allowance from individuals earning in excess of £100,000 in 2010/11 relies on a methodology which has caused problems for withdrawing the higher age related allowances for many years. The implementation of the proposal has meant HMRC has had to write to those taxpayers who might be affected. The tax system is not designed to accommodate the clawback and will inevitably cause many taxpayers just over the threshold to underpay tax.

73. We note the progress made by HMRC's Administrative Burdens Advisory Board in reducing the costs of tax compliance placed on business but consider that more work is needed. Andrew Hubbard suggested that whenever a new tax policy is proposed, HMRC's implementation proposal should also consider what will be needed to implement it in practice. This would include explaining how the relevant forms for that tax would need to be amended.

74. The practicability of a tax—ie the ease with which it can be collected, and the compliance burden imposed on the taxpayer—should be fully understood and explained at the time of the tax change. The accuracy of these assessments, quantified wherever possible, can then be compared with outcomes over time. The Government has introduced a new impact analysis for tax measures which is intended to ensure that compliance burdens and collection costs are systematically considered. We recommend that this impact analysis should include a detailed assessment of the way in which any proposed new tax, or a change to a tax, would be implemented. It should be accompanied by dummy forms, to ensure that the real practical issues are properly addressed.

75. Publication of such detailed analyses alongside tax proposals will enable the tax profession to assess their quality and alert Government to shortcomings. As a first step, we recommend that the Government should produce an example of such an analysis for a recently introduced tax measure so that we can assess how to make such analyses as helpful as possible.

5 Scrutiny of tax

76. Tax policy and legislation could be and should be better scrutinised. This is not something that Parliament can do alone; the Government and tax profession must also play a part.

77. As we have already noted, the previous administration introduced reforms to give more time for consultation on tax changes. Where possible, it published draft clauses in advance of tax legislation. This was welcome. The current Government has taken further steps to extend the time between policy formulation and enactment to allow time for better consultation before legislation is drafted and a further opportunity before it is enacted.

78. The proposal is that there will be:

- A Spring Budget in which policy proposals are announced for consultation
- Draft Finance Bill clauses, published for comment in late summer.
- Finance Bill published in the autumn
- Finance Act published around the end of the calendar year to take effect from the following April.

79. This will also mean that the Finance Act is in place well ahead of the tax year it will first affect. Even though 2010 was a transitional year, we have seen already more time being built into the budgetary timetable, in which a short post election Finance Bill in June was complemented by a further Bill in the autumn, which had been preceded by the publication of draft clauses in July. The Finance Bill 2011, is following the same pattern: draft clauses were published for comment on 9 December 2010 and we already know the Bill itself is due to be published on 31 March 2011. We have already welcomed this more deliberate approach to tax policy making.

80. Last year, the Exchequer Secretary invited the Committee to consider the Government's proposals for improving tax policy. In his reply to that invitation, the Chairman of the Committee emphasised the importance of Committee engagement:

As some of the reaction to HMRC's consultation on PAYE reform has shown, even technical matters relating to tax policy and administration can involve highly political questions about the individual's relationship to the state and the allocation of resources. It is therefore crucial that elected representatives in the House of Commons are fully engaged with the policy-making process. Any move that could compromise, or could be perceived to compromise, the primacy of the Commons in this area would be unacceptable. The IFS discussion paper argued that there is scope for improved scrutiny of tax policy through the select committee system. In particular it suggested that select committees could undertake pre-legislative scrutiny of such proposals.

We agree with the discussion paper on this point, and this Committee intends to take a more active role in this respect in the future. We will seek to report on draft

proposals, when appropriate, in time to inform the final legislation. However, that will only be possible where there is a clear and consistent timetable for consultation, which takes account of parliamentary sitting patterns and gives committees time to consult external experts.⁵⁴

81. However, although this Committee has an important role in scrutinising Government proposals, it is not equipped for a comprehensive role in the legislative process, nor are there precedents for a departmental select committee playing such a regular role.⁵⁵ Some might argue that we should take on the task, as happens in other countries, but that would represent a transformation of Parliamentary practice. Improvements to the current scrutiny arrangements of the Finance Bill should be the first step. Our response to the Exchequer Secretary also emphasised the importance of ensuring that debate on the Finance Bill was properly structured and given adequate time. There may be an occasional need to limit debate on the Finance Bill to make arrangements before a forthcoming election. We would be dismayed if, in other circumstances, there was no opportunity to debate individual provisions. However, those outside the House need to recognise that on occasion, a provision may not be debated simply because there is general agreement that it is satisfactory.

82. Since we recognise that tax law can be a complex and technical subject, we have invited the tax professional bodies to brief us on the Government's proposed tax changes, so that we are in a position to comment at the time of the Budget. This will, we hope, assist colleagues in their consideration of the Finance Bill. We continue to believe that the Government should examine how consideration of the Finance Bill can be structured in order to facilitate engagement between experts and Members, and allow Members the time to debate both technical and politically controversial matters in Committee.

83. Others have argued for more resources to be made available. In *The Political Economy of Tax Policy*, published ahead of the Mirrlees Review, James Alt, Ian Preston, and Luke Sibieta consider that

in order to undertake effective pre-legislative scrutiny, MPs require more resources. At present, much advice and support comes through external organizations, and this could be extended. However, another possibility is a formal in-house service akin to the Congressional Budget Office in the US, which could be explicitly charged with providing analysis of tax policy for MPs.⁵⁶

We are attracted by the concept of a specialised unit to provide MPs with technical support and analysis of tax policy. We recognise that in a time of stringency, this may only be achievable by diverting resources from other research centres; but there is a case for ensuring that MPs are better briefed on tax matters by Parliament. We will return to this issue.

54 <http://www.parliament.uk/documents/commons-committees/treasury/DavidGaukeletter.pdf>

55 The role of the select committee in the quinquennial Armed Forces Bill is not directly comparable.

56 IFS, *The Political Economy of Tax Policy*, Chapter 13

6 Conclusion

84. Tax policies provide the framework for our tax system. The tax raised by these policies taken together funds the UK economy.

The Committee recommends that tax policy should be measured by reference to the following principles. Tax policy should:

1. **be fair.** We accept that not all commentators will agree on the detail of what constitutes a fair tax, but a tax system which is considered to be fundamentally unfair will ultimately fail to command consent.
2. **support growth and encourage competition.**
3. **provide certainty.** In virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs. **Certainty about tax requires**
 - i. **legal clarity:** Tax legislation should be based on statute and subject to proper democratic scrutiny by Parliament.
 - ii. **Simplicity:** The tax rules should aim to be simple, understandable and clear in their objectives.
 - iii. **Targeting:** It should be clear to taxpayers whether or not they are liable for particular types of charges to tax. When anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system.
4. **provide stability.** Changes to the underlying rules should be kept to a minimum and policy shocks should both be avoided. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
5. The Committee also considers that it is important that a person's tax liability should be easy to calculate and straightforward and cheap to collect. To this end, tax policy should be **practicable**.
6. The tax system as a whole must be **coherent**. New provisions should complement the existing tax system, not conflict with it.

85. No tax system is, or can be, static. There will always be trade-offs and difficult decisions; a desire for fairness may increase complexity; a desire for certainty may increase administrative complexity. Nonetheless, the principles we set out, which reflect a surprising degree of convergence within our evidence, give a direction of travel which, in the long run, can both secure consent and improve the performance of the economy.

Conclusions and recommendations

Introduction

1. While we attempt to construct some principles to guide policy makers, we recognise that sudden wholesale reform is likely, in some areas of the tax system, to be impracticable. The principles we and others set out can shape the system over the long term. We welcome the fact that tax policy making is currently the subject of considerable analysis and scrutiny, particularly by practitioners. If this can be sustained, there is a reasonable prospect of gradual improvement to the tax system. (Paragraph 13)

The basic principles

2. A tax system which is felt to be fundamentally unfair will quickly lose political support. However, judgements about the fairness of policy details are politically contested and a major way in which parties distinguish themselves from one another. This can obscure the fact there is a significant amount of consensus on fairness. The differences are often matters of degree and emphasis. (Paragraph 23)
3. Governments of different parties will have different views of what constitutes welfare and different policies to pursue it. The use of taxation should not be ruled out as a means to that end. However, the indiscriminate use of taxation to achieve wider policy goals may increase the complexity of the system and be counterproductive. Governments should be wary about using tax policy as a substitute for direct policy measures, doing so only after careful analysis shows it to be the most effective tool. (Paragraph 32)
4. The scope for tax arbitrage has grown substantially over the last quarter of a century. Globalisation is likely to increase it further. A tax system which is not competitive by international standards will not support growth. Competitiveness is not a simple matter of tax rates, although they have a bearing, but of the stability of the system as a whole. (Paragraph 35)

Procedural principles

5. Legal clarity is important, but the statutes may require interpretation. In theory, certainty could be achieved by giving HMRC greater powers to interpret the law, and giving it power to make binding guidance, or a wider range of non statutory concessions. This would not be acceptable. HMRC's powers should be limited and should be subject to reasonable challenge in the courts. The public interest in ensuring that the HMRC is not sole arbiter of the law overrides the interest in certainty. (Paragraph 42)
6. However, although tax law should have a statutory basis, we do not consider it realistic to expect that all tax law will be made by primary legislation, or to rule out the use of Commissioners' directions, or the use of extra statutory concessions, providing they are limited to formulating policy in the interstices of the tax

legislation, dealing pragmatically with minor or transitory anomalies, cases of hardship at the margins or cases in which a statutory rule is difficult to formulate. However, if details are to be left to secondary legislation, or to directions, scrutiny is important. (Paragraph 43)

7. We support measures to improve the drafting of tax legislation. However, clarity of language will not help the taxpayer establish his or her situation with certainty if the underlying policy is unnecessarily complex. (Paragraph 46)
8. We welcome the establishment of the Office of Tax Simplification. This has been established for the life of the current Parliament. Whether this body or something similar could make a further contribution in the next Parliament will be assessed by this Committee and others when its current projects are completed, and the Chancellor has responded. In principle, higher quality work from HM Treasury and HM Revenue and Customs in this field should render such a permanent body unnecessary. If and when the benefits of the Office of Tax Simplification are clear, its resources should be reviewed. (Paragraph 49)
9. Tax policy must be clearly targeted, so that taxpayers can have certainty about which rules apply to them. (Paragraph 53)
10. The way in which any GAAR might be framed and implemented needs careful consideration and full consultation. While there may be advantages to a General Anti-Avoidance Rule, taxpayers need a safe harbour to operate effectively without the undue uncertainty over their tax liability which an ill thought through or impracticable GAAR might bring. (Paragraph 59)
11. Sudden and unexpected changes to tax policy are harmful to business and to the Exchequer and should be avoided unless there are exceptional reasons requiring immediate intervention. Tax policy has to change in response to changing circumstances. It is important that business has early warning of policy changes, except in cases where the tax base is at risk. (Paragraph 63)
12. Greater stability in tax policy, secured by advance notice and better consultation, should also assist in securing the certainty which so many of our witnesses thought was essential in a good tax system (Paragraph 65)
13. The practicability of a tax—ie the ease with which it can be collected, and the compliance burden imposed on the taxpayer—should be fully understood and explained at the time of the tax change. The accuracy of these assessments, quantified wherever possible, can then be compared with outcomes over time. The Government has introduced a new impact analysis for tax measures which is intended to ensure that compliance burdens and collection costs are systematically considered. We recommend that this impact analysis should include a detailed assessment of the way in which any proposed new tax, or a change to a tax, would be implemented. It should be accompanied by dummy forms, to ensure that the real practical issues are properly addressed. (Paragraph 74)
14. Publication of such detailed analyses alongside tax proposals will enable the tax profession to assess their quality and alert Government to shortcomings. As a first

step, we recommend that the Government should produce an example of such an analysis for a recently introduced tax measure so that we can assess how to make such analyses as helpful as possible. (Paragraph 75)

Scrutiny of tax

15. Since we recognise that tax law can be a complex and technical subject, we have invited the tax professional bodies to brief us on the Government's proposed tax changes, so that we are in a position to comment at the time of the Budget. This will, we hope, assist colleagues in their consideration of the Finance Bill. We continue to believe that the Government should examine how consideration of the Finance Bill can be structured in order to facilitate engagement between experts and Members, and allow Members the time to debate both technical and politically controversial matters in Committee. (Paragraph 82)
16. We are attracted by the concept of a specialised unit to provide MPs with technical support and analysis of tax policy. We recognise that in a time of stringency, this may only be achievable by diverting resources from other research centres; but there is a case for ensuring that MPs are better briefed on tax matters by Parliament. We will return to this issue. (Paragraph 83)
17. The Committee recommends that tax policy should be measured by reference to the following principles. Tax policy should:
 1. **be fair.** We accept that not all commentators will agree on the detail of what constitutes a fair tax, but a tax system which is considered to be fundamentally unfair will ultimately fail to command consent.
 2. **support growth and encourage competition.**
 3. **provide certainty.** In virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

Certainty about tax requires

 - i. **legal clarity:** Tax legislation should be based on statute and subject to proper democratic scrutiny by Parliament.
 - ii. **Simplicity:** The tax rules should aim to be simple, understandable and clear in their objectives.
 - iii. **Targeting:** It should be clear to taxpayers whether or not they are liable for particular types of charges to tax. When anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system.
 4. **provide stability.** Changes to the underlying rules should be kept to a minimum and policy shocks should both be avoided. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

5. The Committee also considers that it is important that a person's tax liability should be easy to calculate and straightforward and cheap to collect. To this end, tax policy should be **practicable**.
6. The tax system as a whole must be **coherent**. New provisions should complement the existing tax system, not conflict with it. (Paragraph 84)

Formal Minutes

Wednesday 9 March 2011

Members present:

Mr Andrew Tyrie, in the Chair

John Cryer	Mr Andrew Love
Michael Fallon	John Mann
Mark Garnier	Mr George Mudie
Stewart Hosie	Jesse Norman
Andrea Leadsom	

Draft Report (*Principles of tax policy*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 85 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Eighth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Tuesday 15 March at 11.15 am

Witnesses

Tuesday 25 January 2011

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Francesca Lagerberg , Partner, Grant Thornton, John Preston , Partner, PricewaterhouseCoopers, Andrew Hubbard , Immediate past President, Chartered Institute of Taxation, and John Dickie , Director of Strategy and Policy, London First	Ev 11

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List of additional written evidence

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Third Report	Appointment of Robert Chote as Chair of the Office for Budget Responsibility	HC 476
Fourth Report	Office for Budget Responsibility	HC 385
Fifth Report	Appointments to the Budget Responsibility Committee	HC 545
Sixth Report	Spending Review 2010	HC 544
Seventh Report	Financial Regulation: a preliminary consideration of the Government's proposals	HC 430

Oral evidence

Taken before the Treasury Committee

on Tuesday 25 January 2011

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon
Mark Garnier
Andrea Leadsom
Mr Andrew Love

Mr George Mudie
Jesse Norman
John Thurso

Examination of Witnesses

Witnesses: **Stuart Adam**, Institute for Fiscal Studies, **Professor Richard Blundell**, Institute for Fiscal Studies, and University College London, **Professor Stephen Bond**, Oxford University, and Institute for Fiscal Studies, and **Paul Johnson**, Institute for Fiscal Studies, gave evidence.

Q1 Chair: Thank you very much for coming to see us. You are not quite settled in. I will just wait a second until you are. I am hoping you do not need to refer to those huge volumes that are coming out of your rucksacks. I am particularly concerned by what might come next. Perhaps what you are doing is a metaphor for why we need some reform. I hope that is the whole of the Tax Code, but I fear it is only a small part of it. Why don't I begin with the first question, which I will ask Professor Blundell? Why does growth not play a central role in your early description of the objective tax system?

Professor Blundell: All right, I will certainly kick that off. We focus on efficiency, and the kind of real remit behind what we are doing is really to come up with a system that creates an amount of revenue, distributes fairly and enhances efficiency. And we would argue that efficiency is often what people think of as growth, that is trying to get the most resources.

Q2 Chair: All right, but is it what you think of as growth?

Professor Blundell: Yes, there's—

Q3 Chair: Are you trying to maximise growth here or not?

Professor Blundell: We don't attempt to think of a way of getting or maximising the highest long-term growth rate. We don't look at that objective. We think—

Q4 Chair: So your principles will result in us paying a price in terms of long-run growth?

Professor Blundell: No, we don't think that.

Chair: No.

Professor Blundell: The idea is that—

Q5 Chair: Then efficiency and growth must be the same.

Professor Blundell: Efficiency is the way of getting the most you can out of a given set of resources and, in a medium term sense, that's the same thing as growth, yes.

Chair: Okay, so when we read the word "efficiency" in here, we could cross it out and put "growth".

Professor Blundell: You could put in "medium-term growth". Yes, that's right.

Q6 Chair: You're very keen on the view that there should not be specific encouragement of individual policy goals, but your own paper lists quite a number of ones, which you think should be counted as exceptions; in fact, there are four at least. Do you not agree that everybody sitting in this room at the moment has their own view about what should be an exception?

Professor Blundell: That's a good question. One kind of principle you enter in this is that you should have a kind of neutral system wherever you can. That should be the starting point. You don't want to introduce or have distortions unnecessarily, but there are some key places where economics and reasonable thinking tells you where distortion or non-neutrality should be when it comes to encouraging environmental goods, discouraging bads—externalities—and other places where we see that.

But in general, we aim at a neutral system. We think it's kind of simple. There will be certain cases to be made for distortions, but they have to cross a high bar. We lay out what that bar should be. It should be efficiency-enhancing, generally, and we make that case. And of course, there are a number of examples we give, whether it be environmental, research and development, particular types of goods, where that would be the case.

Q7 Chair: Yes, but you have said it should be simple and neutral, and then given your own collective preferences for a huge deviation from those principles. I am asking you this, and I will ask it one more time: do you not agree that everybody in this room has their own view about where they would like to see that deviation? They may not have the same list that you have. Therefore, if I complete the question, does it not drive a coach and horses through your conclusions?

Professor Blundell: I wouldn't agree. Everybody may have their own list, but our list is drawn from objective measures and that's where we come from.

Q8 Chair: All right, what are they?

Professor Blundell: They're the idea of efficiency, so when we talk about picking out environmental goods for subsidies or environmental bads for taxes and those kinds of things, that's an efficiency-enhancing view of improving the tax system.

Q9 Chair: So if we did not do sin taxes, pensions, R&D and educational investment, and we did not do childcare, for example, would we have lower GDP?

Professor Blundell: Yes. We would have lower welfare overall, but lower GDP in the cases you picked out, yes. That's right.

Q10 Chair: Sorry, just to be clear, are you distinguishing between welfare and GDP there?

Professor Blundell: Yes, we always do. The idea generally is to increase welfare, and that doesn't line up precisely with GDP. There are distributional and fairness objectives and other considerations.

Chair: Yes, which involve others making value judgments about what constitutes welfare.

Q11 John Thurso: I would like to start with Paul Johnson, not because I particularly think he can answer the question, but I'll give you a go and work that way. What do you think are the key elements of a tax system that are necessary for the system to be effective?

Paul Johnson: A tax system is all about raising a certain amount of money in the most efficient way possible, given your distributional objectives. That's essentially where we start from. Not always, but often, an important part of that is to treat similar activities similarly, because if you treat them differently, you create all sorts of opportunities both for avoidance and evasion and complexity, but also if you're not very careful you create unfairnesses, because you treat one group with a particular set of preferences differently from another group who have a similar set of preferences. So that's the kind of overall important element. And that tells you quite a lot about where you want to go, including relative to where we are at the moment.

So if you want to achieve any given level of distribution, it makes sense to do that as efficiently as possible. That implies taking account of what you know about how responsive different sorts of people are to the tax system. If you want to promote efficiency over time, a very important element of the tax system is the way you treat saving. If you have a tax system that discriminates against saving, you're distorting both individual decisions about when they consume and potentially long-run growth potential of the economy, because you're potentially reducing investment.

And another part of it, which I think is often overlooked, is that each bit of the tax system is linked up. So if you think of corporate tax, taxing the self-employed, and taxing individuals, individuals can have choices as to whether they're employees or self-employed. Self-employed people can have choice about whether they're self-employed or whether they incorporate. So actually, lining up and thinking about all those different bits of the tax system together is pretty crucial to ending up in a system that doesn't

result in all sorts of distortions about the way people behave and how they choose to behave.

And I think one of the most important things that came out of what we did is this idea. It sounds terribly obvious, but when thinking of a system and whether you're going to change the income tax system, what impact is that going to have on the self-employed and our employees and on the corporate tax, and what do you need to adjust around the system to make it work?

Q12 John Thurso: Is it therefore true that complexity in the tax system automatically breeds the kind of inconsistency and unintended consequences that you've just been talking about and, therefore, simplicity is a necessary principle, not simply because it's a nice thing on its own, but because it mitigates the law of unintended consequences?

Paul Johnson: I think, broadly, I agree with what you're saying, but I think I'd put it the other way around in the sense that it's the lack of treating similar things similarly that creates complexity. So if you treat differently, for example, money that companies raise through equity as opposed to debt, you create a big complexity about what equity actually is and what debt actually is. If you treat different sorts of savings differently, you create complexity there. If you treat different sorts of income differently, you create complexity there. You're never going to get a simple tax system. It's always going to be hard, but you can remove unnecessary complexity.

Q13 John Thurso: Well, you could. Some places charge 15% or whatever it is on everybody, end of story, but then the counter-point to that is then a lot of expenses that they don't have that we do, so it's not good. I don't want to go there but you could have, theoretically, an extremely simple system, but for all the reasons that we want all sorts of expenditure, we don't have a simple system. To what extent should simplicity be a core principle in seeking to design the tax system?

Paul Johnson: We think that it's clearly a desirable outcome. We think it almost falls out of a desire for efficiency and neutrality, but the way that you achieve simplicity is to think about neutrality and efficiency as core principles. If you think of simplicity as a core principle, you might end up in the same place. It may just be a different way of thinking about it, but that's the way that we came at it. And one of the reasons we want neutrality and efficiency is because we want simplicity at the end.

Q14 John Thurso: Professor Bond, you see I'm being very logical in my direction of travel of the panel. In your view, what are the major policy defects in the current UK tax system? If I said to give me two or three things that you'd really like to nail, what would they be?

Professor Bond: I'm not speaking for the Committee. Speaking personally and focusing on my areas of interest a little bit, I think the way we treat household savings has major problems. We treat different forms of savings very differently. Overall, we probably try to tax the rate of return to household savings too highly.

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On the corporate side, there is the distinction between debt and equity that Paul has already alluded to, and the fact that overall we raise the cost of business investment in a way that I think is particularly damaging in an open economy, inducing capital to go elsewhere. Those are the two.

Q15 John Thurso: Could I just ask exactly what that is for the lay people among us? The difference between debt and equity as far as Government goes is that equity is taxed and debt isn't. Is that it, broadly?

Professor Bond: If a company borrows to finance investment, the cost of borrowing and the interest payments are deductible against tax. If you use your own resources, there's an equivalent: what economists call "opportunity cost", which is the return that you could've earned by putting that money somewhere else. And that's a cost to you, if you put it into your own business and there's no corresponding tax deduction in the current system.

John Thurso: Are there any others? That's one, and household savings.

Professor Bond: I think my colleagues will give you much more informed views than me about issues to do with the welfare benefit system that impacts on decisions to work or not to work and decisions to retire perhaps earlier than we might like.

Q16 John Thurso: I think that may come up a little later on. Perhaps I'll leave you, Professor Blundell, because you had the first question, and come on to Stuart Adam. What are the best characteristics of other tax systems that the UK ought to be looking at mirroring, adopting and copying?

Stuart Adam: We didn't do a detailed study of tax systems around the world. What we have done is say there are certain features of certain tax systems that we think look very good and that the UK could copy or import.

Q17 John Thurso: What is your top three, top two or top one?

Stuart Adam: Top three: the New Zealand VAT system, or GST as they call it; the Belgian corporation tax; the Norwegian shareholder income tax. These all look particularly good, and all basically correspond to—I wouldn't say we reached the conclusion that those are good ideas by looking at those countries, but we thought that they looked like good ideas and then said, "Okay, is this being done anywhere? Do we have practical examples of it working?" Those three examples looked very good.

John Thurso: I like your internationalism. Thank you, Chairman.

Q18 Jesse Norman: May I first register my concern that we are modelling anything on the Belgian corporate tax system? This is a question for whoever wishes to pick it up. I think I heard Professor Blundell say that you have not actually done any growth projections when you have been thinking about the economy as a whole system. That is to say, you haven't done any macro GDP modelling based on assumptions about the Tax Code that you are making.

Can I just dig into that a little bit? What level of GDP as a consumption of tax have you taken as a baseline?

Paul Johnson: We've essentially taken the current level of taxes and said, "What is the most efficient way of raising that level of taxes?" As Richard said, what we didn't set out to answer was, "Taking a macro growth model and then fixing a tax system in it, what impact is that going to have on growth?" That's simply not the way that we approached it.

What we did do, and what is clearly very important, is look at the ways in which individual bits of the tax system impact on people's behaviour, GDP and welfare. So we've looked at things like work incentives in here and how you might change work incentives. I think one of the surprising things for us is that even with pretty modest assumptions about how responsive people are, you can make changes to the tax system, around retirement for example, to make pretty significant changes to the numbers of people in work and, therefore, the level of national income. If you look at the way the corporate tax system works, we quote some work in there that suggests that moving the direction that Steve was talking about would have, over time, a potentially quite significant one-off impact on investment and national income.

I think our take on the tax and growth literature is that you can't really say very much about the total level of the tax take and its impact on growth. You can say quite a lot about the individual bits of the tax system, and the structure of the tax system, and the inefficiencies of the tax system. If you look at getting rid of those, there's quite a bit of evidence that that could have a one-off impact on the level of employment and level of national income. I think it would be fair to say we're sceptical of claims that you can substantially change the overall long-term growth rate of the economy by changing aspects of the tax system.

Q19 Jesse Norman: All right, so this would mean that a given set of tax changes, for example around equity versus debt, capital raising side, or longevity assumptions of how people stay in the workforce would have a one-off effect. You could say this is quarter of a per cent on GDP or this is half a per cent on GDP.

Paul Johnson: It would obviously take a while to get there, but yes.

Professor Bond: Fundamentally, we think you would increase the level but, once you've reached the new level, you wouldn't permanently grow at the rate you were growing as you go from the low level to the high level. Certainly, you should be very cautious about anyone who claims that they have a recipe for tax reform that would change the long-run growth rate.

Q20 Jesse Norman: Sure, but when you've taken the assumption about the amount of GDP-consuming taxes, rather optimistically the review has us in the middle of the European average or the national global average: between 30% and 50%. Actually, we are way up towards 50% at the moment. We're on something like 48%, I think it's fair to say. Is that the level at which you've been pitching it or have you been taking 40%, as it were, a generational level of tax consumed?

Professor Bond: Are you talking about total tax as a share of GDP?

Jesse Norman: Yes.

Professor Bond: That's not something that we have really taken a view on. Our starting point was that that's for you to decide collectively. Our focus is much more: given the level of revenue that the political process decides it wants to raise, what would be the most efficient or welfare-enhancing way of collecting a given amount of revenue? Our focus has been very much on the structure, not the overall amount.

Q21 Jesse Norman: You have costed all these proposals out, so you know there'd be no net increase in tax or no net reduction in tax.

Professor Bond: That is our broad objective.

Q22 Jesse Norman: All right, so you could take some of these out and there would be a tax reduction, or take some out and there would be a tax increase.

Professor Bond: Well, you could. We wouldn't advise you to do that, but one certainly could, yes.

Q23 Jesse Norman: Right, but you're selling this to the world as a package of measures. So it wouldn't hang together if you took some of it and not others.

Professor Bond: It may well not, yes.

Q24 Jesse Norman: I think that is quite interesting. What do you say to the body of literature that suggests that the sheer amount of GDP consumed in taxation may be itself a constraint on long-term growth?

Stuart Adam: My reading of that literature is, first of all, that different studies have come to different conclusions. For the most part, those that find a significant connection between the overall level of taxes and the rate of growth are mainly picking up on what Steve described as a "levels effect" rather than growth effect. By reducing the discouragement to work or reducing the discouragement to investment, you will over time move to a higher level of GDP and, during that process, you will therefore see a higher level of growth. There is a difference between that and something that increases the long-run trend rate of growth. I think most of the empirical studies are picking up the former rather than the latter.

Professor Blundell: And remember, what we are doing here is quite a long-run step change. If you look at investment, education and the structure of savings, this would happen over a long time, and you don't expect to change the long-run growth rate 2% or 3%, but you do expect quite a big enhancement in the overall level of GDP.

Q25 Jesse Norman: What is the improvement in efficiency that you calculate as a result of the adoption of these measures?

Professor Blundell: Some of them are very easy to calculate, and we lay those out where we do. Some are more speculative and some we felt it was very difficult to do. I guess the one that is very difficult to do is the one on savings and capital taxation, because that is a kind of longer-run impact. It's quite hard to work out the precise impact on the level of GDP, and we don't particularly do that. We try to do it in the

case of corporate tax. In the case of the specific reforms around work incentives, we come up with particular figures on employment and, for example, with the efficiency improvement by reforming the VAT system, again, we come up with 1% or 2% level increase overall.

Q26 Jesse Norman: So just to be clear, the efficiency increase you would expect as a result of this would be in the order of 1% to 2%?

Paul Johnson: I think we haven't put it all together because, as Richard said, some of it is really hard to calculate, but it is pretty clear that some of the work on corporate taxes suggests that some of the change we've suggested there could impact on investment and GDP to a reasonably significant amount. If we moved to road pricing, the welfare increase is potentially very substantial. As Richard said, the employment impact of some of the other reforms are substantial. Adding those up and saying that the answer is 5% of GDP, given that there's quite a lot of uncertainty around each of those, is not something that we've tried to do, but we are talking percentage points rather than tenths of percentage points between A and B.

Q27 Jesse Norman: It's just that I'm grappling as to what the evidential basis for policy is, if you're suggesting efficiency equals growth and you can't actually point to the scale of the efficiency gains, except in specific cases, but you've already told us that the thing only hangs together as a package. It just feels slightly hard to understand. This feels like a wish list with a lot of discussion about it rather than anything that could be a really robust basis for policy.

Professor Bond: It is precisely areas where we feel we have some evidential basis where we've been prepared to put some numbers or quote other people's numbers that we think are somewhat credible. For every single area of the tax system where we think there's scope for improvement, we just don't have that solid evidence that would lead us to want to give an approximation.

Q28 Chair: This step change from a less efficient to a more efficient system is a huge undertaking that will take place in any sensible economy over a very long-run. Given that the economy is organic and behaviour is changing all the time, by the time you've done that, you've got another step change to go chasing: correct or incorrect?

Professor Blundell: What we've laid out here is something that should be fairly robust to a number of things. One is the amount of revenue you want to collect; the kind of principles stay the same. With the distributional objectives you have, the principles would stay the same. It allows for a fair change in the kind of demographic population and style of the economy because, in a way, it's around a set of principles and not specific.

Q29 Andrea Leadsom: I'd like to go back to the principles of a tax system, particularly the one of simplicity versus fairness, because you talk about the importance of simplicity and fairness, but surely they are a trade-off, are they not? I think a very good

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example of that is the very recent policy on child benefit, where it would be possibly, arguably fairer to treat families together, but far simpler to treat them separately, and then you get an awful lot of complaints that it's not fair. So can you just comment on whether you agree that those two things are, to a certain extent, mutually exclusive?

Paul Johnson: Very often they go hand in hand, but of course there are all sorts of different views about what fairness means. Take one example: the differential rates of VAT on different products. Now, you can make the argument that having the significant additional complexity that's associated with having different rates of VAT gives you fairness, because people on low levels of earning spend more proportion of their income on food and so on.

I think we would argue, actually, that the system is rather unfair. People who happen to have preferences to buy lots of stuff that has low VAT on it are well-treated, but those who don't are less well-treated, and in addition you can achieve more redistribution at lower economic cost in other ways. So I guess our view there is that simplicity and fairness go together, but in a way that I suspect most people would want a bit of a debate about. I think there are significant other areas of the system where fairness and simplicity go together.

Now, clearly if you're equating fairness with substantial amounts of progression and progressivity, that can create a degree of complexity relative to, say, a flat tax system, though again you can trade those off. I think the issue that you're particularly focusing on is the issue of how you treat individuals against how you treat the family. I think one of the big complexities in the current system is one that we can acknowledge and say this is—I think you're right—hard to do something about, as we have an individual-based tax system and a household-based benefits system. There are good reasons of fairness for doing that, but it undoubtedly creates complexity at points where these things meet.

Q30 Andrea Leadsom: So, where does fairness and simplicity lie? Is it to make the benefit system focus on the individual or to treat families' income as taxable? Because obviously, it was long ago decided to be far too complicated to treat household income for tax and, therefore, it goes up the scale of complexity but potentially also up the scale of fairness. Can you comment?

Also, whilst I'm on the subject, what about a flat tax? Is that simpler and fairer, or is it just simpler?

Paul Johnson: Does one of you want to talk about households?

Professor Blundell: I can start, but we can all chip in here. In a sense, one idea that we had here, which I think is an important underlying one, is that to have an overall progressive welfare system, you don't have to have every tax as being progressive and fair. The upshot of that is you can make huge simplifications in some parts of the tax system while maintaining overall fairness and redistribution. Of course, one way we suggest, and it is quite sensible, is to do this through the benefit and income tax system rather than through the VAT system or some other part of the tax system.

Q31 Andrea Leadsom: Are you going to say why? Why is it fairer to do it through the benefit system?

Professor Blundell: It is because it gets directly at the thing you're interested in, and that is the income of individuals. If you start playing around with other parts of decisions people make, it introduces distortions and inefficiency without going specifically at the target, which is redistributing resources to families that have lower income or lower earned income. It's targeting exactly where you want the redistribution to occur, rather than cuts across.

Q32 Andrea Leadsom: Can I just come back to you on that? It's a fact that a number of families who receive a number of benefits change during the course of an award period, for example, people with lots of different partners, or a relationship that breaks down, or new babies arriving and so on. Therefore, in theory, I would agree with you that you can target benefits, but in reality isn't the benefits system a bit of a blunt instrument with which to be able to keep track?

Professor Blundell: We looked at integrating, for example, the tax and benefits system as one huge kind of Code, and we came down against that because we felt they are trying to do different things, and we do think of poverty and redistribution around family income. It should be adaptable much more frequently than the income tax system, so you do want to separate those two things out. There's always a compromise on how quickly you allow the benefit system to adapt to changes in circumstances, but it should do more than the tax system needs to. That's why we come down in favour of a kind of integrated benefits system that reduces hassle and stigma across picking up any benefits, and can adjust to different conditions more rapidly and coherently. It is an integrated benefits system, but separate from the tax system itself.

Q33 Andrea Leadsom: Why should benefits adjust more rapidly than tax?

Paul Johnson: I think for exactly the reasons that you're describing, which is that benefits are aimed at people whose circumstances may change within the year, and they potentially need that income for a short period of time within that year.

This is not something we're proposing, of course, but ideally the tax system would look at your income over your entire lifetime and say, "Let's take the right proportion across your lifetime". Actually, you can go a bit of a way to that by changing the way you tax savings because, if my income goes up and down but I have the same average income as someone who has more stable earnings, I will end up paying more tax than the person with the more stable earnings. It's not obvious that that's appropriate, but you clearly need to have some way of having a time period for tax.

For benefits, we're talking about people with low levels of income, which is exactly as you describe. It may change quite swiftly and we're helping them with that kind of smoothing out.

Q34 Andrea Leadsom: I understand what you're saying, but you're working on a presupposition that somebody on benefits is poorer than somebody paying

income tax, whereas if you have a small business and you go bust next Monday, and you've still got tax bills to pay to the end of the year, you could be in considerable hardship. So I don't really understand why you're saying that the benefit system needs to be more fleet of foot than the tax system. Is that your fundamental argument for not having a completely integrated tax and benefits system?

Paul Johnson: I think there are two important arguments for not having a fully integrated system. One is exactly the point that you raised about the difference between the household and the individual. It seems to us there are strong reasons for thinking about the household when you're looking at benefits. It really would be problematic, I think, paying benefits to the non-working partners of very high earners, for example. It would just be very expensive.

Andrea Leadsom: I'm sure they'd be fine with it.

Paul Johnson: I'm sure they'd be happy, but it would be very expensive. When you're looking at taxing earnings, partly for reasons of simplicity, partly for reasons of privacy, and partly for reasons of distribution, there seems to be a good case for doing that on an individual basis. Sticking the two together in that sense is hard.

The second reason is this point about the period over which you pay. If you're very poor for a couple of months during the year then you probably want a benefit system that helps you there but, as I say, the tax system wants to take a view over a longer period. Those are the two reasons we think that full integration is pretty hard.

Q35 Andrea Leadsom: Just one last question and it's this: we have so many different rates of income tax; is it the case that it's encouraging people to do things that they would not otherwise have done, now that we've got so many different income tax bands?

Paul Johnson: Income tax always encourages people to do different things. The fact that we have income tax is going to have some impact on work incentives, so there are a number of issues that you may be raising. One is that we have the top rate at 50% for over £150,000. We think it's genuinely hard to know what impact that will have on revenue, because it's genuinely hard to know what impact that will have on people's behaviour. Clearly, there will be some behavioural response to that. We think that the bigger problem is around the withdrawal rates at the bottom of the income distribution. So people who are moving into work and people on relatively low earnings face effective marginal rates when you look at their withdrawal of benefits, which are much higher than 50% and that are 70% or more. There's a lot of evidence that that impacts, particularly for some groups, on their decision whether to go to work or not, and that's really potentially quite problematic.

I think as I just said, there are two groups where we know that has a really big effect. One is those maybe between 55 and 70, those who are sort of towards the end of the standard working life, and particularly for mothers with school age children. That's where we specifically think there are some changes we could make that would reduce the impact of the system on people's behaviour.

Q36 Mark Garnier: Can I turn to our international competitiveness? "Concerned" is probably the wrong word, but I picked up on the fact that you hadn't done a huge amount of work looking at other people's tax systems. This is a question generally to all of you. What do you feel are the most important elements for a UK competitive tax system?

Professor Bond: I can certainly answer it. I think the corporate tax is a very important part of that, so when we talk about international competitiveness, I would worry about things that may not happen in the UK if our tax system is too far out of line with tax systems in other countries.

One of the ones where we have the most evidence that companies may choose to relocate elsewhere or companies may choose to locate certain activities elsewhere is on the corporate side and how we tax corporate profits. For high skilled individuals, doubtless there are similar issues. To a first approximation, as you go down the skills distribution or the earnings distribution, you have less international mobility and those issues become less central.

Mr Mudie: Could you speak up?

Professor Bond: Sorry.

Mr Mudie: I'm sure it's very interesting what you are saying.

Professor Blundell: Even I lost that last bit of it.

Chair: It's all the more intriguing.

Professor Bond: I'll try to move a little closer to the microphone. Anyway, more skilled people are more mobile than less skilled people, is all I was saying.

Professor Blundell: We didn't do comprehensive studies of every other tax system. We did, though, look across the broad sets of tax systems that are around, by the way, in some detail. In that huge tome there, we specifically in every area got some international expert along with an IFS researcher to put together what we know broadly across all tax systems and how it might impact on the UK or how we think about the UK. We didn't look at Belgium as a whole or Norway as a whole, but we did look across—and that's one aspect of just seeing how things work—how tax changes and tax reforms have evolved. In particular, when we say, "This is the way we expect people to behave", we're drawing that from international evidence, because you can't just look at the UK. That's one aspect. The other aspect is—

Q37 Mark Garnier: I'm sorry. Can I just interrupt that part? So what you're saying is that when you're looking at the international field, you're examining it because you want to see what behaviours are, as opposed to examining it because you want to see how it compares with the UK.

Professor Blundell: Yes. I could give you a good example, and that is how you think about employment reacting to tax changes. You can look at the UK, and we do. You get a huge amount of additional information by, say, comparing the UK, France and North America, because at the same time, they have also changed the tax structure as it affects pensions and as it affects work. By looking at that you can piece together a big picture about the way people react. We focus on the UK because that's what we're

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looking at. The UK, of course, is a different set of people, but you do none the less want to draw from other behaviour in other countries because some of the reforms have happened there.

Q38 Mark Garnier: What I'm really sort of trying to get to the bottom of is that you talk about corporation tax being very important; clearly, it is. Then you talk about highly-skilled individuals in terms of, presumably, income tax and the higher rate of income tax. If you were to drill it down to two, three, four or five points, which are the five single most important? If you were to have the most important points that would be a summary conclusion of all your work, what are the key things? In words of one syllable, what are the key things that are going to make the UK the most competitive tax system in the world, or in the developed world? That is a long pause. Who is going first?

Stuart Adam: This isn't a particularly profound answer. In general, you will have a more competitive system by having lower tax rates. We adopted the constraint of saying, "Let's keep the tax system's overall revenue where it is by assumption". If you are then saying, "Okay, which of the tax rates are particularly important?" then the natural thing to do is to say, "Well, if it's international competitiveness and international mobility you have to look at, you have to look at how mobile different things are". Corporation tax taxes corporate profits. Particularly insofar as these are paper profits, they move around. They are relatively mobile. As Steve was saying, highly-skilled individuals are more mobile than lower-skilled individuals. That means that income tax rates at the top matter more in terms of international competitiveness than income tax rates lower down. Consumption is probably less mobile than profits and, therefore, VAT matters less for international competitiveness than corporation tax or whatever. Those are the considerations, but fundamentally a more competitive tax system means lower tax rates. Now, there are reasons you can't just reduce—

Q39 Mark Garnier: What about simplicity?

Stuart Adam: Now, yes, there is also a sense in that tax is being—a lower burden of tax, put it that way, which is both the tax rates and the compliance costs.

Q40 Mark Garnier: Perhaps I could just change the question around. If I were an international bank, having moved in from the solar system and looking to set up a system, what are the key things I'm going to be looking at when deciding where to locate, and does the UK match that or do we need to change things?

Professor Bond: I think the example of a bank may not be the most representative example to look at, because they'd be very concerned about regulatory factors as well as tax factors, but if you were the kind of canonical widget producer that economists like to talk about then it depends very much on the profitability of the operation that you plan to be running. If you plan to make a return that is just okay, then you'll be attracted by tax systems that will give you allowances for all your costs and will raise very

little revenue from you on the basis of your operation, which is just earning the return that you need to make it viable.

If you have some unique brand or some great idea that is going to allow you to be a lot more profitable than that, other considerations come into play. To a first approximation, the statutory corporate tax rate is going to be very much more important to the very profitable operations, and the allowances that you're allowed to claim against your revenues in deciding how much corporate tax you pay will be very much more important in the case of ones that are close to the line as to whether they're viable operations or not. Different types of operations and different types of firms will probably give you different answers to that question.

Q41 Mark Garnier: Then on top of that you've got simplicity, presumably, because you don't want to spend too much money on accountants.

Professor Bond: Indeed.

Q42 Mark Garnier: And then on top of that is the income tax rates and how it affects your valued staff.

Professor Blundell: One thing: when we set out, we took account of the UK being a smallish open economy, so when we say for example about the top tax rate—whether increasing the top tax rate collects more or less revenue; what impact it has—we're drawing on evidence about the way higher incomes settle in the UK versus elsewhere. It is how taxable income at the top changes.

In thinking about corporate tax, we're obviously thinking about the full integration of the personal tax system with the corporate tax system to make sure it aligns in a simple way. Part of the simplicity in the proposals is to make sure that that works in a very straightforward way, which it doesn't currently.

Q43 Mark Garnier: Can I just ask one final question, which is on the general anti-avoidance rule? How do you see this fitting in with the UK tax system in particular, and are there any problem areas associated with this?

Stuart Adam: I think the short answer is that we're not really the right people to ask that. The person on the editorial team who really knows about that is Malcolm Gammie, who is currently somewhere in Australia. He's done a lot of work and written a lot about the merits or otherwise of a GAAR.

Very broadly, we considered it briefly. We didn't go into it in that much depth, just because we didn't see it as a panacea or a terrible idea. The devil is always in the detail. Some countries have had good experiences with them. Some countries have had bad experiences with them. A lot depends on things like what you want to do about pre-clearance regimes and how much administrative costs you're willing to put up with, whether you view it as an alternative to reams of specific anti-avoidance rules or as coming in on top of those, and things like that.

As I say, I'm sure Malcolm would be delighted to talk about it at length, but I'm not sure we're the right people to do that.

Q44 Mr Mudie: In your report, you keep referring to the fact that this will be difficult and there will be winners and losers. You've taken the level of tax at the moment and made these changes against that total: the redistribution effects, for example, between corporate and personal. Have you done an exercise in terms of that? Can you give us some idea of what that would amount to?

Paul Johnson: The redistribution across the population of changing corporate and personal taxes?

Mr Mudie: That is between the groups. I've looked at the budget book and you're got clear groups. Now, how much, for example, do you anticipate taking out of the corporate taxation and putting into personal taxation? You have said ACE, the tax on equities, is going to personal rather than staying in corporate. Now, have you done that redistribution exercise, and can we have the figures?

Paul Johnson: We've got figures on how much ACE would cost.

Professor Bond: We've got very broad-brush figures on how much ACE would cost: of the order of £5 to 10 billion. Then there are choices as to—

Q45 Mr Mudie: Have you published these?

Professor Bond: They are in the longer report.

Q46 Mr Mudie: They are in the report, so we can see that and can make up our minds how much. Now, John Thurso raised the question of the abolition of the tax on equities to create a level playing field with the lack of tax on leverage. Now, sitting through the crisis and sitting here in this Committee year after year, leverage is the big danger that transformed the economies. I have always sat here thinking, "Why on earth don't we do something about this by taxing it?" You're actually acknowledging that it's not taxed, but instead of raising it and making it a level playing field that way, you're actually saying to take off the tax for equities. You would do the Western world—the whole world—a lot of good if you stuck to taxing leverage.

Professor Bond: Of course, if your only objective was to secure equal treatment of debt and equity, there's clearly two ways that you can correct the current imbalance. One is that you can increase the tax on debt-financed investments or, alternatively, you can reduce the current tax on equity finance.

Q47 Mr Mudie: Just one intervention: are you saying to me they're both the same yield?

Professor Bond: No, we currently give interest deductibility, which lowers the tax burden on debt-financed investments.

Q48 Mr Mudie: No, but what I mean is: if you actually taxed borrowing and leverage, do you have an idea of what the yield would be?

Professor Bond: If you were to take away interest deductibility, there would be enormous problems for businesses who have borrowed on the presumption that you're not going to do that. But if you were to do that, you would raise a lot of revenue. I don't have a number to give you.

Q49 Mr Mudie: What's "a lot"? Do you have a number in terms of the work you've done?

Professor Bond: We haven't looked at that particular option, no. We've looked at the other way.

Q50 Mr Mudie: Is that not one of the most interesting questions?

Professor Bond: Just to give you a little bit of background as to why we've come down on that side: if you thought the only problem was equalising the treatment of debt and equity, it seems like a 50:50 call and you would raise revenue by taxing debt-financed investment more and, you might think that's a very good thing. On the other hand, you discourage investment, so if you think that the problem is too much consumption and too little investment, you'd be going in exactly the wrong way. We actually thought that was also very important.

Q51 Mr Mudie: When I raised leverage, though, you all gave knowing smiles. Is that not such an important part of the economies now? And how it has changed the economies for the worse?

Professor Bond: I couldn't agree more.

Q52 Mr Mudie: Yes. Why have you not just put that in the balance and said, "Well, it's about time we did it"?

Professor Bond: The implication of treating equity-financed investments as generously as debt-financed investments is that you reduce this artificial incentive to have too much debt finance.

Stuart Adam: Our proposals would reduce leverage in that sense. At the moment, equity is taxed and debt isn't, so people use more debt than they otherwise would. By giving equity a more favourable treatment, we are encouraging people to use more equity finance and correspondingly less debt.

Q53 Mr Mudie: From reading your conclusions in the report—I think you printed too much for any of us to read—I had the impression that you are conceding to the corporate world that you aren't put tax up or give a redistribution against them because of the behaviour of the multinationals in terms of their mobility.

Professor Bond: We think there would be big downsides. The downsides would be that you would be a less attractive location and UK workers would end up earning lower wages. That's what we care about.

Q54 Mr Mudie: I accept that, but let me just ask you, because Richard Lambert has touched on it in terms of his speech yesterday: are we treating the corporate world as one inasmuch as the multinationals can get up to all this mischief with offshores, and even move, if you wish? It doesn't amount to the same arguments with great strength with the rest of the corporate world. Do you know the yield from multinationals, compared to medium and compared to small, in the corporate world? Do you have a breakdown?

Professor Bond: I haven't got those numbers.

Mr Mudie: No, but did you see that?

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Professor Bond: Those numbers are available from HMRC, I believe, certainly by firm size.

Q55 Mr Mudie: If you have them, can you pass them to us?

Professor Bond: I'd certainly be happy to do that, but the short answer is that corporate tax revenue is very largely skewed towards large corporations. Who pays the vast majority of corporation tax are the large corporations.

Q56 Mr Mudie: It is the multinationals. What percentage would you put it at?

Professor Bond: I wouldn't like to. I'm happy to send you a number.

Q57 Mr Mudie: Okay, now, the last thing is, just keeping on the same theme, you only mention avoidance in the context that you have just put on the table: if they move. It's clear with the tax gap that the multinationals have a growing habit of using avoidance methods. Now, that's estimated between £20 billion and £80 billion; people gather around £40 billion. That's a total corporate tax. That's the tax gap: £40 billion. That is considerable in a tax year. Now, why haven't you put that on the table and addressed that in terms of tax gap?

Professor Bond: I guess the short answer is we don't think there's a simple solution.

Q58 Mr Mudie: Does that stop you? Do you only do things when there's a simple solution? No, it's a fair enough point.

Professor Bond: One reason why there's no simple solution for the UK is that the ability of multinational corporations to shift profits out of the UK into other countries is not just within our control. The way the international tax system hangs together such as it does creates those opportunities. One of the reasons why we err on the side of not wanting to put the corporate tax rate up is that you would just increase the incentive for them to do that more.

Q59 Mr Mudie: I know, but then, although the solution is international, is that not worth making the point in your report and actually suggesting some themes, venues and partners? All the countries seem to be taking the same attitude. If we take these fellows on, they'll move to there and we're being played off against each other. £40 billion is a lot of money, isn't it?

Professor Bond: I guess we largely focused on things that we thought the UK authorities could do without requiring a utopian degree of international co-operation.

Q60 Mr Mudie: No, but it's not very fair, is it? If I were an ordinary lad, paying high tax, working hard in an office and paying my tax, you are going to hit me because you know I can't move and you have me, whereas the characters who are—

Professor Bond: Well, you want to spend the revenue at the end of the day.

Mr Mudie: Sorry?

Professor Bond: I should think you guys want to spend the revenue at the end of the day.

Mr Mudie: There has to be some morality in it though.

Professor Bond: You can only raise that revenue from sources that we take it from.

Professor Blundell: Just to be sure, we did think, for example, on the taxation of financial services and a level playing field there, that financial services are under-taxed, especially through the VAT system. Of course, to fix that, one would really have to do that on a European-wide basis and we make that case. We make that case very clearly, because I think it comes out of our principles. Where we thought it was really a clear case of one sector being more generously treated than it should—and financial services is one of them—we did propose things. Some of them would have to go though. We proposed that, really, the European Union should stop worrying about self-interest from those groups. We put forward a practical package, rather like the one the IMF has suggested, actually. There were cases where we tried to take a European side.

Q61 Mr Love: In your report, you mentioned that progressivity should be achieved as efficiently as possible. Now, you mentioned earlier that not all taxes need to be progressive. One presumes that that would mainly focus on taxes on income. What does "as efficiently as possible" mean?

Paul Johnson: In broad terms, it means raise the income tax and redistribute through benefits in ways that have the minimum impact on people deciding not to work or to work less than they otherwise would have done. We know that the current system imposes very high tax rates on people right at the bottom of the income distribution, so if you want to move from working not at all to working just five or 10 hours a week, for most people, that's not worth it at all, because they have almost all of their earnings taken away. They then have a bit of an incentive to move into work at 16 hours a week and then that's withdrawal.

The question we're asking ourselves mostly in answering that question is: are there ways of designing the benefits system so that you provide better incentives for people to work? That's part one. Secondly, we know different sorts of people respond to incentives differently. Again, those around retirement are really quite responsive to incentives in the system. Mothers with school age children are really quite responsive to incentives in the system, so you might want to focus reforms on some of those groups where you know the impact you're likely to have will be quite significant.

That is essentially what we mean by efficiency. How do you design the system to minimise the work disincentive effects, and how do you identify those people where the disincentive effects are most likely to be a problem at the moment, because we know that people respond to them more?

Q62 Mr Love: Let's change direction, because in an earlier answer you suggested that there's a great deal of evidence in those boundary areas that you're

talking about between tax and benefits. Therefore, there's a lot of guidance you can look to in deciding what is efficient or not. You then also went on to say that at the higher end of the income scale, there's little or no evidence; therefore, little or no guidance as to what is efficiency. What can you say about that higher end, if we don't know whether people will go abroad because there's a 50% tax rate? In other words, it is left purely to politicians' prejudice. How can you help us overcome our prejudices?

Paul Johnson: That's a good question and it's genuinely difficult. Basically, to be slightly nerdy about it, the amount of data that are available on these very rich people is much less, because there are very many fewer of them, than the kind of data that we have available on people—on other groups.

Mr Love: It could be a major contributory factor.

Paul Johnson: They're a huge contributory factor in all sorts of ways. They contribute a lot to the Exchequer. They also are important to the way the economy runs. Now, colleagues of ours have done some work looking at this and looking at what we know from what's happened as a result of tax changes in the 1980s, and they've made some attempt at getting a handle on the impact of the 50p rate. I think this is the right way of putting it: the best that we can say is that you certainly can't say with conviction that that will raise significantly more revenue, because it appears that they have historically found ways of either moving abroad or reducing their taxable income.

That said, if what you want to do is get more money out of that group, you can do things, for example, to widen the tax base, which is what the last Government and this Government has done through restricting pension tax relief for that group. So there are ways of changing things as well as the rate to change people's behaviour and, therefore, the amount of income that they pay.

Q63 Mr Love: Is there any merit in looking internationally—not to countries with higher tax rates; the United States has lower tax rates—to other economies and the way in which people respond to those incentives and disincentives?

Professor Blundell: If you really think about it, when have we had big changes in the top tax rates in the UK affecting the top 1%, 2% or 3% there? Most of the changes we're going to draw evidence from, because we haven't had data on the most recent, are going to come from 20 years ago, in fact. We have analysed that data in huge detail, but of course we wouldn't want to stop there, so we've looked at what's happened in North America and Scandinavia. They're the big places where you can see variation.

There is a huge meta-analysis done by a well-known professor at Harvard and it all comes down to how responsive—just an elasticity—it turns out that the one we use is very close to his preferred estimate looking across Scandinavia and North America, so we felt that we're in the right ballpark, but there's an amount of uncertainty there.

I think—Paul's point—in a way, the focus now is to say you can't really look at that independently of the base. So if you've got differential tax rates across

capital gains or other forms of taking earned income or other types of income, that should be the place to look for policy. If you look at what we've done here, we've suggested aligning rates across all forms of income, whether they be capital gains or earned income, or above-normal returns. One of the main reasons for that was to cut down escape routes in a sense for tax rates at that point. If anything, we've made it easier with these reforms to get revenue at the top, but it's very hard to claim too much about what will happen.

Q64 Mr Love: The OECD has done a major report, and I want to come back to issues that the Chairman raised about growth, because they were very definitive. They said corporate taxes are the most harmful type of tax for economic growth, followed by personal income taxes and then consumption taxes. Do you share those views? Can it be justified from their report and from the work that you've done?

Stuart Adam: I come back to what I was saying about—by “good” or “bad” for growth, do you mean raising a permanent long-run trend rate of growth or do you mean having an impact on growth over a period of years as you get to a higher steady state? If what you mean is the latter case, which is what I understand the OECD to have picked up—although I haven't studied that report in detail—in that case I broadly agree and it is for similar reasons that we argue that normal rates return to saving and investment should not be taxed, and our proposed reforms to both personal taxation of savings and corporate tax reflect that.

Q65 Mr Love: You mentioned earlier on that your study is taking as given the overall level of taxation in the economy. If, because you believe corporate taxes should be lowered, for competitive reasons it is decided that we need to compete with Ireland in terms of the level of corporate taxes, does that not mean that you distort other taxes in order to make up the gap?

Paul Johnson: The figures that we've quoted on the change to the allowance for corporate equity system—which, as Steve said, would cost between £5 billion and £10 billion; they would show the extent to which that could increase welfare and investment—have assumed a movement to consumption taxes. So if you were to move from getting that £5 billion to £10 billion from corporation tax to getting that £5 billion to £10 billion from an increase in a broad base VAT then that, according to the figures that we have looked at, would suggest that you would have an overall fairly significant increase in investment.

Q66 Mr Love: I wasn't so much talking about this balance between equity and debt but more the headline rate of corporation tax, which is a very emotive subject, as you will be well aware.

Stephen Bond: We are not specifically proposing anything on corporation tax. We're proposing to keep the corporate tax rate more or less where it is. We could debate whether that means 28% or 24%, but in that ballpark. We're proposing quite significant reforms to the corporate tax base, which would cost revenue, and it's that revenue that would indeed have

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to be raised somewhere else. The simple reason why we are proposing that is that we think the corporate tax is more distorting and more costly than the other taxes we're proposing to—

Q67 Chair: I have one area that I think we must cover before closing this session, which is the question of neutrality in the small business sector, between the small business and the self-employed. First of all—and you can just say yes or no—am I correct in assuming that the principle of neutrality should mean that the tax treatment of those two groups, the self-employed and the small businesses, should be the same?

Stephen Bond: Broadly, yes.

Q68 Chair: How do we get there? You have one sentence.

Stephen Bond: One sentence: we need to get more revenue from the self-employed than we currently do relative to the employed. The employed are the disadvantaged group currently.

Q69 Chair: This is my last question to each of you. You have already answered it, Professor Bond, much earlier when you said you wanted to address the preference for debt over equity in the corporate tax system. You are now the Chancellor of the Exchequer; you are about to produce a Budget; there is one

measure above all else in this report that you want to make sure is in. You cannot have your package because the officials have told you you can't have it, which is what they would have done even if George agreed with it. What do you want? Let's start with Stuart Adam.

Stuart Adam: I suppose it depends on what you would count as one measure. If I'm allowed to interpret a measure broadly, I would say a uniform tax rate that applies for all consumption but in which I include financial services consumption and housing consumption, with the revenue used appropriately to compensate low income users and so on.

Chair: I am sure that will go down well in the Budget speech. What about Professor Blundell?

Richard Blundell: I'm going to go for aligning the rates of taxation across different forms of income.

Chair: We have had Professor Bond. Paul Jones?

Paul Johnson: I wouldn't disagree with those but if I was to add one then it would be reforms to the direct tax and benefit system, making them more integrated and more efficient in the way that they impact on people's work incentives, including reforms for some of the particular groups that we've mentioned.

Chair: That was interesting and helpful. Thank you very much for coming today. We found it stimulating. We are going to take a five minute break before starting the next session.

Examination of Witnesses

Witnesses: **Francesca Lagerberg**, Partner, Grant Thornton, **John Preston**, Partner, PricewaterhouseCoopers, **Andrew Hubbard**, Immediate past President, Chartered Institute of Taxation, and **John Dickie**, Director of Strategy and Policy, London First, gave evidence.

Q70 Chair: Thank you very much for coming before us this morning. Some of you, I think, have heard some of the evidence that we have taken from the Mirrlees Review. I think Francesca was there for the whole of it.

My first question therefore is to her. Did you find out anything you didn't already know?

Francesca Lagerberg: Probably nothing particularly new, but beautifully explained, I thought, particularly as they are still sitting in the room. I think what you have there is an incredibly complex current system, and trying to distil that down into a meaningful way forward is always going to be very hard. I think, if anything, it highlights the fact that if you can come to some conclusions about a good framework, going forward, you'll have achieved a huge amount from this review.

Q71 Chair: Did anybody else hear much, or has anyone else here read carefully the Mirrlees review?

John Preston: I have certainly read it.

Q72 Chair: And do you have views on it?

John Preston: I thought it was a very carefully thought-through work. I thought it had some very good points; I thought it was very constructive in its approach. I thought some of its conclusions were more

political in nature than the document indicated. That doesn't mean to say they were wrong, but some of them were political in nature.

Q73 Chair: Which were those?

John Preston: For example—and again, I am not making any comment about whether it is right or wrong—the observation that the tax system should be used to redistribute wealth. I'm not saying that's a bad thing, but I'm not sure that's a fundamental principle of tax policy. That's a political decision as to whether that's a good or a bad thing, but I don't criticise the report for that; I just think it had some political commentary.

Q74 Chair: Did you agree with the areas that they drew out, about which I asked at the start, as the four areas where there should be a deviation from the general principle of simplicity and neutrality? That is pensions, green taxes, childcare costs and sin taxes. Did you have ones you want to subtract or add?

John Preston: I think environmental taxes probably does fall into that category. With some of the others, I think, it's a much more complicated debate.

Q75 Chair: All right. Thank you very much. I don't know whether you heard it, but did you agree with

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what was said by any of the witnesses on growth and the relationship between the tax system and growth?

Francesca Lagerberg: In my view in terms of growth, tax works best when it is about collecting money, and that's what tax at its best is able to do. When you try to do something more sophisticated with tax, you tend to run into difficulties.

So if you're looking at growth, what you most probably need the most efficiently and the most effectively is a tax system that has a level of certainty, so you know what's going to happen when you do a transaction, and an element of simplicity. The two do not run very easily hand in hand.

I think if you're looking at growth from the UK's perspective at the moment, it's competitiveness that leaps off the page as something the UK needs to achieve. It needs to be a competitive place to do business, and that doesn't run very easily alongside simplicity.

Chair: Before I pass you over to John Thurso, I just should warn you that at the end of the session I'm going to ask each of you for your one measure that you want to see in the Budget.

Q76 John Thurso: Adam Smith, rather famously, put together his principles. The ICAEW have come up with 10 tenets. In the last session we had a raft of principles. What, in looking at the tax system, should be the two or three or four key principles that Government should be looking to? Could I ask each of you in turn, starting at this end of the panel, just for a quick answer on that one?

Andrew Hubbard: I think certainty is a very fundamental point in all of this. I spend a lot of time with smaller businesses and medium-sized businesses, and the idea that their tax position might be open for years because of disputes over the interpretation of particular items is a very difficult thing for them to deal with. So, to the extent that certainty can be brought into the system, I think that is absolutely fundamental.

Then you always have the trade-off between fairness and simplicity. I think it's wrong to say you want to have a fair *and* simple tax system, because there are inevitably conflicts between those. You could have a very simple tax system by saying, "How much money does the Government need to raise? How many people are there in the country?" and divide one by the other. That is simple, but it would hardly be a fair system. So it's always about the balance.

I think of simplicity for straightforward tax affairs—John will deal with very large multi-national businesses whose business affairs are complicated, and therefore one would expect that there should be some complexity in the tax system. For individuals and smaller businesses whose business affairs are relatively straightforward, I think there's a strong rationale for saying that the tax system should be as straightforward as possible.

John Preston: I would agree with everything Andrew has just said. I think it's quite difficult to start drawing individual items for these. I think the whole point of a coherent tax policy is that the policy ought to contain all of these elements if it's to work as

efficiently as we would like it to, and it becomes difficult to differentiate.

If I was to make one comment, I would say it is about direction of travel. This goes back to Andrew's point, not just for corporate taxes but for all taxes, that there should be a clear understanding in both Government and the public's mind about what the direction of travel for all the major taxes are, whether it's corporate, personal, environmental or capital, so that people—either businesses or individuals—can make long-term plans, certain of the broad direction in which the tax system is going to go.

John Dickie: I would make a similar point, I think, but using different words, which is the importance of due process around any proposals to change the way in which tax works and will affect people, in particular the importance of avoiding policy shocks, which are something that businesses cannot hedge against. It is a risk that you cannot understand, and when proposed tax changes create policy shocks as, for example, happened over the moves over Lord Adonis's taxation a couple of years ago, that creates a very disconcerting effect to all of those working in the UK particularly, but more in respect to London as a whole. They wonder where it will lead and what it is the harbinger of. Those shocks are not easily countered by creating stability and predictability in future, because people remember them. So I would say due process is the key.

Francesca Lagerberg: I had to write the 10 tenets; it was over 10 years ago. Good Lord. We have been talking about it for a long time but, funnily enough, I think all 10 of them are pretty good. But if I was to pick some I would agree: competitiveness is up there, certainty is definitely up there, and really picking up on the point John has just made, it's about consultation. To get it right, you need time and you need to have the right people involved in that decision-making process.

Q77 John Thurso: How important is it that it needs to be fair and progressive? I accept that fairness and progressivity—or whatever it is called—are not necessarily the same things, but how important are those?

Francesca Lagerberg: I think there's a very important point about people perceiving that they're being treated appropriately. Fairness is crucial. It is very hard to be fair in relation to everyone's personal perspective on the tax system but I think if you stand back and something seems particularly penal for one part of the population, it clearly can't be appropriate. So I think you end up with a proportionality element here. Is it appropriate for that particular sector to be taxed in the way that it is? It isn't always very straightforward but I think, as you have seen with the 50p tax rate, you've got a lot of people who perceive that as being unfair on them, and a whole new group of people who see themselves as aspirational, higher rate taxpayers, who think one day it could be unfair on them. It's interesting to see people's social reaction to some tax rates.

Q78 John Thurso: I thought the definition of an unfair tax was one that I pay. Andrew Hubbard, the

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Chartered Institute has said the Government's paper stopped short of addressing the issue of parliamentary scrutiny. You clearly think that's a shortfall. What would you like to see us do?

Andrew Hubbard: I've always felt that there is a high level of engagement with the Finance Bill process, and reading the debates I've always been very impressed as to how people have got to grips with really difficult issues. The thing that I'm concerned about is the broader framework of that. How do we best support MPs in their job by giving them the right background information in order to ask the right questions? I think sometimes the debates are quite narrowly focused.

One of the things that we've done some work on is what happens in the United States with a joint committee, where there is effectively a group of professionals who are there to support the activities of legislature and to enable them to understand the economic and behavioural impact of some of these things in a way that gives just a broader framework for people to make intelligent and rational decisions. So it's a sense of whether or not there are more ways that one can support the work of Parliament. I think there is a role for the House of Lords in this. I know that's constitutionally difficult, but there's a lot of expertise there that potentially could help with some of the analysis of all of this.

Q79 Mark Garnier: I was very interested in listening to your principles as you were going through them. In fact the only person who mentioned competitiveness was you, Francesca. I suppose my question is partly: why do you not think the competitiveness is that important? Why would the three of you not have that as one of your key principles? Who wants to go first?

John Preston: I'm happy to take that one. Firstly, I would say that competitiveness is key, but it's what comes out of all of the other principles. When I was talking about direction of travel, particularly in the business context, I think that's exactly what we're talking about. Is business clear that the direction of travel that the tax system is moving in is going to be one that will enable them to make decisions that make them want to locate their people and their activities in the UK, encourage entrepreneurial activity, encourage risk-taking and so forth? That's a consequence of doing all the other things, but it has to be at the forefront of everything you're doing.

John Dickie: I entirely agree with that. Competitiveness is an output of the process. But as you've just spent most meetings—certainly the last one—discussing, there are all kinds of difficult trade-offs that you have to meet when you're raising taxation to fund public expenditure. The point about due process is that due process doesn't actually cost anything. Getting the process right, consulting at the right stages, thinking through what it is you want to consult on as HMRC and so on doesn't involve those difficult trade-offs; it just involves managing the process right, which is why it is both a very important part of how the system should work as a whole but also the relatively achievable and easy to achieve part.

Q80 Mark Garnier: Sure. When you talk about direction of travel, presumably you're not just simply talking about the fact that we are going to a corporate tax rate from 28% to 24%. You're talking more about the whole system: simplicity and—

John Preston: Very much, yes.

Q81 Mark Garnier: The other big philosophical question is: should an outcome of the taxation system be economic growth? To what extent do you think that economic growth is a key thing, particularly with the economy in the state it is now? Why don't you have a go at that?

Francesca Lagerberg: Tax is just a part of that, clearly. It's not the sole driver of it and never would be, but it should be part of the support programme for it. It's very interesting to look at some of the work going on with the Office of Tax Simplification at the moment around the relief and exemptions in the UK. It is a really valuable piece of work. Is it possible perhaps to remove or change some of those reliefs to make the UK system more effective?

And an element of that drives growth too. Some reliefs and exemptions positively encourage investment. You could argue that things like encouragement for R&D stems from some of the tax breaks around that area. Where do you draw the line? What does tax drive, and what does tax support? I think on the whole, though, tax is a support system for other forms of economic growth. Undoubtedly, it can also be a break. So if it isn't properly structured and if it isn't working effectively, it can prevent growth or make growth go off to other parts of the world and leave the UK.

Q82 Mark Garnier: Do you not also agree that by having a ferociously complex tax system, you are drawing away a lot of the resources a business has, from research and development or whatever, to just simply dealing with the system? Is it not fair to say that in an ideal world, you chaps, being tax experts, would be out of business? We would have such a simple system that we wouldn't need you. Would you agree with that?

Andrew Hubbard: I think there's an element of that. I don't think we would go to that logical conclusion, though. But if you asked a lot of the businesses I deal with in manufacturing—medium-sized businesses, small businesses in the Midlands—what was the one thing HMRC could do to encourage their growth, they would probably say it would be to get off their back. So there is an element of saying that the burden of complying with the tax system, dealing with change and all of those sorts of things gets in the way of business growth, even if the policy there might support it. You always have the issues. Say, for example, that you want to incentivise capital expenditure by capital allowances. I don't think in all the years I've been a practitioner I've ever seen a client say to me, "Well, I wasn't going to buy this asset, but now I'm going to get enhanced capital allowances, I will". Your experience may be different but that's certainly mine.

Also I think there is an element that if you are going to use some form of incentive, it has to be quite

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tangible pretty quickly. When you introduce a specific relief, there are delays in the system. If you issued a relief today, it might be another nine months before the year end of the company, then there's nine months or whatever before the tax is due. So the client would come to Francesca or me and say, "What's my tax liability for the year?" "It's X." "Yes, it would have been Y, had I not done this thing." But it's so distant. I think the real sense of incentive needs to be much closer and more direct.

The R&D tax credit has worked quite well though, because it's turned into a cash incentive on PAYE. That, I think, has been welcome because people can immediately see a tangible benefit rather than it just getting lost in the tax charge somewhere.

John Preston: I think it really depends what you mean by that. We've done surveys of smaller businesses, and one of the quite disturbing things is that most small businesses aren't even aware of the great majority of the reliefs that are out there, and the smaller the business you get to, with businesses that can't afford strong professional advice, the less aware they are of some of the reliefs that are out there.

Q83 Mark Garnier: So the system is regressive in that respect?

John Preston: If what you are asking, therefore, is whether I think that the tax system should constantly be trying to introduce new specific forms of relief to try to encourage particular activities, actually I strongly don't. Because the evidence is firstly that it's not particularly effective. It's simply over complicates the tax system and, as Andrew says, most businesses in the smaller sector are saying, "Can you please get off our back? We're more interested in going after the next pound of revenue than we are in wondering about the tax system".

If on the other hand what you mean is: should the tax system—which by definition is taking money away from people; you have to do that in a civilised society—be geared towards minimising the disincentive for people to take business decisions and conduct entrepreneurial activity? Yes, it should. But I put it that way around rather than the growth way.

Q84 Mark Garnier: Just moving on to the recent OECD report—and I think, Mr Preston, in your written evidence you've said you agree with this—the report on tax policy states, "Corporate taxes are the most harmful type of tax for economic growth, followed by personal income taxes and then consumption taxes, with recurrent taxes on immovable property being the least harmful tax". Excluding you, because you have already spoken, do the rest of you agree with that or strongly disagree?

Francesca Lagerberg: Certainly corporate tax is a massive issue in terms of encouraging growth, and lower tax clearly just generates some additional growth to it, but it's very hard to pick off a single tax because an awful lot of organisations have a number of taxes impacting upon them. It's very rare for just one tax to be the sole tax that's relevant. They intertwine so much, and particularly in a more complex organisation, or even a relatively small business but one that trades across international

borders, it's a whole range of jurisdictions that apply. So I think it's quite difficult to just cordon off one area and say, "That's the problem".

Q85 Mark Garnier: But in a broader sense, you wouldn't say corporate tax and then personal income taxes are a big issue? We haven't really talked about personal income taxes yet.

Francesca Lagerberg: They are the ones that leap off the page headline-wise, but I think when you start delving underneath them it's a more complex web. Certainly the reaction to this staged reduction for corporate tax rate has met with an awful lot of approval from the businesses that I deal with and also from the businesses around that pay the smaller rate of corporation tax. They're hoping that they'll see a fall off in the corporate tax rate too. So clearly the business message is that they like the thought that those headline rates will fall.

John Dickie: It depends a bit on where you're at. As a hierarchy, that sounds about right to me but, as Francesca said, the Government are reducing the headline rate of corporation tax. What we have now is a very uncompetitive headline rate: the top rate of income tax. So the interaction depends on quite where you're starting and what the relative balances and levels are, certainly from the perspective of the businesses we deal with in London. And of course, the London economy is hugely dominated by the service sector. The agglomeration of the talent here in the centre of London is characterised by highly able, highly mobile, highly productive individuals. London having a top rate of tax that is higher than that of all our competitors in the UK is a disincentive and a disadvantage.

Q86 Mark Garnier: Is it damaging our economy?

John Dickie: You had the conversation earlier with the IFS, which I wouldn't want to try and second guess, but it is very difficult to quantify these things. The view I get in discussions anecdotally across a variety of sectors in London, time and time again, is that it is certainly having a damaging effect on growth and, in particular, it's reducing the attractiveness of London to people. The issue is never—

Q87 Mark Garnier: I am sorry to cut across you; I just want to be clear about this because there's quite a strong argument going on about this. There are two sides to it. One is the international whizz kid, if you like, who may not come to London because of that, and the other is the UK-based whizz kid who is paying that high rate of tax. They are less likely to leave. By the time you've got your roots in this country and you've got your kids at school here, you're less likely to leave. Are we talking about those people not coming and the international jetsetters who might leave, or what?

John Dickie: The issue is much less about mass exodus because, as you rightly say, if you are British or you are a Londoner, you might like living here almost irrespective of the things Government can do to make life unpleasant for you. But this is from the perspective of future growth and from the perspective of businesses thinking, "Do I locate this team in

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London with other teams or do I locate it somewhere else? If I am thinking about putting together a business unit to do something, do the people whom I would get to work in that business unit want to come and do it in London or would they rather do it somewhere else in Europe, or indeed somewhere with much lower tax jurisdictions elsewhere in the world?" Over time, as I say, the critical success factor, if you like, for London's economy is a deep talent pool. It's the agglomeration of benefits of having a concentration of human capital within a few square miles. Over time, if you diminish that competitive advantage, suddenly the level might start to be a little bit less attractive and that will be a problem.

Mark Garnier: Mr Hubbard, do you have anything to add?

Andrew Hubbard: I think there's a different perspective again in the small business context because where you've got a business that is essentially a family business the distinction between the corporate level of tax and the personal level of tax is largely illusory. In the end, what those people are looking for is the overall burden of taxation from that economic activity, whether it's at a corporate level or whether it's in terms of the money that they actually get in their pocket. Looking at the corporation tax rate on its own doesn't really give you, I think, the complete picture.

I'm always quite concerned about just looking at these terms in terms of individual rates, because what you really need to say is, "What is the appropriate rate for an individual?" and to say, "Once he's paid all his taxes he has the rest of the money for him or herself, however much is left". That's an interaction between, typically, corporate tax rate, national insurance rate and income tax rate. All of the issues that we've had for years about getting a stable small business tax system are really a result of the interactions of those things. So I think in the smaller business, to concentrate on one rather than the other pulls you in the wrong direction.

Q88 Mark Garnier: I have a couple of questions in one. Mr Dickie, you referred to policy shocks as being an issue. My two questions are: do you all agree with that? And secondly, what are the major policy deficits we have in the current UK system?

Francesca Lagerberg: Undoubtedly, knee-jerk reaction legislation or things that come in that appear to be completely out of the blue are hopeless to deal with. They are very hard for businesses to cope with and very hard for individuals.

A classic one was the non-corporate distribution rate, which was an idea that cropped up around small business taxation. It lasted for 18 months. It was quite penal and very hard to operate, and it was removed because it just didn't operate. That's a classic example of how not to do things. So I totally agree with the concept. You'd never want to go there.

Do we have any at the moment? We've become an awful lot better, I think, in the UK in terms of stepping back and not legislating without the thought. I'm really impressed at the moment; we have Finance Bills coming out in draft three months ahead. That's fantastically useful for getting good consultation. So

there has not been, in the last, say, six to nine months, any glaring examples of such knee-jerk policy, but there are plenty of examples going back over the last 20 years to show you how it shouldn't work.

Q89 Mark Garnier: Yes, sure. Would anybody like to add anything to that?

Andrew Hubbard: I would say there's one area that we don't yet have right, which is the way that we encourage private investment into small businesses. We've tried over the years with the BES and EIS and other things and, for understandable reasons of concern about avoidance, those rules have become almost impossible to operate. So if anybody comes to me and says, "I want to raise money through the EIS mechanism" you start to go through the checklist and then in the end they say, in a lot of cases, "Okay, it's just not worth it". So if there was a way of encouraging the tax system to allow entrepreneurs to invest in small businesses or baskets of small businesses, I think that's an area that would be very welcome and a good example of using the tax system to prime some economic purpose. But I don't in any way suggest that's going to be easy, because we've had a lot of history of avoidance in that area. But that would be where I would put some significant effort.

John Preston: I think the observation I'd make, and I hesitate to say this in a political environment—

Chair: Could you speak up?

John Preston: I'm sorry. I hesitate to say this in a political environment, but part of it is that politics gets in the way. Clearly, it's very understandable that a Chancellor wants to use the Budget to make a very politically attractive headline and sound bite the next day, but that overcomplicates the tax system on a regular basis. I'm not saying you can never have an approach that says, "We will have a clear direction of travel" with the result that we won't have short-term measures, but the attractiveness of introducing those short term measures to politicians, which I understand, I think moves in the opposite direction of clear policy.

Mark Garnier: Interesting, thank you.

Q90 Chair: Mr Hubbard, do you have a scheme in your back pocket for this investment in small business problem?

Andrew Hubbard: No. I have a number of—

Chair: So it is rather tough to ask the Chancellor to find one.

Andrew Hubbard: No. There are ways that one could start structuring that, and a lot of work has been done on that. I don't have a scheme in my back pocket, but we and the profession have some thoughts around that.

I suppose the issue for the Chancellor is the extent to which he is prepared to accept some risk around the edges of investment in things that he doesn't really want to support for the greater good. That's always a difficult balance in this. But I don't think we've got it right at the moment.

Q91 Michael Fallon: We saw some changes, Mr Hubbard, in the treatment of VCTs in the Budget. Is there not scope there for further incentivising the way that angel investors might be attracted through VCTs?

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Andrew Hubbard: Undoubtedly there is, but I just feel that whole area has become so complicated that it almost needs to start again and rethink as to what sort of businesses we really want to have, how we want to support them, and what degree of tax relief we are prepared to give. I suspect that what we have now is a patchwork going back 20 years, and some of what we have has been based on what in the BES. It's a bit of a sticking plaster.

Q92 Michael Fallon: But why do you think angel investing is so much more attractive in the United States? Is their system much simpler?

Andrew Hubbard: I'm not an expert on that, but my understanding is that it's simpler and that there are more effective tax breaks available, but it's not an area I've got great expertise in.

Q93 Michael Fallon: Mr Dickie, coming back to UK competitiveness in tax, are there examples of where very sudden changes in Government policy have discouraged overseas investment into the UK? I think you said some of the evidence in this area was fairly anecdotal.

John Dickie: The evidence I was saying was anecdotal was the sense we have picked up from our members in London about the impact of the increase in the top rate of income tax. I think the area where you could find some evidence would be around the changes in non-domicile legislation and the tax levied on them, where first of all a very broad ranging consultation process set all kinds of hares running as to what would be the shape of the regime, which didn't materialise and weren't what was intended. For example, people found the idea of the disclosure of worldwide assets very disconcerting.

Q94 Michael Fallon: But you've all been arguing for a longer consultation process before each tax change. Now you're telling us the effect of the longer consultation process was to discourage—

John Dickie: No, I think the challenge is to consult on what it is you are thinking of doing; not to consult on all the things you could do. Because I think setting hares running is disconcerting. It cuts across having a clear direction of travel—

Michael Fallon: This is the announcement by the previous Government on non-domiciles?

John Dickie: Yes.

Q95 Michael Fallon: Are you able to measure any kind of effect of that?

John Dickie: I have some numbers in front of me, which I could take out, in terms of the effect of people leaving the country, if I can find it here. The Government have estimated that they have raised, I think, £162 million in tax from non-domiciles paying the levy, which is 5,400 people paying it in its first year, which is below the original estimate of course. It's difficult to know whether the estimate was wrong or whether there's been a greater migration of people to avoid paying the levy.

Q96 Michael Fallon: Or indeed onto the tax system?

John Dickie: Indeed. But if you look at the impact of other taxes paid by non-domiciles, because of course the levy is only a part of what they would pay, the Treasury has estimated that non-domiciles pay around £4 billion in income tax and £3 billion in other taxes: VAT, capital gains and so forth. If you are working on the premise that around 10% of people in this category have left, the causality is a difficult thing to be certain of, but none the less, if you are 10% down on what you thought you were going to get by way of the levy, that rather implies you are about £800 million down in terms of the aggregate tax take from this group, compared with having raised £162 million.

Now, as I say, it is very complicated to work out the causality for these things, but it doesn't sound like a great policy success.

Q97 Michael Fallon: Were you surprised that only 5,400 people had paid the levy? How many did you expect the levy to catch?

John Dickie: We'd not made a forecast.

Q98 Michael Fallon: How many non-domiciles are there?

Andrew Hubbard: I think one of the problems in this and other areas is a lack of real data to support—

Q99 Michael Fallon: Sure, but have you estimated it? Somebody must know roughly how many there are.

Francesca Lagerberg: You may recall there was a whole bunch of figures flying around in 2007 that the Treasury couldn't confirm.

Q100 Michael Fallon: How many do you think there are?

Francesca Lagerberg: To be honest, it's almost—

Michael Fallon: Are there 10,000, 20,000 or 100,00? How many are there?

Francesca Lagerberg: There is no firm set figure because people didn't have to report it like that, and they've never been able to produce statistical evidence that would be of value to you. The Treasury are the best people to ask to get the figures that they think are the most relevant.

Q101 Michael Fallon: You have numbers on this, Mr Dickie. You must have a personal estimate of how many non-domiciles you think there should be.

John Dickie: I do not have a personal estimate but it does, if I may—

Michael Fallon: But you suggested that 10% of them may have gone.

John Dickie: These are from the Treasury's numbers; they are not from my numbers. It makes a wider point, though, and now may be the right time to make it, and it relates to the point I was making about the 50% tax rate: there is a dearth of objective analysis and evidence on some of these very political questions. Now, I can tell you my views about the impact of the 50% tax rate but I absolutely accept they are anecdotal and they are impressionistic.

The Institute for Fiscal Studies has done work on this. They were coy earlier about being able to predict the impact on revenue of the 50% tax rate. When the 45%

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tax rate came in, they did say that the evidence they had obtained from elasticities around the Mirrlees review was that 40% was probably about the revenue maximising rate. But these things are difficult to know. If people such as ourselves, a business organisation, go away and do some work, you might perfectly reasonably think it is self-serving. The arguments, rather as I think Andrew was saying earlier, for some kind of Congressional Budget Office equivalent where you can ask these questions and people do authoritative objective work—as objective as things that may be a bit subjective can be—would be a great asset to having some of these discussions.

Q102 Michael Fallon: That leads me to my final question. We talk about objectivity of organisations like the IFS. Do you share Mr Preston's concern that some of the Mirrlees' review appears to have been rather "political" in involving itself in rather subjective choices?

John Dickie: I think there is a challenge—indeed, it came out of your questioning—when you're looking at the tax regime. Do you simply consider an absolutely abstract or do you ground it in the way that it works in Britain today? You can skew that either way. So I don't think there is anything wrong with working on the basis that there is a broad consensus that you want a tax system that is aligned with benefits and produces minimum distortions, but that does rather presuppose that you are using the tax system to do redistribution.

Q103 Michael Fallon: But they went further than that, didn't they? They wanted a system that was more redistributive and more targeted at rebalancing equality.

John Dickie: I don't think you need to take that view in order for the conclusions that they reached to be valid. That is to say there is a spectrum of where you can put policy. The framework they gave you to put it in seems to me to be a reasonable one.

Andrew Hubbard: Might I make a small point on non-domiciles? You gave us the challenge as to how many there are. I think that there are 500,000 non-domiciles, probably more than that, but the vast majority of those people who are non-domiciled have no significant overseas income; they're your cliché Polish plumber, all those sorts of people. People that are second generation or third generation people who are non-domiciled who may not even know it. Their tax status under the old rules wasn't affected by the fact they were non-domiciles, because all their income was in the UK. One of the issues that comes out of this is that if you're going to tax non-domiciles then you have to have in your mind an entire picture of what you mean by non-domiciles because the rules as they were drafted, I think, have been drafted very much in the target of high-earning international-type non-domiciles, rather than those in the UK who may have very small amounts of income abroad, or go abroad for a few weeks to help on the family farm over the summer.

Those people are non-domiciles, and I think one of the issues around trying to define policy in all of this is to say, "Okay, when we talk about non-domiciles or

a group of people, what do we mean? Who do we have in the target?" And I think that that has been potentially why we've had so many difficulties in that, because the mindset of who we're dealing with is not necessarily rooted in reality.

Q104 Andrea Leadsom: I'd like to come on to the question of the ease with which you collect taxes, because obviously that also is fundamental to how successful and how much of incentive tax is. Do you think that there is enough consideration given to making it easier and simpler for people to pay their taxes?

Francesca Lagerberg: I think it's an incredibly valid point. The majority of tax, of course, is collected through the PAYE system and, although it's had a bit of a kicking this year in terms of the PAYE notice of coding, it's broadly held up very well over an extended period of time. The difficulty with the existing system is that it wasn't built around multiple employments, people changing their job very frequently, maybe having two, three, four employments, and having a wider range of more extensive benefits in the sense of medical insurance, that kind of benefit in kind.

I think the success of the PAYE system is that people don't have to do that much for tax to be collected, and that's why it's been so efficient. When you start looking at other taxes that require extensive paperwork, people having to understand very complex issues and get their forms in right, this is very live at the moment. Here we are in January, when a large part of the population who have to file tax returns are struggling to make sure they get their return in on time and get it in accurately. There's quite a lot of complications as soon as you get into form for the exercises. So I think it is a very vital part of it and certainly in terms of the success, if you can judge a tax in terms of success, the easier it is to get the money in and the more efficient it is to get the money in, the better it tends to work.

Q105 Andrea Leadsom: So what about this move towards self-assessment and online filing? We have a separate review into the processes and workings of HMRC, but I would have thought a key principle of any tax system is that it has to be easy to collect, and not fraught for the end user. We all have countless examples, as I am sure you do, of companies who inadvertently have made a genuine error or they just don't understand, and get themselves into all sorts of problems. How much of a priority should it be, and what is the impact of all this self-assessment and online filing for companies, not just for people?

Francesca Lagerberg: If I can just pick up on the online filing point, there's a huge and obvious draw and opportunity with online filing to make some things more efficient and more effective. Somebody having to key data in puts in another layer based on cost but also potential error.

The real difficulty that's been around online filing for tax purposes is: has the system been able to cope? Is it sufficiently trialled, tested and piloted? Very live at the moment is the issue around IXBRL for corporate filing, which is about to come live in the UK. There

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is a lot of concern that on the accounting piece of that, not just the tax piece, a lot of the software providers aren't ready and are struggling to be ready on time. It is partly out of their control and partly just of the complexity of having to produce it, and a huge concern for businesses knowing that they're potentially going to have to file with today, not knowing quite what that's going to look like, what it's going to cost, what it's going to mean and how they are going to train.

It takes you back to what we tend to refer to often in tax as the Carter principles around online filing from the Patrick Carter review. You should never introduce a system until it's been properly piloted and properly tested. As we all know, IT has a tendency to go wrong in the first 12 months, so it needs time to work effectively. There's nothing worse than introducing a system that falls down because the IS isn't quite ready or doesn't support what it's trying to achieve.

Andrew Hubbard: Generally speaking, I think online filing for individuals works well now. I think the reason it's worked well is in fact that it's in everybody's interests to work well. It's obviously in HMRC's interests, but it's created a lot of efficiencies around accountancy practices and it's actually for individuals.

But the lesson there is that it's taken about 10 years. These are very long projects. It seems to me that this is a classic situation where to introduce it, you need carrot and stick. You have to have some form of stick to say, "Okay, we need to do this" but what it should be is that it becomes self-fulfilling and that it makes sense for the filer as well as for HMRC. If you can get that to work and accept that it's going to take a long period of time, I think you've got big advantages for everybody. None of us would want to go back to paper filing now because we see the advantages for taxpayers and their agents. We will get to the same thing, I'm certain, with corporation tax filing. But the message from me is that these are long-scale projects. You can't expect to do them very quickly and accept that it will be in everybody's interest for it to work properly at the time.

Q106 Andrea Leadsom: Just one slight aside on that, are you aware that Members of Parliament aren't allowed to file online, and is that a matter of security? Is there the whole issue of security of data because it's so easy to break into the system?

Francesca Lagerberg: A lot of it will be about the software not being capable of coping with what an MP's tax return looks like. Because of the effort of producing that part of the software and because of some peculiarities around the way that MPs' tax returns work, they've not invested the money in it to get the software ready to help it to file.

Security wise, I know there's a huge amount of energy gone into ensuring that it's the most robust system that HMRC can have, but of course they have been subject to repayment claim attacks. There are large volumes of fake repayment claims going in, so they have to be incredibly live to that. Anyone who's tried to set themselves up online will know the process you have to go through to get your activation code to get it all set up.

I'm just picking up on something Andrew said about the carrot and stick approach. What really won people over to online filing in relation to some of the early income tax-related filing was getting some money back. Money talked there, and suddenly people thought it was a good idea when that carrot was there.

Q107 Andrea Leadsom: What can be done to reduce the costs of collecting tax, generally speaking?

Andrew Hubbard: I would have one suggestion in relation to any new provisions, which is that if anybody in the Treasury or Government or HMRC is putting together some form of policy then at the same time they ought to be required to produce, at least in draft, the form that the taxpayer will need in order to get the benefit or report the income or the box on the tax return. It's been a big disconnect in the past that you've had some theoretical discussions, say, on the nature of pre-owned assets, inheritance tax or some of the things in relation to employee share schemes that in abstract may seem quite sensible, and then it's been very much at the last minute that somebody's thought, "Okay, what boxes are we going to put on the tax return for this?" or "What form are people going to have to fill in in order to claim this relief or report this?" When that happens, you then find almost certainly that after a couple of years there have to be radical changes to make it practical. So in terms of new policy I would certainly advocate that as a very strong working practice.

In terms of the current efficiency of paying tax, I think HMRC have done a pretty good job in a lot of areas in this. I think their approach to debt management has been very good and much improved from where it was. I think electronic filing is the way forward and I would say give it time to bed down rather than push it too fast. That would be my—

Q108 Andrea Leadsom: One last quick question: as we embed the new PAYE system over the next few years, what advice would you have for HMRC in trying to keep the complexity down and avoid a repeat of what has just happened?

Francesca Lagerberg: I think the most useful thing they can learn from is in relation to the IT system, because they're obviously looking at real-time data exchange now for PAYE; again, that's a project you do not want to rush. They've just come through that very difficult PAYE notice of coding time. They've done a lot of work on amalgamating databases and learning from that project. That took a long time to achieve. Real-time PAYE has a lot of attractions, but if it's rushed it will go wrong.

Q109 Andrea Leadsom: Is that going to be another 10 years?

Francesca Lagerberg: Let's hope it's less than that.

Chair: Let's all hope that.

John Preston: I don't think it will take 10 years. Just to make one point in relation to your question about how you can simplify it, I think there's a more strategic point which is that, if we're talking about policy, the best way of the simplifying the tax system is to try to only tax the same base once. So you don't try and apply lots of multiple taxes to the same type

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of income. An obvious example, which is controversial, is PAYE and national insurance, where you're applying different taxes to the same basic base and that obviously hugely complicates the process.

Q110 Mr Love: Could I come back to some of the questions you were asked earlier on about high net worth individuals? Mr Dickie, we all know that London is one of the two or three world cities. It is the engine of the British economy; much of that is based on financial services and business services. For that to succeed, we need to have a flow of people coming into and out of it, but as you admitted earlier on, we know remarkably little about the numbers in terms of non-domiciles; we know remarkably little—you've given some evidence, but you admitted it was very limited—about the impact of the 50% tax. Why is that, considering how important this all is to the success of the British economy?

John Dickie: I guess at its heart it's because there's the lack of an objective resource along the lines of something the Congressional Budget Office that deals with these aspects of the interrelationship between general public policy and competitiveness in the economy. So it's do-able to provide better analysis and better estimates, and some of them will always be somewhat objective and, of course, you're in a moving field. Other countries change their rates and their policies too. But nonetheless, we could do better where I think we're have some kind of institutional traction that would help create it.

Q111 Mr Love: Let me come on to ask the rest of you, because I don't know whether you're partners in firms that will offer services to the people that we're talking about: non-domiciles or people who would be affected by 50% tax rates and so on. You're doing that on a daily basis, yet given the amount of evidence, is it not the reality that because this is such a politically charged area of activity, in a sense nobody really wants to know and we want to all feed our own prejudices?

John Preston: I think there may be element of that, but certainly I think there's a much broader issue here, which is not just in relation to this but in relation to tax in general, that we don't have in the UK a dynamic model of the tax system. So it's not possible to say, "If we do this, if we increase the income tax rate, if we reduce the corporation tax rate, it will have this effect". We know—because a number of us have done an awful lot of work on this, particularly the total tax contribution stuff we do—that for every pound of corporation tax you have, for example, you get something like five times as much in other taxes collected.

But all Government policy has to be restricted. If we reduce the corporation tax rate, we have to pay for that by an equivalent reduction in capital allowances or in some other way. There's no way of saying, "How do we model the dynamic impact of a tax change?" I don't think that's a particularly difficult thing to do. I don't pretend to be an expert myself, but the people who know this stuff tell me it's perfectly do-able. It wouldn't even be hugely expensive in a macroeconomic sense. That combined with the sort of

data from an Office for Budget Responsibility would give you the data that you need to make that decision.

Q112 Mr Love: Can I come on now to ask Ms Lagerberg about GAAR? Will that help in any way in this area of activity?

Francesca Lagerberg: I don't think it's going to help immediately. Even if one came in, it could help in the longer term potentially. I think the experience you've seen in other jurisdictions that have gone the route of the GAAR—and we've got some great other jurisdictions to look at, now we've followed this route—is it took a couple of goes to get there and the early versions of it didn't work quite the way that was intended.

I think the difficult with something like a GAAR is that it isn't like a silver bullet that will solve everything to do with tax avoidance planning. What it's more likely to do is run alongside some of the existing legislation. So there's no massive win in removing a whole raft of legislation and replacing it with a better system because you probably have to run them all in parallel until the GAAR, however it was constructed, was bedded in.

The wording of the GAAR obviously is crucial. If you put too broadly businesses will have huge uncertainty about the tax implications of what they're doing. Do it too narrowly and it might not hit the mark. It's certainly not an easy route to follow. I will be fascinated to see how the report on the GAAR this year, but experience suggests it's just part of an answer; it's not the silver bullet.

Q113 Mr Love: Mr Hubbard, what does the Chartered Institute say to the Treasury in relation to these matters, or is that confidential at the present time?

Andrew Hubbard: No, I'm very happy to answer. There are two matters that you've talked about, and I'd like to talk about the GAAR in a minute. The other one was about the data and the lack of data on 50%. The problem is not that it's just the lack of data on 50%; it's the lack of data on anything.

I'm working on the Small Business Review, and Fran and I have been looking at that for years. It is difficult to obtain the figures as to how many small businesses there are, how many husband and wife businesses there are and how many companies there are with just a proprietor, because all of that information is just not there. So frankly, with the best will in the world, you are just moving almost in the dark and intuitively as to what you might think, but there is no real solid information to go on. That makes life very difficult for everybody in terms of trying to predict and plan for the future.

On GAAR—

Q114 Mr Love: Can I just ask you in relation to that: are we going in the wrong direction? Because all the pressure in recent years has been to reduce the level of regulation, including financial and reporting regulation, on small businesses to ease up on the claims of bureaucracy. Are we going in the wrong direction to gain that information?

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Andrew Hubbard: My sense is that information is there but the Revenue's systems are not geared up to report it. So it wouldn't require people to report things that they don't currently do, but it would have revenue systems designed to produce the data. I sense that the systems have never been designed to do that.

On GAAR, I think there is a move. From conversations I have had, people feel that the time is right to talk about the GAAR, whereas 10 years ago it wasn't. Why is that? I think for two reasons: one of which is we that have what we like to call "mini GAARs" in parts of the legislation anyhow, so if you have anti-avoidance provisions locked into particular sections, why not have a consistent approach?

The second is a slightly constitutional point: the courts at the moment have their teeth into all of this, to where they want to draw the line between acceptable and unacceptable avoidance, and it is almost impossible to track from court decision to court decision where those boundaries lie. I think there is a case for saying it would be much better to have something that had gone through parliamentary approval and say, "These are the rules". You would still obviously have to interpret them, but at least the ground work would be laid down there rather than being left to the courts.

I'll wait to see what comes out of the GAAR, but I think there is likely to be a more positive reception to at least engage in it than there may have been about 10 years ago.

Q115 Mr Love: Let me ask finally, because I can't resist asking: I'm not sure if any of you are expert in the area of land value taxation. We've been here before certainly in terms of taxing the development part of land, which was not a success for all the reasons I think we know, and of course when it comes to council tax, revaluation is a huge political issue. This is suggested in the Mirrlees report and in fact it's very prominent as one of their strongest recommendations: is there any practical possibility that we could introduce land value taxation? Be optimistic for me. Does anyone have a view or any expertise?

John Preston: I certainly don't claim to be an expert, but I'm afraid I do see very real practical difficulties with it. I see the attractiveness of it. We could spend an hour talking about some of the issues, but the practical difficulties with it are very real.

Q116 Mr Love: Does anybody take the slightly more optimistic view that it could be achieved over a long term?

Andrew Hubbard: Anything could be achieved, how much time and effort do you want to put into it?

Mr Love: You should come into politics.

Andrew Hubbard: But the issue is compliance cost, isn't it? Over the years we've had different systems of land taxation. Some of them have worked, some of them haven't. What are you trying to achieve? Are you trying to raise money or are you trying to do something different? I think that's the starting point. I can't see any great welcome for it in the business community.

Q117 Chair: I want to ask all of you to end by saying what policies you think are the most distortive, since what has certainly come out is common ground about the need to try to reduce distortions in the tax system, even if there are differences about the agenda that comes out of the Mirrlees review, for example, between yourselves—we've heard a lot of the evidence—and the team that we had in from Mirrlees this morning.

If you feel like answering that question with your preferred Budget measure, about which we want to be not self-interested if possible, we would be very interested as well. Let's start on the left with Mr Hubbard and move towards my right.

Andrew Hubbard: I think there are two distortive things that I would look at, one of which is VAT thresholds. I think VAT thresholds can be very distortive. I can remember talking to another adviser who'd said to one of his clients that they had to close their business over a particular weekend because if they hadn't they would have gone over the threshold, and although they would have produced more income, they would have made less, post-tax. So thresholds are distortive.

Where would I put my priority for Budgets? I think it's got to be a serious look at what the implications are of amalgamating taxation and national insurance. It is very difficult stuff and we've looked at it for years, but it seems to me that you're not going to solve the structural problems for small business tax, which is the vast majority of tax, until you've finally addressed that issue. So that would be my priority.

Chair: So, you would grasp that nettle?

Andrew Hubbard: Yes.

Q118 Chair: Mr Preston?

John Preston: I think in terms of distortion, it would probably be the increasing difference between the tax treatment and accounting treatment of entries in company's accounts. That's becoming more and more of a concern as the system gets more complicated. I do find that distortive. If I was to pick, I would go for two. I would certainly agree with Andrew on the PAYE and national insurance, and I would just repeat what I said earlier. I think a Budget policy measure that makes clear what the direction of travel is, particularly for environmental taxes, would be a very welcome development.

Q119 Chair: Part of this inquiry is about trying to elicit and provide some guidance and some sense of direction along the lines you're describing. Mr Dickie.

John Dickie: I have two points for the Chancellor's Budget speech. The first is that the speech as a whole should not be constructed in such a way as to generate short-term exciting headlines that are at the expense of long-term good policy. I think the forbearance effects of that over time will be to the benefit, not the detriment of the Chancellor's—

Chair: Mr Dickie takes away the lollipops.

John Dickie: I take away the lollipops being produced out of a hat. Due process in lollipops is fine. As a particular measure, we would like to see a commitment to the restoration of the 40% top rate of income tax by the end of this Parliament on the

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grounds of its impact on competitiveness and on sustainability of tax revenues.

Q120 Chair: Very helpful. Francesca?

Francesca Lagerberg: Tax and NIC clearly has to be up near the top of the list there. We need the alignment of the two. And an understanding that NIC is but a tax and should be treated as such would be right up near the top of my list. The whole plethora of issues around employment status, around being self-employed and being an employee and the distorting elements—

Q121 Chair: Did you agree with the recommendation we had from the Mirrlees' team that the self-employed tax level should be raised in order to create neutrality?

Francesca Lagerberg: To have sensible rules that apply consistently, I think, is more where I'd go rather

than necessarily just a blanket revenue-raiser. There's a lot of distortive issues around the way people behave dealing with one regime or another, and I think there is a much better way that we could potentially enable people to know exactly where they fall on the tax line, but also so that you don't have people doing some quite unusual things to get themselves into a different camp because they perceive it as being better, even though it might not necessarily be better for them.

Chair: This may have been a relatively quiet session by the standards of the Treasury Select Committee, but we have in mind the fact that mistakes on tax have been behind the lion's share of the world's revolutions over the centuries and we'll therefore tread very carefully before recommending any of your suggestions this morning.

But in any case, thank you very much, all of you, for coming before us and giving us the benefit of your advice.

Written evidence

Written evidence submitted by London First

1. INTRODUCTION

1.1 London First welcomes the opportunity to submit written evidence to the Treasury Select Committee's inquiry into the fundamental principles of tax policy. London First is a business membership organisation with a mission to make London the best city in the world in which to do business. Our membership includes around 200 of the capital's leading employers across diverse business sectors.

2. BALANCING SHORT TERM AND LONGER TERM REVENUES

2.1 The UK tax regime needs to be:

- internationally competitive;
- consistent and predictable; and
- implemented in an efficient way with minimum compliance burdens on tax payers.

2.2 The current challenging economic climate puts intense and conflicting pressures on the tax system: on the one hand tax revenues are required to address the budget deficit and pay for the demands on public spending, demands which increase at times of economic downturn; while on the other hand, the tax system needs to support and encourage private sector growth. These challenges need to be addressed within the broader policy framework, including considerations such as the equity of the system.

2.3 The scale of the UK's deficit and the economic uncertainties facing not only the UK but many of its key trading partners mean it is now more important than ever to ensure that the tax system operates efficiently. It must strike the right balance between securing short term revenues and the longer term goal of maximising both the tax base and revenue raising potential. Getting the right balance should reassure the markets regarding the UK's ability to address its current issues while ensuring tax receipts are sustainable over the longer term.

2.4 In doing this, tax policy decisions should be assessed against:

- how they support private sector growth;
- whether they present an attractive investment environment to potential inward investors; and
- whether they encourage globally mobile individuals to work in the UK (or at worst do not deter such individuals).

2.5 Thus, the UK tax regime needs to be competitive internationally; consistent and predictable; and implemented in an efficient way with minimum compliance burdens on tax payers. Adhering to these fundamentals when developing tax policy should ensure that the UK, and particularly London, continues to be recognised as a leading location for international investment and provide a solid foundation for domestic growth.

3. COMPETITIVENESS

3.1 The UK, and particularly London, operates in a global market and hence UK tax policy should be developed in a global context. While the UK has its own set of criteria to meet both in terms of its economic requirements and its public spending commitments, if it is to secure the largest possible tax base and generate the maximum revenue from this base over time it is essential that the tax regime is internationally competitive. Government must not only ensure individual taxes, such as corporation tax and income tax, are set at competitive rates, but also that the total tax burden applied to businesses and individuals does not act as a disincentive for investment and growth.

3.2 In determining a competitive level of taxation which also supports the UK's public spending needs it would be unrealistic to expect the UK to match the low rates applied in jurisdictions such as Singapore and Hong Kong. However, the UK must be sensitive to comparisons with other key competitors such as Germany, France and the US. It is also important that the UK keeps a watching brief on who its competitor jurisdictions are; over coming years it is expected that China and India will, among others, become key competitors.

3.3 Failure to deliver an internationally competitive tax regime could result in both businesses and individuals choosing to invest or locate elsewhere. This is likely to be most apparent in London, where the deep talent pool (one of London's key competitive advantages) and positive agglomeration effects derived from London's business clusters could be diminished. If a negative cycle were to start with individuals and businesses no longer choosing London, it would not be long before more established businesses decide to leave the UK. Once such a trend has started, it is hard to reverse.

4. CONSISTENCY AND PREDICTABILITY

4.1 A competitive tax system is not solely achieved through competitive rates but is also reliant on the regime being consistent and predictable. Businesses and individuals value certainty when they are making

investment decisions, especially long-term commitments. Providing a clear process and framework for tax policy does not cost the Exchequer and provides an environment that is conducive to investment. In contrast, frequent and unexpected changes to the tax regime—in respect to both personal and corporate taxes—will deter long term investment.

4.2 London First welcomed and responded to the recent HM Treasury and HMRC consultation on tax-making policy and supported many of its themes. While changes need to be made to the tax system over time, these should be managed in a way that minimises uncertainty. This can be achieved through providing frameworks for tax policy which identify the anticipated direction of travel of key taxes over time (an approach that was taken to corporation tax cuts in the June 2010 budget) and setting a clear process by which changes will be consulted on and implemented.

5. EFFICIENT IMPLEMENTATION WITH MINIMUM COMPLIANCE BURDENS

5.1 Tax policy should target the maximum return to the Exchequer while imposing the minimum cost on the tax payer. The Government's commitment to simplifying the tax regime should result in reduced bureaucracy and hence reduced compliance costs and, while this is likely to be a long and complicated process, a clear commitment to simplicity is welcome.

5.2 To minimise the risk of unforeseen behavioural consequences and high implementation and compliance costs to tax payers, detailed impact assessments should be carried out prior to the introduction of new taxes or significant changes to current taxes. To ensure a clear understanding of the practical implication of tax policy, policy makers should conduct an open dialogue with business and be willing to develop measures in a cost minimising way. This approach would be beneficial not only in assessing the impact of changes to the corporate tax regime but also changes to personal taxes. Given the UK's dependence on the service sector, it is vital to business that the personal tax regime is sufficiently attractive, both in terms of rates and compliance, to ensure the UK is able to compete for the best talent.

6. CONCLUSION

6.1 Delivering an efficient and competitive tax regime will provide a strong foundation to underpin the UK's economic recovery. The principles set out above, if applied across the UK's tax regime (corporate and personal taxes), should provide a positive business environment in which the private sector can grow and deliver the increased tax revenues needed to restore fiscal balance.

January 2011

Written evidence submitted by PricewaterhouseCoopers

PwC welcomes the opportunity to submit written evidence to the Treasury Select Committee inquiry on the subject of the fundamental principles of tax policy.

1. Executive Summary

1.1 The UK tax system needs to be strategic, coherent and efficient, and fair and transparent. The system also needs to be as simple as possible.

Strategic, so that taxpayers in general, and business in particular, see consistent, long term policy which is clear, stable and predictable which can be used as a firm basis for making future planning and investment decisions. There needs to be a "clear direction of travel" for all major types of taxes ie business, personal, capital and environmental.

Coherent, to ensure the enactment of good legislation which achieves the desired objectives across the range of taxes, and efficient so that the cost of compliance and collection are minimised for both the taxpayer and the tax authority.

Fair and transparent in that the legislation, including anti avoidance provisions, are consistently and transparently applied to ensure trust in the tax system, and that they engender an environment of mutual respect between tax authority, taxpayer and tax agent.

1.2 Tax policy can support growth. The competitiveness of the tax system as a whole is an essential part of UK government policy to ensure that the UK remains an attractive place to do business with an ability to help attract foreign investment and to support job creation. The corporate tax system is a key part of this with a need here for certainty to help long term planning. However, so too is the impact of the tax system on individuals and entrepreneurs, encouraging amongst other things entrepreneurial risk-taking which can help create private sector economic growth.

1.3 Taxes should have a clear purpose, whether it is revenue raising, or an intention to encourage behavioural change for any particular activity. The tax system should be designed to raise the necessary amounts of revenue required to fund overall public expenditure with the aim of balancing tax revenues and current spending in the medium term in line, with the Government's fiscal mandate. However, there will also be areas where specific economic intervention is desired, and where tax policy is perceived to be a necessary tool to provide a suitable

carrot or stick to encourage behavioural change. However, in this respect it should be used sparingly for major policy goals rather than to satisfy short term objectives.

1.4 The ease and efficiency of paying taxes is important. It is clear that indirect taxes can be a very efficient way to collect large amounts of tax revenue, and governments around the world are increasingly using indirect taxes as a major part of how they collect their tax revenues. However, it is essential that the compliance burden is kept to a minimum.

The use of technology, avoidance of multiple taxes, and the use of self assessment are all key elements to consider when looking to improve the ease of paying taxes and helping to lower the compliance burden.

1.5 There are a number of provisions currently included within the tax system that give rise to distortions, and which we consider worthy of investigation.

2. What are the key principles which should underlie tax policy?

It should be strategic

2.1 A stable, consistent and predictable system is needed. This requires the Government to be clear on a direction of travel for all forms of taxation, ie business, personal, capital and environmental.

2.2 The tax system should aim to take a fair proportion of the value of the country's natural resources and production in tax revenues, whilst allowing individuals and business the opportunity to achieve a fair reward for their efforts.

2.3 Taxes should have a clear purpose, whether it is revenue raising or an intention to promote behavioural change for any particular activity. This is particularly true for environmental taxes.

2.4 It should avoid distortion that cause decisions to be based on tax without sufficient regard to the underlying economics.

2.5 It should encourage taxpayers to locate to or remain in the UK, and therefore the tax system must continually be reviewed to ensure it is competitive with regard to how systems in other economies operate.

2.6 Tax policy around personal income tax rates should strike a balance between the need to raise revenues, the need to be fair, the need to encourage entrepreneurship, and to help the UK to be an attractive location for wealth creators.

2.7 It must be flexible and responsive to economic and social change. This is not inconsistent with the need for stability provided the overall direction of travel is clear.

2.8 It should be based on a largely territorial approach, taxing in the UK only those activities with sufficient nexus to the UK rather than automatically looking at worldwide income, profits and assets.

2.9 It should provide for full relief from double taxation in cross-border situations, by credit or exemption, both on a unilateral basis, and bilaterally with other territories with whom the UK negotiates formal treaties based on the OECD model.

2.10 The tax system should be as simple as possible. The volume of tax legislation in the UK has grown immensely over the last 20 to 30 years. While this reflects the increasing complexity of transactions, the addition of new taxes, and a desire to deal with avoidance, Government should avoid introducing comparatively minor measures which while they may be politically attractive, have relatively little economic impact. The current focus on simplification, including the work of the Office of Tax Simplification, is welcomed, but it does not currently have sufficient resource to deal with these issues adequately.

2.11 There needs to be a clearly developed and coordinated policy around environmental taxation and related regulation.

It should be coherent and efficient

2.12 The tax authorities need to be sufficiently resourced.

2.13 There should be mechanisms in place to allow for proper prior consultation with relevant stakeholders, helping to assist and inform policy makers and those responsible for drafting legislation.

2.14 The overall tax system should be understandable and clear, with detailed guidance which is easily accessible. This is particularly important for those expected to act as collecting agents, like employers.

2.15 To preserve certainty and fairness, retrospective changes should not generally be made, whether by amendment to statute or "restatement" of the understanding of case law or interpretation of statute or changes in policy, except in extreme cases.

2.16 The interaction between taxes should be fully considered and operate sensibly. This consideration should extend to multinational interactions with, at least, the countries with which we have the greatest international links but preferably with as wide a range of countries as is feasible.

2.17 Bearing in mind other points made, it should be as cost effective as possible for the tax authorities to run the system.

Fair and transparent legislation consistently applied

2.18 Lack of clarity in legislation or over-reliance on HMRC practice or discretion can result in uncertainty and should be avoided.

2.19 The tax rules should be based on legislation that is accessible to users, rather than being dependent on the practice of HMRC. In its interpretation, HMRC should be open about advice it has received and especially so when there is a change of view, or recognition that a view is incorrect.

2.20 HMRC needs to support and help taxpayers as well as police the system. There is a need for mutual respect but also for greater realism in the relationship: the majority of taxpayers see it as a necessary part of civil society that they pay taxes but they expect fair and courteous treatment by the tax authority. HMRC officers should have a strong understanding of taxpayers and their businesses. Secondments to and from HMRC/ Treasury can help, but further cultural change is needed within these bodies.

2.21 There should be administrative rules that ensure the tax system is enforced in a consistent manner, and that enquiries of taxpayers are handled sensibly, distinguishing deliberate attempts to mislead on the one hand and where inadvertent errors are made on the other. There should be a clear and accessible route for taking and resolving a dispute, and one that operates to a sensible timescale with no inherent requirement that additional tax be secured. The system should encourage openness and disclosure.

2.22 A system of advance clearances/ rulings for areas of uncertainty should be widely available (whether private or published anonymously). A non-statutory clearance system was introduced from 2008 for applications from businesses and their advisers in limited circumstances in which there is demonstrable material uncertainty (with similar measures in relation to IHT and interests in businesses). However, the limitations of Code of Practice 10 (or VAT Notice 700–6) applications make it virtually impossible to get rulings in other situations.

2.23 Taxpayers should be entitled to rely on confidentiality, and to expect that every effort should be made to avoid data on their affairs becoming publically available.

2.24 There should be recognition of the role of tax advisers as an important part of the smooth running of the tax system.

Dealing with anti-avoidance

2.25 On detailed aspects of anti-avoidance, we would prefer to see very targeted measures wherever possible and for a principles-based approach to be used as a last resort, since this creates uncertainty.

2.26 We have concerns about the practicality of a general anti-avoidance rule (GAAR) and the level of uncertainty which may result. However, we recognise that a study is currently underway to see if it can be framed appropriately and we wait to see whether this will ease our concerns.

2.27 Wide ranging mini-GAARs, dealing with specific areas of the tax system, and consequent “legislation” by guidance are particularly unsatisfactory to apply, on the basis that legislation should be as clear as possible, with HMRC discretion kept to a minimum.

2.28 Rules for reporting various tax avoidance arrangements (like the current DOTAS regime) should operate to curtail or at least alert HMRC to planning which the Government may consider is contrary to the intended tax policy objectives, but it needs to do so in a practical way.

3. *How can tax policy best support growth?*

3.1 The relationship between tax decisions and both tax revenues (the Laffer curve effect) and wider economic effects, should be more dynamically modelled. Impact assessments of proposed tax changes have proved particularly inadequate, and tax policy decisions could be better informed if improved analysis tools were available.

3.2 The competitiveness of the tax system is vital for the UK to be a good place to do business. The Government’s consultation document of 29 November 2010 on a programme of corporate tax reforms acknowledged this and included reform of the UK’s controlled foreign company (CFC) rules as an important priority in that regard.

3.3 Taxpayers are keen to see long term policy that enables them to make decisions with a clear expectation as to the tax consequences, whether it is capital investment or human investment by employers. This applies not just to large multi-national enterprises but also to entrepreneurial businesses and individuals, all of whom can help to fuel growth.

3.4 We broadly agree with the recent OECD report on tax policy that “corporate taxes are the most harmful type of tax for economic growth, followed by personal income taxes and then consumption taxes, with recurrent

taxes on immovable property being the least harmful tax”, and accordingly suggest this forms the basis of tax policy while acknowledging that political factors may lead to different conclusions.

4. To what extent should the tax system be structured to support other specific policy goals?

4.1 There will be areas where specific economic intervention is required and where tax policy is a necessary tool to provide a suitable carrot or stick. However, it should be used sparingly for major policy goals rather than to satisfy short term objectives and care will be required to minimise unnecessary/ unwarranted distortions to economic decisions.

4.2 Care needs to be taken to recognise when the tax system is being used for political rather than purely fiscal objectives. Inheritance tax may be regarded as a good example of this.

4.3 The tax system has a significant impact on capital markets and tax incentives are a necessary tool which can encourage investment, for example to help with the so-called “equity gap” in which businesses find it difficult to raise funds.

4.4 In a PwC survey carried out last year (Appetite for Change) businesses indicated that they want more incentives to support investment in environmentally beneficial activities. In addition, they feel government should be taking action on climate change, that they want to be involved in policy development and implementation, and that they have a preference for monies raised from environmental taxes and regulation to be directed towards green/ environmental projects and initiatives. There is support therefore for using the tax system to pursue the “green” agenda.

5. How much account should be taken of the ease and efficiency with which a particular tax can be imposed and collected?

5.1 Our latest annual Paying Taxes study carried out with the World Bank indicates that while the UK does comparatively well on the ease of paying taxes (16th out of 183) for a small to medium sized case study company when compared with other economies around the world, the UK ranking has slipped as others have improved their systems, either with lower total tax rates or improved administrative procedures. Globally, on average over the last five years the overall total tax rate for the case study company has fallen by 5%, the time taken to comply with tax rules has fallen by almost a week, and the number of tax payments has fallen by almost four. The UK system has not kept pace to date with these changes. Our experience (including our Enterprising UK survey last year) suggests that the compliance burden for businesses is something on which they are increasingly focusing, whether as a payer of taxes or collector of tax at source.

5.2 Use of technology, including electronic filing and payment of taxes, eliminates excessive paperwork and interaction with tax officers, reducing time spent in complying, increasing compliance and reducing the cost of revenue administration.

5.3 As a general principle the ease of paying and collecting tax is relevant. In this regard, while indirect taxes (including VAT) tend to be less progressive, they tend to be one of the most efficient ways of collecting large amounts of revenue. However this efficiency is achieved by passing a significant compliance burden to business and it is essential therefore that this burden is kept to a minimum.

5.4 The extent to which taxpayers are subject to multiple taxes should be minimised, particularly avoiding the situation in which the same tax base is used for different taxes. National Insurance Contributions are a good example of this.

5.5 Self-assessment is an efficient way of determining taxes in most cases, when backed up by appropriate audit and enquiry procedures. Collection of tax at source is also an effective method provided excessive burdens are not imposed on employers and other intermediaries.

6. Are there aspects of the current tax system which are particularly distorting?

6.1 We consider the following to be areas where distortions are particularly worth investigating, but this list is not exhaustive.

6.1.1 Poorly targeted tax reliefs (the work of the Office of Tax Simplification should help to identify these reliefs and the ease of their repeal).

6.1.2 Differences between the taxation of entities set up as foreign branches and those set up as separate companies (being addressed in the corporate tax reform package).

6.1.3 The distinction for businesses between things considered to be on capital or revenue account.

6.1.4 The national insurance contribution (NIC) regime. It is now a de facto tax and could be combined with income tax. However, this would need to be considered in conjunction with the benefits system and issues concerning the self-employed.

6.1.5 The personal tax residence and domicile rules. Putting the rules on a statutory footing, would provide a less arbitrary and clearer regime, helping not only the individual taxpayers but also employers who act as collecting agents.

6.1.6 Differences between the tax and accounting treatment of transactions. The benefits of attempts to

harmonise these have, over the years, become much reduced by the growing numbers of carve-outs and add-ons (e.g. the loan relationship and derivatives rules). The freezing of current UK General Accepted Accounting Principles (GAAP) for tax purposes where the accounting treatment changes, as with the Finance Bill 2011 proposals for leases, is a concerning development.

- 6.1.7 The distinction between the tax treatment of trading and investment companies (including the proposal that the tax exemption in respect of foreign branches should not be available to investment companies).

January 2011

Supplementary written evidence submitted by the Institute for Fiscal Studies

While giving oral evidence on Tuesday 25 January, we offered to send the Committee figures on the extent to which corporation tax payments are skewed towards a small number of large companies.

The relevant figures are available from HMRC Statistics (http://www.hmrc.gov.uk/stats/corporate_tax/menu.htm).

Table 11.6 shows that in 2008–09 (the latest year of data):

- A quarter of all corporation tax revenue (strictly, liabilities arising) came from just 41 companies.
- Almost half of revenue came from the top 453 companies (0.05% of those with positive liabilities).
- 70% of revenue came from the top 1% of taxpaying companies.
- 80% of revenue came from the top 3% of taxpaying companies.

Table 11.3 shows that, in 2008–09, of 915,000 companies paying corporation tax, only 46,000 (5%) were subject to the main rate of corporation tax, yet they accounted for 75% of taxable profits (before accounting for double tax relief).

We hope you find this helpful.

Paul Johnson

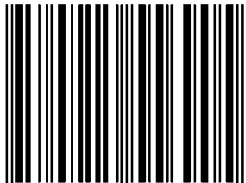
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February 2011

ISBN 978-0-215-55690-5



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