XST speech

Challenges faced by the Government on coming into power

1. Good afternoon, and thank you for inviting me to speak here this afternoon.

The UK's Challenge

2. On election in 2010, the UK Government faced some significant challenges to say the least.

3. Of course, we were not alone. Many of those issues were faced worldwide, and many of our problems were shared by the US –

4. High levels of private debt, which had fuelled a housing boom similar to that over here.

5. High levels of public debt, which had grown rapidly and significantly as a result of the downturn in 2008.

6. And a rapid decline in financial services, which had formed such a significant part of our economy – leaving a major gap.

7. But in some respects, our differences with the US made that situation even worse. Our economy is smaller – and less diverse. Financial services constituted ten per cent of our economy and, based on industry figures, over 12 per cent of tax revenues. The balance sheets of UK banks were worth more than five times our GDP.

8. Our economy was more concentrated geographically – London was responsible for a fifth of UK economic output, and several parts of the country had become increasingly reliant on public spending from the tax revenues it generated.

9. And of course there is our location – geographically, politically, and economically – in Europe, which continues to suffer from possibly the largest scale currency and sovereign debt crisis in history. Almost half of UK exports go to the rest of Europe, and so the uncertainty and decline in Europe's fortunes created a further drag on the demand side of our economy. And the panic that had been created as a result of a sovereign debt crisis that started in Greece, and threatened to creep across Europe – as it still does – created a new imperative to reduce the deficit, as well as sustaining growth.

10. The property boom and unsustainable profits and remuneration in the financial sector in the pre-crisis years had driven rapid growth in tax receipts. As tax receipts fell away during the crisis, the public sector was revealed to be living beyond its means

11. When we came to office, the UK was forecast to have the highest deficit in the G20, and the economy was expected to be more than 10 per cent smaller by 2016 than expected before the crisis.

Government Approach

12. In that context, it was clear that strong and decisive action was necessary. Two parties in the UK – the Conservatives and the Liberal Democrats – came together to form the first British coalition government since the Second World War to address these historic challenges.

13. The scale of the problem demanded large scale reform of the UK's economy and finances:

14. Fiscal consolidation, to restore the public finances to a sustainable path;

15. Monetary activism, to support the recovery and increase the availability of credit

16. Financial sector reform to increase resilience and reduce risks

17. Structural supply-side reforms, to promote sustainable growth across a wider range of sectors and regions

18. And tax reform to improve our competitiveness, reduce distortions, and promote private sector enterprise and growth.

19. Today I would like to talk particularly about the last of those – what we chose to do and why, the effects that our actions are having, and the actions I believe we should take in the future.

20. The ambitious programme we embarked upon needed to tackle both the major problems we faced – large and unsustainable public debt, and a troubled economy built on shaky foundations.

21. Despite the size of the shock in the UK – which experienced a bigger shock and has a lower capacity to sustain debt than the US – there were many who argued – and still do – that our two goals were incompatible – that it would be impossible to make the reductions to public spending that we thought necessary to return sustainability to the UK finances, while at the same time promoting growth.

22. Often there is indeed a tension – not least in the area of tax. At a time when we needed to plug big gaps in the nation's finances it might have seemed like an easy path to take to ramp up taxes on popular targets.

23. But that was a temptation that in our case needed to be resisted. The picture was much more sophisticated than a simple 'growth or cuts' narrative that some wished to paint.

Tax Reform

24. That's particularly true when it comes to tax policy. The success and efficiency of an economy is not only dependent on the overall level of the tax burden.

25. Looking at how a tax is raised is often much more important than considering just the absolute amount levied – we must consider: the base on which the tax is charged, the structure of that tax, the design of it, the certainty around it, and the way it interacts with other taxes, wider government policy, and the wider economy.

26. The art of tax policy is a fine and subtle one. It needs to be treated carefully, and the right thing to do is not always the most popular.

Corporation Tax

27. This takes me to one of the great challengers of tax policy making. By and large, the most economically damaging taxes are very often the most popular taxes. Or perhaps I should say, least unpopular taxes. This is because the public tend to be less concerned about those taxes that they perceive as being paid by someone else.

28. This includes Corporation Tax. There are those who advocate taxing 'big business' more, as if the burden will fall on some remote and impersonal organisation. Of course, all taxes are paid by individuals in the end and the burden of corporation tax will fall on a combination of shareholders, employees and consumers.

29. For a relatively small, open economy like the UK, the academic research points to employees bearing much of the incidence. The reason for this is that Corporation Tax reduces the return on capital which in turn reduces investment that can flow 'elsewhere. The reduction in investment reduces productivity gains and that will feed through to salaries.

30. Our view is that uncompetitive levels of Corporation Tax result in economic distortions, inefficiency and a barrier to growth.

31. And from our first Budget, we made a significant, conscious policy choice to address this by rebalancing the tax system away from taxes on capital and towards taxes on consumption. Reducing corporation tax – even in a context when taxes have increased.

32. Altering the tax "mix" in this way will mean an overall gain for the economy as we remove disincentives to invest.

33. That view is shared by a wide economic consensus, including the Office of Budget Responsibility. This is an independent body we set up as soon as we came into Government in 2010 to produce

credible and independent fiscal and economic forecasts, fulfilling many of the same functions as the Congressional Budget Office and Joint Committee on Taxation here in the US.

34. The OBR forecast indicates that investment is likely to increase as a result of this Government's policy to reduce Corporation Tax, which will help our economy to grow.

VAT

35. To say that cutting taxes can help the economy is uncontroversial, but it does not come for free – other taxes need to rise or spending cuts need to be made - or borrowing must go up.

36. So as well as working towards nearly 80 per cent of our planned consolidation through spending reductions as opposed to tax rises – around a three per cent real terms cut across the board – we have looked to raise more efficient taxes on wider bases that are less easily distorted – particularly on consumption.

37. In 2010, we increased Value Added Tax from 17.5 per cent to 20 per cent – more in line with prevailing European averages.

38. VAT is a more efficient tax – taxes on consumption are less damaging than taxes on profit or employment. And the structure of

the UK VAT system, which excludes most food items means that the tax does not have the regressive impact that some have suggested.

39. But it is a very visible tax and, of course, lots of people pay it. The decision to raise VAT was not an easy choice but was necessary in light of the fiscal challenges we faced. Sometimes we need to take something of a political hit in order for the economy to gain in the long run.

Competitiveness

40. Efficiency is a big part of the story, and perhaps the main reason we chose to pursue the path we did. But there is a wider context that makes Corporation Tax reform, and wider reforms to our tax system all the more imperative.

41. In an increasingly globalised world, with freely moving labour and capital – it is vital for the UK's interests that an open economy like the UK can attract the investment it needs from abroad.

42. We had to reverse the steady decline in UK competitiveness that had scarred the last decade. In 1997, the UK had the tenth lowest main rate of corporation tax in the EU. But by the time we came to office, it was 20th.

43. The UK's tax regime had lost its competitiveness and this was causing some businesses to leave the UK.

44. The main focus of my remarks today is with regard to Corporation Tax. But the point can equally be made with regard to Income Tax. In 1988, our top rate was reduced to 40 per cent one of the most competitive rates in the world – below the OECD average. That rate remained in place under the last Labour government, at least for 4722 days of their 4758 days in power; but by the time we came in, we inherited a rate of 50 per cent, one of the highest rates in the developed world. It discouraged talented individuals working in the UK, raised little if anything in revenue and sent a signal that Britain was not open to business.

45. As of next April, that rate will be reduced to 45 per cent. That will put the UK's top statutory rate below that of Australia, Canada, Germany, or Japan.

46. But taken as a whole, our objective for the UK tax system is both clear and ambitious. We want to establish the most competitive tax system in the G20 – to support enterprise and attract new business.

47. Our tax system was once viewed as an asset, and that's a perception I want to restore.

48. I hope that the action we have taken with respect to Corporation Tax will help to achieve that. We have already cut tax from 28 per cent to 24 per cent. In two years' time it will be 22 per cent, within sight of 20 per cent.

49. By 2014, the UK will have the lowest corporation tax rate in the G7 and the fourth lowest in the G20.

Patents, R&D, and CFCs

50. But as I said – a strong and competitive tax system is not just about cutting rates – it is about making sure that the whole tax system is structured, and tax policy made, administered, and enforced in a way that is friendly to business and friendly to growth.

51. It means offering businesses the stability and certainty they need to make long term investment decisions and to feel safe and certain doing business in our country. So we have both committed to tax changes, and are making sure that businesses are informed of those changes well in advance. We took the unprecedented step of setting out our plans for corporate tax policy over the next five years, and have brought forward the publication of tax legislation so that the public, business and advisors have months, rather than weeks, to scrutinise it before it is taken through Parliament.

52. It means ensuring the tax system is as simple, straightforward, and easy to understand as possible. So we have established an Office of Tax Simplification to provide independent advice on simplifying the tax system, which has already published recommendations to improve small business tax, share schemes and tax reliefs – most of which we are now adopting.

53. It means close and extensive consultation with business and other stakeholders, while genuinely paying attention, taking note, and adapting policy accordingly.

54. And it means looking at how we can tailor specific, innovative tax proposals to offer the incentives and rewards needed to make the UK competitive in the modern global world

55. Let me talk about a couple of examples – introducing a new patent box, and our reform of the Controlled Foreign Companies Regime.

56. In recent years, businesses have become increasingly focused on creating and exploiting intangible assets. Multinational groups have a choice over where they locate work generating scientific and high-tech IP, and where their patents are held.

57. So it has been crucial to ensure that our tax system remains competitive for innovative businesses – particularly as many of our

European neighbours – France, Belgium and the Netherlands to name a few – already have Patent boxes or similar schemes in place.

58. So we introduced a scheme to apply a reduced rate of 10% corporation tax on profits from patents - encouraging innovative businesses to invest in the UK and locate high-value jobs and activity there.

59. And in addition, we are increasing the support to business through R&D credits that encourage expenditure in research and development.

60. New innovations and research and development generate enormous benefits that spill over well beyond the companies that develop them – just taking a look at some of the major innovations over the last decade confirms this – advanced touch screen technology, hybrid cars, the ability to grow human organs for implant from scratch. Firms reinvesting in R&D cannot capture all the benefits that accrue from their investment, and so it falls to Government to promote the right level of investment, as well as to ensure that we continue to be world leaders in patented technologies.

61. The UK has also needed to ensure that its tax base rests on profits from domestic activities rather than income that is earned overseas, and that profits are not artificially diverted from the UK.

62. That means that an open economy like the UK has needed to move towards a more territorial system of taxation – taxing the income earned in the UK but not elsewhere.

63. Reforming the taxation of foreign branches of UK companies, by introducing an opt-in exemption from corporate tax, levels the playing field with the taxation of overseas subsidiaries.

64. And we have modernised the UK's Controlled Foreign Company rules that protect against the artificial diversion of profits to low tax jurisdictions to reflect better the way businesses operate in a globalised economy.

65. The CFC reforms have been described as a 'watershed' moment. The UK is changing the basis on which it taxes overseas profits with a focus on taxing profits from UK activities – striking the right balance between making the corporate tax system more competitive and providing adequate protection of the UK tax base.

66. CFC reform has stemmed the flow of businesses leaving the UK and has encouraged businesses to return to the UK, such as WPP, which left only a few years ago because of the adverse Corporate Tax environment. While others have recently announced that they are considering moving to the UK.

Tax administration

67. And finally, the UK has played a leading role in improving tax administration – easing burdens on business while maintain a strong response to tax avoidance and other risks.

68. Her Majesty's Revenue and Customs take a direct approach to engaging with large businesses – pursuing open and transparent working relationships. The complexity of these cases and the amounts involved often make this the most cost-effective way to improve tax compliance while at the same time supporting business. For the largest 2000 corporations in the UK, we have dedicated relationship managers to ensure both support for the businesses they handle and ensure rigorous compliance.

69. This strategy has be very successful – producing positive business feedback from business, while also helping HMRC to maximise revenues by recovering the right amount of tax.

70. For example, HMRC has tackled the most serious avoidance cases amongst large businesses through dedicated task forces – enabling them to resolve over 1800 outstanding tax issues, and bringing in additional revenue of nearly £16 billion since this approach was established.

71. This use of intensive relationship management, tailored to risks, has been endorsed by the OECD in its recommended approach

to aggressive tax planning, and is increasingly being followed by tax administrations around the world.

Results

72. These are the steps that the UK has taken, and the results have been welcome.

73. Ernst and Young described our tax regime as ‘close to best in class’, while Deloitte suggests that our tax regime is ‘the most competitive in Europe’ among ‘normal countries’ (their words, not mine).

74. More than a million private sector jobs have been created since we came to power in 2010; and the World Economic Forum this year placed the UK 8th for overall competitiveness – up from 10th last year.

75. For the first time in over a decade, we have been exporting more to the rest of the world than to the European Union.

Conclusion

76. These are not sermons or prescriptions. Our economies – while closely intertwined, and with much in common, have fundamental differences.

77. There is much we can learn from each other; but each country has its own position and challenges – and the US in particular, with its global dominance, and a reserve currency – is in a unique position.

78. But I do hope that I have been able to show you the commitment we have to addressing the challenges we face, and to making the UK an excellent place to do business for countries across the world.

79. The UK has a lot going for it – a central position between time zones, a liberal, open economy, a sensible, welcoming approach to foreign business and investment, and a position as a gateway to Europe.

80. The approach we are taking is strengthening that position still further, and making the most of the considerable assets we have.

81. The last few years have been challenging for most western economies. And over the decades ahead, the long term challenges are considerable in terms of responding to the emerging economies and maintaining competitiveness. Some countries will succeed in

meeting those challenges. But others will fail. The UK Government, however, is determined that in our tax system, as elsewhere, we are ready to meet those challenges.

82. Thank you.