

## GEORGE OSBORNE: PRINCIPLES OF TAX REFORM

I want to thank Policy Exchange for providing me with this opportunity to speak to you today. I hope that in future you bring the kind of innovative thinking to tax and economic policy that you have already brought to discussions on public services and security policy.

For the tax systems of all developed economies face profound challenges over the next few decades, with serious consequences for what and how we tax.

We face mobile flows of capital and labour, when the building blocks of our tax systems were largely designed for a much more closed economy in which only tradeable goods crossed borders.

We face the challenge of preventing catastrophic climate change, when the vast majority of our taxes are levied on productive activities with no regard to how polluting they are.

And we face a crisis of public trust in taxation that is summed up by that new addition to the political lexicon: stealth taxes.

But there is no evidence that the present Government understands these long term challenges, let alone has any plan to address them.

Instead, Budgets and Pre-Budgets are driven by the shortest of short term political considerations with little apparent regard for the longer term economic consequences.

The results have been catastrophic for public trust in taxation and for Britain's reputation as a place to invest.

Last Spring's Budget, for example, attempted to present an increase in income tax on the lowest paid as a reduction in headline income tax rates. The con trick lasted all of three hours before it was exposed.

Last Autumn's Pre Budget is still unravelling. The ill-judged increase in capital gains taxation and the clumsy changes to the tax treatment of non-domiciles have resulted in a toxic mix of complexity, uncertainty and negative signals to the rest of the world.

They have been a perfect lesson in how not to make tax policy.

Badly thought through proposals; announced with no consultation; made with no reference to underlying principle and in ignorance of the economic

consequences; shaped entirely by a cack-handed attempt to out-fox the opposition; then changed and re-changed as a dithering government tries to minimise the political damage.

I suspect the Chancellor of the Exchequer will never recover a reputation for competence.

But what concerns me most is the damage done to Britain's long-held reputation as a stable and predictable place to do business.

If the damage to our reputation is not to be lasting, we urgently need a new approach.

We need a fundamental rethink to prepare our tax system for the twenty first century.

We need tax policy designed to address long-term challenges and based on solid underlying principles.

We need to restore public trust in taxation and end the stealth tax.

Britain has a proud history of tax reform based on clear principles.

The Meade Report, published in 1978 and named after James Meade its Nobel Prize winning chairman, is probably the most influential single publication on the economics of taxation for the last fifty years.

Not only did it establish the reputation of the Institute for Fiscal Studies, but it helped to launch the careers of some of our most distinguished economists, from Mervyn King to John Kay.

It sparked a huge international literature on the characteristics of an ideal tax system.

And over the following decade our tax system became much closer to the expenditure tax that it recommended.

For example, British tax policy led the world with Geoffrey Howe's shift from direct to indirect taxation.

Our tax policy led the world again in the second half of the 1980s, when Nigel Lawson demonstrated that reductions in income tax and corporation tax rates could over time boost both economic performance and increase revenue.

And Britain led the world in the 1990s with environmental tax reforms such as the landfill tax.

I hope that the next Conservative Government will continue this proud tradition of leading the world when it comes to tax reform.

It was my determination to plot a long term course towards a simpler, flatter tax system that led me more than two years ago to set up the independent Tax Reform Commission under Michael Forsyth's Chairmanship.

Its final report constituted one of the most thorough reviews of the tax system ever seen in Britain.

Indeed, it is striking how many of their proposals have shaped the tax debate since the publication of their Report.

Their work was built on by our Economic Competitiveness policy group last August.

Not all of this thinking on tax policy is coming exclusively from the Conservatives.

I am happy to acknowledge that both ourselves and the Liberal Democrats have looked at the future of aviation taxation and come to the similar conclusion that it makes environmental sense to move from a passenger-based tax to a plane-based tax.

This will incentivise fuller planes and cleaner engines and I am glad the government, having fiercely opposed our plans, now want to adopt them.

To mark the thirtieth anniversary of the Meade Report, the Institute for Fiscal Studies is now coordinating another report on tax reform, led by another great British economist James Mirlees, who was himself awarded the Nobel Prize for his work on the theory of optimal income taxation. It should be a very interesting piece of work.

I see no equivalent long term thinking coming from the Government.

No Tax Reform Commissions. No involvement of external expertise.

Not even a single speech by either this Chancellor or his predecessor on the principles underlying tax reform.

Perhaps they find it difficult to turn a set of short term political manoeuvres into set of lasting principles.

So if the Government is not capable of addressing the long term challenges facing our tax system, we will have to.

What should our tax system look like in the long term?

The four principles of good taxation that Adam Smith outlined over 200 years ago provide a good starting point.

His first principle was that taxes should be efficient, so as “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.”

His second principle was that taxes should be certain.

Indeed he argued that certainty was “a matter of so great importance that a very considerable degree of inequality... is not so great an evil as a very small degree of uncertainty.”

His third principle was that taxes should be transparent, so that people could understand easily what taxes they were expected to pay and when they were expected to pay them.

And finally he called for taxes that were fair.

People “ought to contribute towards the support of the government”, he wrote, “as nearly as possible in proportion to their respective abilities.”

I believe that Adam Smith’s four principles – efficiency, certainty, transparency and fairness – still provide an excellent guide for the design of tax policy today.

How should they be applied?

First, efficiency.

Adam Smith understood that high taxes “obstruct the industry of the people”.

That was in a Britain just beginning to go through the industrial revolution and when the concept of international tax competition was restricted to the levels of custom and excise duties.

These days the realities of the new global economy have significantly increased the dynamic impact of taxes on international investment, making it vital to maintain competitive tax rates on the most mobile parts of our economy.

Around the world the best solution to this challenge is to combine a broad tax base with low tax rates.

The evidence for the effects of tax rates on the location of investment is clearest in the case of corporation tax.

Ireland is the poster-child country that has reaped huge rewards from attracting foreign investment with a lower rate of corporation tax.

The Netherlands has led the way with reforms to corporate taxes that helped encourage Shell to tax headquarter there rather than in Britain.

And the new EU member states have also added to the competition on our continent, with countries like Slovakia and Estonia introducing flat taxes.

Meanwhile Britain, which was a pioneer for lower business taxes in the 1980s, has been left behind.

Ten years ago we had the 4th lowest corporation tax rate in the EU.

We now have the 19th lowest.

It is time for Britain to set the pace again.

The evidence on the positive economic impact of lower corporation tax rates is strong.

The work of leading academics such as Jim Hines from the University of Michigan has shown that capital and investment are extremely sensitive to tax rates.

The evidence is not conclusive on how large this dynamic effect is.

The consensus is that it is not large enough to make cuts in corporation tax self-financing in the short run, but over a longer period the returns are likely to be large.

There is also overwhelming evidence that multinational companies shift profits

around the world to take advantage of low headline tax rates, however hard tax authorities try to enforce transfer pricing and thin capitalisation rules.

So I believe there is now a compelling case for a reduction in Britain's headline corporation tax rate.

In the age of globalisation, 28 per cent is too high.

If British business is to compete effectively then the rate of corporation tax needs to come down.

Given the constraints of the current budget deficit, a significant reduction in overall business taxation is simply and sadly unaffordable in the short term.

So for the moment the focus has to be on reducing the rates of corporation tax by broadening the base – in other words, by removing the reliefs and allowances which in any case create complexity and can lead to unexpected distortions.

This was the view of the Tax Reform Commission, and we are continuing to work with PriceWaterhouseCoopers on the technical details around implementation.

So simpler business taxes and lower rates are the right responses to demands of the modern world for a more efficient tax system – and would satisfy Adam Smith's first principle.

His second principle was certainty.

Uncertainty has damaging effects throughout the tax system.

It undermines incentives for investment in a similar way to high tax rates.

And it raises costs for taxpayers who are not sure how they should arrange their affairs.

Rarely has this been truer than over the last few months.

Thousands of entrepreneurs have been unable to decide whether they should sell their businesses thank to Gordon Brown and Alistair Darling's dithering over capital gains tax.

Even the usually reserved Institute for Fiscal Studies called it a "shambles".

And now, thanks to yet another u-turn, thousands of non-doms are still in the dark about the Government's intentions to tax their offshore income. Many of

them are thinking of leaving as a result, taking with them their talent and investment.

But the capital gains tax and non-dom fiascos are just the most recent examples of a persistent pattern.

Remember the chaotic changes to the taxation of trusts two years ago?

Or the starting rate of corporation tax which was introduced by Gordon Brown and then changed almost every year before he was finally forced to abolish it?

These episodes are as damaging to the economy as increases in tax rates.

And they stem from a lack of understanding of the unintended consequences of tax policy.

A Conservative Government must not make the same mistakes – we need to fundamentally change the way we make tax law in this country.

I have sat on Finance Committees and watched in dismay as the Treasury produces hasty and ill-thought-out changes to our tax code that then pass into law with little consultation and no scrutiny. That has to change

That is why I have asked Geoffrey Howe to lead a group of senior tax specialists and experienced politicians and propose long term reforms to the way we make tax law in this country.

These reforms will include a requirement on the Treasury to publish technical changes to the tax system in the autumn before the Budget.

Those changes would then be scrutinised by a new Parliamentary committee, which would take evidence from external experts from the tax professions.

By the time the legislation reaches the statute book it will have been thoroughly examined and scrutinised by the people who will have to implement it.

That means no more stealth taxes.

I look forward to receiving the conclusion of Geoffrey's group so that we can embed Adam Smith's principle of certainty in a new way of making tax law.

That leads me on to Adam Smith's third principle - transparency.

Transparency is not just a good in itself, it is also vital to maintaining trust and public confidence in the tax system.

People do not trust the tax changes announced in Budget speeches because over the last decade they have got used to the fact that the tax rises are buried in the small print, often never mentioned by the Chancellor, and usually concealed in complex and stealthy ways.

The public is left with a strong and unsettling sense that taxes have risen, and their family budgets have been squeezed, without knowing exactly how.

This undermines trust in politics in general. It also undermines our ability to make good tax policy.

For example, there are very strong economic arguments for shifting the burden of taxation away from work and investment and towards pollution – just as they were thirty years ago for shifting from direct to indirect taxation.

The next Conservative Government will raise the proportion of total tax revenues that come from environmental taxes – under Labour it has fallen from 9.7% to 7.3%.

But Gordon Brown has given green taxes a bad name by using them as stealth taxes. The doubling in Air Passenger Duty was a classic example – not only was it a badly designed environmental tax, but the increase was not offset by reductions elsewhere.

That is why I have pledged that any new environmental taxes that we propose will be replacement taxes not additional stealth taxes. Any additional revenues will go into an independently audited Family Fund that can only be used to reduce other taxes on families.

That means no more stealth taxes dressed up as green taxes.

That is the way to build transparency into the tax system and restore public trust.

But the biggest enemy of transparency is complexity.

I think Adam Smith would have greeted the complexity of our tax system with a mixture of amazement and disapproval.

Our tax code is probably the most complex in the world.

It is certainly the longest – we overtook India for that dubious honour following last year's Finance Bill.

The size of Tolley's tax handbook has doubled over the last ten years.

Complexity is also incredibly costly – a survey by the Institute of Chartered Accountants found that the total cost to UK businesses of implementing new legislation is £10.2bn.

That is why we are working with the experts to do the long term thinking on simplification.

With PWC on simplifying corporation tax.

And with Grant Thornton on simplifying income tax and National Insurance, and the administration of VAT.

And it is why the final aspect of the proposals being examined by Geoffrey Howe's group will be so important – the establishment of a new Office of Tax Simplification with a remit to examine the existing tax system and make proposals for simplification.

With a permanent staff of tax specialists aided by secondees from the tax professions, this will create a powerful institutional momentum towards a simpler tax system.

That is how we can create a simple and transparent tax system that Adam Smith would have approved of.

Adam Smith's fourth and final principle is as relevant today as it ever was – fairness.

Nobody likes paying taxes, but if the system is not seen to be fair it will not continue to command the trust of taxpayers.

And without trust the costs of transactions, avoidance and enforcement will inevitably rise.

The proposals that I announced at the Conservative Party conference last October were designed to address the long term trends that have begun to undermine perceptions of fairness in the tax system.

One of these is rising asset prices.

As a result of the increase in house prices over the last fifteen years, Inheritance Tax is increasingly seen as an unfair tax on ordinary families, and not what it was originally designed to be – a tax on the very wealthy.

That is why I have pledged to raise the inheritance tax threshold to one million pounds, so that only millionaires pay tax on their death.

The same is true of stamp duty on property purchases.

Because the threshold has failed to keep pace with house price inflation, the average first time buyer now pays £1,675 in stamp duty, compared to nothing in 1997.

For many first time buyers that is a substantial proportion of the deposit they have worked hard to save for. It has become a barrier to home ownership.

That is why I have pledged to lift the threshold for stamp duty for first time buyers to £250,000, taking nine out of ten out of tax altogether.

Another long term trend is the increasing international mobility of our workforce.

This has brought huge benefits to the UK – the success of City of London in particular depends on it.

But nor is it sustainable to say that people living in this country, benefiting for example from our legal system and the protection it brings, should in some cases avoid paying anything.

In order to strike the right balance between a competitive tax system that attracts international talent and a fair tax system that commands public support, I proposed last year a flat rate charge on non-domiciles in return for a promise not to change other aspects of their tax status for at least five years.

The reason why we designed a flat rate charge was precisely to avoid the need to pry into people's bank accounts and try to assess their offshore income.

It was a good deal and it was broadly welcomed by the City as striking the right balance between fairness and competitiveness.

A panicked Alistair Darling and Gordon Brown failed to strike that balance in devising their own hastily cobbled together package.

As a result their non-dom tax plans have not only disintegrated – like their capital gains tax proposals. The very public dithering from the Prime Minister and the Chancellor has created damaging uncertainty in the minds of the most internationally mobile of people.

It could not have been handled worse and we wait to see what the long term negative impact will be.

## Conclusion

These four principles – efficiency, certainty, transparency and fairness – will underpin the tax reforms which Britain needs and which the next Conservative Government will deliver.

Of course, what the principles don't tell you is what the overall level of taxes should be.

I am clear that in a fiercely competitive global economy taxes should be lower.

I think the state consumes too much of the nation's income, and then spends too much of what it takes badly.

So as Chancellor I will approach each Budget looking to see if we can reduce taxes as well as reform them.

But nothing is more damaging to the reputation of politics than parties that promise to cut taxes and then end up increasing them. We remember Gordon Brown and Tony Blair promising 'no tax increases at all'.

So I will only reduce taxes if those reductions are lasting and sustainable.

That means taking no risks with economic stability or sound public finances.

We currently have the largest Budget deficit in Europe. It now costs the same to service the national debt every year as it does to pay for the defence budget.

A new report out today warns that borrowing could rise as high as £150 billion, in the words of the authors "blowing the fiscal framework to smithereens".

It is a truly incompetent and irresponsible position to be in after fifteen years of economic growth, but that is where we are today.

The way out of this fiscal mess is to share the proceeds of economic growth so

that, over an economic cycle, government grows more slowly than the economy does.

Sharing the proceeds of growth will reduce the share of national income taken by the state and provide a stable platform for a sustainable reduction in tax.

That is a binding long term commitment.

For as research by the OECD has shown, successful fiscal consolidations around the world have tended to be associated with explicit expenditure strategies such as our policy of sharing the proceeds of growth.

To help achieve it we need independently verified fiscal rules that really do constrain government spending – unlike the busted rules we have at present.

David Cameron and I have been arguing for this long term approach to sustainable public spending for years.

Now the Labour Government have been forced by their own profligacy to adopt plans for the coming three years that halve the growth rate of government spending from 4% to 2.1%.

They too will be sharing the proceeds of growth. Not through choice but by necessity.

We do have a choice.

We can either: stick with our long term course; stick with the commitment I made to spending growth of 2.1% for the coming three years; review the final year when we know the state of the public finances; and understand that in an economic slowdown this will mean tight spending plans and difficult decisions about government priorities.

Or we can head off onto the margins of the political debate and reduce spending growth even further for the sake of a short term argument.

Never mind that it would probably be unachievable in a slowdown, when tax revenues fall and welfare spending rises. Never mind that it would be lower than anything Margaret Thatcher achieved during the economic turbulence she faced in her first parliament. At least, we are told, it will give us 'a dividing line'.

Gordon Brown believes in the politics of 'dividing lines'. I've seen where it has got him: the most unsuccessful start of a premiership in modern British history.

We are not going to follow him down that dead end. We are a serious and credible alternative government. We will do what is right for the country.

I don't dismiss the frustration of Conservatives that borrowing is so high, that taxes are at record levels and that government has grown so large.

I share that frustration.

But there is no credible quick fix solution. Many Conservatives understand that the pressures on public spending from defence, law and order, education and health care are only likely to increase.

So the right solution is to reform public services, improve their productivity and stick to sustainable spending plans over an economic cycle.

We will stick with this long term approach.

We will stick with the spending plans we have committed to, which are consistent with that long term approach.

We will create a real and sustainable path to lower taxes and sound public finances.

And we will combine it with a programme of lasting tax reform that gives Britain the tax system it needs to meet the long term challenges of our age.