Tax Representation

TAX FACULTY

TAXREP 18/07

2007 HM Treasury Budget Submission

Comments submitted in March 2007 by ICAEW Tax Faculty to HM Treasury in advance of the Budget on 21 March 2007.

Contents **Page 2 *et seq***

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

Contents

Introduction: Measures to improve UK productivity growth

The Government has consistently highlighted the need to increase the levels of UK productivity growth. Increased productivity is key to sustainable growth in economic prosperity and improving productivity growth has been a key plank of this government's economic policy. Significant progress has been made over this economic cycle in closing the gap between the UK and Germany and France on a per worker measure whilst the US still stands as an example of what is possible. On a per hour basis, very significant gaps remain with all three countries[1]. Major regional variations in productivity growth across the UK are also of concern. Achieving greater longer term productivity growth is essential if the UK is to be assured of maintaining its position in the global economy. It is a key indicator of whether our economy is reaching its full potential.

In the 2006 Pre-Budget Report, the Chancellor addressed the long term productivity agenda. With the Eddington report on transport, the Barker Review on planning and the Leitch review of skills, he has focussed on three core areas where Government policy and investment can be improved for the long term benefit of UK business and the economy as a whole. The ICAEW strongly supports these initiatives and hopes that in general the recommendations will be implemented as fully and quickly as possible. However, the ICAEW believes that as well as long term measures to increase productivity, Government should look to take policy decisions year-on-year which will have a more immediate and beneficial impact. This combination of long term essentials and incremental improvements, adding-up to long term change, will have the greatest impact.

In this year's Budget Submission the ICAEW highlights areas where the Government can move now, in 2007, to enable business growth, enhance the standing of the UK economy and make a marked impact on UK productivity growth. Recommendations are made on a range of critical areas, including:

- tackling an immediate and worrying shortage of high level skills for business
- proposing to change the way in which the UK taxes foreign profits
- gaining maximum benefit from changes to the DTI and Small Business Service
- improving the R&D tax credit system for SMEs

Other immediate issues where our members have concerns are HMRC service levels and the tackling of MTIC fraud, which are also addressed.

Chartered accountants have a key role working in businesses or as advisers to business, in evaluating and deciding upon where to invest to grow. They play a key role in decisions around research and development, capital and budgets for training of staff. Chartered accountants understand the link between investment and business growth. They are also in a unique position to appreciate what factors are blocking business growth right now and what is needed for development for the long term. Our members often specialise which allows them to play key roles in the City, in companies in the high tech science and innovation industries, in small business start-ups and many other types of business. In their roles as advisers, on issues such as tax and finance, they are also key witnesses to the UK's standing in an increasingly competitive global economy.

Finally, the ICAEW is acutely aware of the implications of the Stern Review for the long term economic, social and environmental welfare of the UK, including UK business. Ensuring the right response to the review and to the Government's stated desire to price carbon is essential. Though early action is needed, ensuring that policies are cost effective and fair is also essential in order to ensure business, individuals and Government can work together effectively. We also examine those issues to help ensure we can go as far as possible, as early as possible, in tackling climate change.

[1] DTI - Economics Paper No. 17, UK Productivity and Competitiveness Indicators 2006, Published March 2006

1. Tackling the Skills Gap

The ICAEW warmly welcomed the publication of the Leitch Report with the 2006 Pre-Budget Report. As Government has identified, tackling the lack of basic skills in the UK workforce is vital to increasing productivity growth. As our own *Enterprise Survey Report 2006* demonstrated, UK business is experiencing a unique challenge from increasingly global competition as well as unique opportunities. Tackling core barriers to UK productivity growth, particularly skills, is essential to equipping business to compete on a global scale.

Immediate needs

Although Government has set goals for improving basic skills, of urgent concern to businesses of all sizes is the lack of leadership and management skills in the workforce, with the shortage of specialist and technical skills as a real problem. Over 50% of our members working in business cited this issue as a major barrier to business growth in our Enterprise Survey Report, with over 40% stating that a shortage of general management skills was also a problem.

Government should recognise this urgent problem and work with business to set targets to address it. Government, through working with business on this pressing issue can develop the relationships needed to tackle the longer term problems. Our enterprise survey demonstrates that ensuring we have world class UK managers and leaders will boost our productivity growth. Training high quality business leaders, who then take positions overseas, particularly in business-related professions, will also help to maintain the UK's international networks and the primacy of our business procedures and systems.

Recommendations:

- Government should address how its skills policy is working with business to tackle the shortage of high level specialist and management skills, both in the short and long term

- Government should work with the professional bodies to ensure that UK professional qualifications are exported. This is to ensure that UK professional standards and procedures will continue their global reach, helping to maintain the UK's international business influence

Longer term skills gap

The UK has lower levels of literacy and numeracy in the adult population of working age compared to many of our international competitors. Twenty six million people of working age have levels of literacy or numeracy below those expected of school leavers[2]. UK employers report significant skills shortages within their own workforce and in the pool of labour from which they recruit.

The DfES has made significant progress in addressing the quality of literacy, numeracy and language learning, and it has introduced standards, curricula, and new teaching materials to raise the quality of learning. The DfES has also raised awareness by advertising and working with other departments to reach their clients, with successful link ups with such agencies as Jobcentre Plus via the DWP. Progress however has not been completely satisfactory. It is clear that more people with the lowest skill levels and those who are least likely to perceive they have poor skills need to be persuaded that improving their skills is worthwhile.

Low skilled employees are one of the hardest groups to reach and their needs are still not being met. Many employers do not place a high priority on staff training and are only likely to become involved if the training offered is very flexible and does not interfere with their business. There also continues to be high barriers to some people taking up opportunities to learn, or to them

[2] *Skills for Life: Improving Adult Literacy and Numeracy* National Audit Office. 15 December 2004.

continuing to learn once started. For all potential learners these barriers can include: recognising that they can improve their skills; being able to find out what learning opportunities exist; having courses in places they can get to; or simply being unable to organise their lives to include regular time in which to learn new skills.

Recommendations:

- To reduce confusion for employers as to what courses are available and to improve the take-up of courses there is a need for better joined-up working between government agencies. Business Link should be the 'gateway to advice' for publicly funded support

- There is a need for more teachers with up-to-date training in teaching literacy and numeracy and the quality of learning needs to be raised to a consistently high level in all areas of the country

- Local Learning and Skills Councils (LSCs) should continue to work with employers to overcome the barriers that employers perceive to providing their employees with improved skills. LSCs should work with providers to help develop choice in flexible learning to meet the needs of employers and employees. Employers will have a greater role to play in delivering a higher skilled workforce in the UK by 2020, and employers will need to build on the £23.5 billion they currently invest annually in training to achieve this[3]

At the ICAEW we are able to comment on this issue as over 50% of our members work in business and report back to us through member surveys. However we recognise that our membership represents some of the most financially capable members of the community. In order to be able to act constructively in this debate we have joined with the Personal Finance Education Group (Pfeg) in a new partnership to help deliver a programme of financial literacy in schools. The programme involves chartered accountants across the UK undertaking a programme of training devised by Pfeg which will then enable them to work with the individuals within their local schools responsible for driving forward financial literacy.

Recommendation:

- Government should encourage business and the professions to develop initiatives or to support existing schemes that are tackling the lack of basic skills in both school children, school leavers and the adult workforce

2. Improving the UK tax system

At the time of the 2006 Pre Budget Report we welcomed the Government's desire to maintain the overall competitiveness of the UK tax system[4]. We have also welcomed the Varney review *Links with large business*, which should make a major contribution to reducing business uncertainty.

We remain concerned, however, that further action needs to be taken now in order to bring about long-term improvements to the UK tax system, both in relation to competitiveness and complexity.

The global competitiveness of the UK corporate tax system

In order to increase the UK's competitive position, we believe that the forthcoming Budget should take action in two areas.

[3]. *Skills in the UK: The Long-term Challenge.* Leitch Review of Skills. Interim Report, December 2005.
[4] see our submission, TAXREP 37/06, to Treasury Committee on the 2006 PBR report which is available on our website at http://www.icaew.com/index.cfm?route=144211

Recommendations:

- The UK should adopt an **exemption system for relieving taxes on foreign profits.** The UK maintains a credit system whilst most other EU countries use an exemption system. Whilst it appears that the adoption of the credit system does not in practice lead to a significant increase in the profits charged to UK corporation tax, the credit method system results in a far higher ratio of business compliance costs to the revenue raised as compared to an exemption system

- **The headline rate of corporation tax should be reduced.** The UK corporation tax rate, at 30%, now looks expensive relative to many of our European Union neighbours, in particular given the 12.5% rate of corporation tax in Ireland and the move to set lower rates in many of the new members of the EU. We appreciate that many UK companies pay corporation tax at the lower rate of 19% and that the actual tax rates are influenced by other factors such as the availability of investment allowances, but the perception created by the headline rates is still a critical factor in deciding the overall level of competitiveness

Keeping multinational headquarters in the UK

There is evidence that the UK tax system is beginning to become less competitive. Our members continue to inform us that an increasing number of multi-national companies are carrying out exercises to assess whether they should retain their headquarters in the UK. This is a very serious issue as once a company makes a decision to move they are likely to remain in their chosen new location for a number of years. FTSE 100 companies have seen their tax bills rise 16% on average over the past year, heightening fears that an increasing number of British businesses will move their headquarters abroad during 2007[5].

At a conference organised last September in London by the Institute's Tax Faculty on behalf of Confédération Fiscale Européenne, the Head of Group Financial Planning and Tax at HSBC, Chris Spooner, shared the platform with Dave Hartnett, Director General HMRC, during the conference session on *Tax as a strategic business objective*. As reported in the media, Chris Spooner noted that he prepares a paper for his main Board every two years (common practice) explaining whether the UK is the best place for HSBC to be based. While the answer was a categorical 'yes' when HSBC first moved its headquarters to the UK in 1993 the issue is now much less clear cut, not least because of the relatively high headline rate of corporation tax in the UK.

Measures to address the complexity of the UK tax system

Reducing the complexity of the tax system is a way to increase competitiveness without impacting on the soundness of public finances. The current complexity of the tax system is a problem for businesses of all sizes. It is a significant factor in the investment decisions of multinational businesses and for smaller businesses it impacts upon such decisions as taking on their first employees and expanding the business.

We welcome Government's desire to reduce the burdens on business and the project undertaken last year to examine the burdens faced by business in complying with the tax system, but we are unclear as to whether the worthy aspirations of that project will be realised. Meanwhile, initiatives to reduce the burdens on smaller businesses appear to have stalled, and the work of the Small Business Review, launched in 2001, has yet to be taken forward. We are also concerned that the volume of UK tax legislation has doubled in the last 10 years and that this has added considerable complexity to the UK tax system.

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[5] PwC Research for the Hundred Group of Finance Directors, quoted in the FT, 17th January 2007

Recommendations:

- **HM Treasury needs to make a formal commitment to tax simplification and set a timescale for implementation.** We appreciate that the Tax Law Rewrite Project has produced benefits and made the UK's tax rules clearer, but it does not address tax simplification, which was the original intention of the legislation which gave rise to this project. HM Treasury should establish an independent committee, including representatives from business and the tax profession, to help achieve consensus on this programme

- HMRC needs to focus on areas for tax reform where there is the greatest potential gain for productivity and business growth. HMRC should bring forward proposals from the Small Business Review to reduce some of the key burdens that small businesses face, for example taking on your first employee

3. Future of the DTI and Small Business Service

It appears increasingly likely that the DTI may have its functions moved to other Government departments or be radically reformed. It is the ICAEW's view that whatever the future of the current DTI, a Cabinet position with an advocacy role for business and industry should be maintained. Business needs a strong voice across Government and in the Cabinet to ensure that its viewpoint on economic and social policy issues is heard and considered. There must be clear strategic leadership and planning to create the best possible climate for businesses to innovate, grow and succeed.

Government needs to have teams responsible for liaising with different sections of industry to understand their interests, problems and points of view. The accountancy profession, for example, needs a section in Whitehall that understands how it plays a key role in business confidence, business ethics and facilitating enterprise. The close working between the ICAEW and the DTI on the Companies Bill and implementation of the subsequent Act is an example of how the Government has worked with business expertise to create better legislation.

The success of UK business itself is not just about the interest of the few, but about the quality of life and future of millions of employees, their families and consumers in general. The private sector is also vital to ensuring effective collective action on issues such as climate change and increasing standards of living.

Recommendations:

- The advocacy role provided by the DTI for business must be maintained at the highest level of Government and in the Cabinet

- Responsibility should be maintained for sections of Government to liaise with specific sections of the private sector, and represent their concerns across Government when necessary

Future of the Small Business Service

Across Government the requirements of small businesses need to be far better understood and represented for the good of the economy as a whole. Sir John Bourne, head of the NAO recently said, 'Government needs a better appreciation of its impact on small businesses and simpler performance management arrangements, if it is to achieve its aim- to make the UK the best place in the world to start a business.' The ICAEW finds that 74% of the costs of new regulation are felt by businesses with under 10 employees despite such businesses representing only 22% of the UK economy. Small businesses are at a strategic disadvantage in having their interests realised by Government- their needs are disparate and entrepreneurs do not have time to influence policy. But the SBS is clearly not fulfilling its role to ensure regulation does not impact unfairly.

Small business concerns need to be brought into the heart of Government decision making. The current proposed changes to the SBS have centred on providing a smaller higher expertise enterprise policy group. However, the ICAEW believes that the proposed changes do not deal with the real need to have the 99.3% of business which are small, at 'front of mind' for policymakers and policy implementers.

Recommendations:

- HM Treasury should take control of the Small Business Service as it has a clear economic role across Government

- HM Treasury should ensure that every Government department has **small business champions** with the capability and experience to help the department take full account of the impact of small business on the enterprise economy

- Regulatory Impact Assessments should test the proportional impact on smallest business as an effective internal control

- The Comprehensive Spending Review 2007 (CSR07) should underline the responsibility of each department to take account of its impact on the enterprise economy

- The SBS should play a key future advisory role to RDAs and local government on enterprise and small business policy. It should continue to share experience and best practice and ensure that the Business Support Simplification Programme objectives are met and maintained

- The NAO should be tasked with providing regular external evaluation of pan-Government performance in dealing with small business interests

4. Improving effectiveness of R&D tax credits for SMEs

R&D tax credits are given to UK companies which have invested in revenue expenditure of a qualifying nature and amount. R&D capital allowances are given to all businesses which have invested in qualifying capital expenditure.

The Institute's Centre for Business Performance has supported research into the effectiveness of R&D Tax Credits and R&D Capital Allowances for SMEs by Mohsen Derregia and Francis Chittenden, respectively of the University of Nottingham and the Manchester's Business School. The initial report questioned whether the system was encouraging new investment or simply rewarding that which was already planned. The final report, to be released in March/April 2007, demonstrates that major improvements are possible. Over 140 businesses, each investing above the £10,000 qualifying threshold for credits, were surveyed in detail.

The level of UK R&D tax credits compares favourably with those available in other countries. The principle of Government's assistance with R&D is sound because of its wider economic benefit whilst at the same time it leaves businesses are able to make their own decision on where to invest.

The question is whether the operation of the R&D tax credits system is optimising the incentive for SMEs to invest.

Interviews with SMEs reveal that **many businesses do not necessarily consider the tax credits before they choose to invest in R&D**. The survey has now confirmed that the majority do not consider the credit upfront. However, as shown in the table below, a significant minority did.

Extracted table from forthcoming R&D Tax Credit Report: *When you plan your R&D expenditure do you take into account the tax credit/or R&D-related capital allowance your firm is entitled to?*

Answer	R&D Tax Credits	R&D Capital Allowance
No	102 (72.34%)	119 (84.39%)
Yes	39 (27.66%)	22 (15.61%)

Respondents to the SME survey strongly agreed that a constant flow of finance is necessary for R&D programmes which cannot be adjusted in line with how much tax credit/capital allowance they get. Whether a firm has previously undertaken R&D also has a major influence on whether it may do so in the future. Tax credits may therefore play an important role in encouraging a minority, in any year, who then go on to continue to invest further for their own business purposes in future years.

There is significant evidence that the R&D **tax credit may not be as effective in encouraging smaller business to invest in R&D as larger business**. In estimating the cost of applying for the tax credit, 60% of respondents said about £1,000, 9% estimated £2,000, 7% estimated £3,000, and 2% suggested costs in excess of £10,000. The remainder received the service as part of a wider package. Noting that the lower limit of expenditure which qualifies for the R&D tax credit is £10,000, which would result in a theoretical 9.5% reduction in cost, the benefits of the credit to smaller claims may be marginal. Furthermore, as one interviewee pointed out, larger businesses, paying tax on a quarterly instalment basis, receive the cash flow benefit of the credits within the accounting year, whilst small businesses, although paying NIC and PAYE (to which the tax credit is linked) throughout the year, will submit their corporation tax returns well after the end of the period, and will not receive the tax benefit until nine months after the end of the period.

The uncertainty for SMEs of having their application for an R&D tax credit approved is also a considerable issue. As shown in the table below, for the R&D tax credit element most respondents said they were 'not at all' confident of success. The average level of confidence for both types of incentive was less than 50%. A business might not know if its claim will succeed until 21 months, or possibly longer, after taking the decision to invest. This uncertainty is particularly problematic for smaller businesses.

The variation in level of specialist knowledge and experience of personnel in those HMRC offices which process applications was also raised, but this has been superseded by the 2006 Government announcement that it would ensure relevant expertise across the country.

Extracted Table from Forthcoming R&D Tax Credit Report: *How confident are you about getting the tax credit/allowance you apply for accepted by HMRC:*

not at all confident =1, very confident =5	N	Mean	Mode	Median	Standard Deviation
R&D Tax Credits	124	2.85	1	3	1.447
R&D Capital Allowances	65	2.89	3	3	1.290

The Confederation of British Industry (CBI, 2006)[6] has also raised issues with the R&D tax credit system. It finds that the R&D tax credit system falls short of its potential and states that the tax policy provides a 5% reduction in R&D costs as opposed to the theoretical 9.5% reduction. It also highlights the additional costs of making the claim.

[6] Confederation of British Industry (2006). Improving access to finance: Enabling the enterprise revolution, Enterprise Brief.

Recommendations:

HM Treasury needs to examine whether the R&D tax system could be made more effective for SMEs and so stimulate more R&D. There are a number of potential improvements which could be made:

- The criteria for identifying expenditure that qualifies as R&D needs to be simplified, particularly for those seeking lower levels of tax credit. One approach might be to align the HMRC/DTI definition (12 pages) to the accounting definitions of R&D (less than 1 page), even if only for smaller claims. This could lower the costs of making an application and reduce the need for small businesses to develop or pay for specialist advice about what HMRC would accept as R&D

- An optional pre-approval process should be developed. HMRC would approve investment proposals from businesses and advisers. Then auditors and HMRC would only need to be satisfied that the pre-approved plans are carried out before releasing the incentive. Improving the certainty of receiving a tax incentive for R&D would help to encourage those who have not undertaken R&D or gone through the tax credit process before

- In addition to the improvements outlined above, the £10,000 lower limit which permits R&D expenditure to be eligible for the tax credit incentive should be removed. Encouraging start-ups to invest in R&D by allowing small R&D claims could make a major contribution towards developing a greater investment culture across the economy

- Stability and predictability of incentives is crucial to giving firms certainty for what are often long term planning decisions. Any review needs to be carried out in a comprehensive manner (e.g. that carried out for the Small Firms Loan Guarantee Scheme). Any changes should be made for the long term and long term commitment to maintaining levels of tax incentive should be given

5. Carbon pricing and what makes a good green tax

The Governments intention to introduce a price for emitting carbon dioxide was made clear in the 2006 PBR. Choosing the right policy tool that achieves the maximum reduction in CO2 emissions for the least cost will allow the UK to go further, faster in tackling climate change. Appreciating the impact on low income groups and small business is also essential.

The ICAEW has drawn on its experience of business information, effective tax systems and regulation to examine the issues at stake.

a. Setting a carbon price; green taxes versus permits

There are two key options for effectively implementing a price for carbon; taxation or trading permits for the right to emit greenhouse gases. Setting a cap for carbon emissions and allowing a permit market to set the price is a more practical way forward for business than Government trying to predict the cost curve of company's potential reductions, and setting a tax level to achieve a particular target. To be effective, any carbon price should be introduced internationally if not UK producers could be out-competed by higher-polluting rivals, leading to greater emissions. International permit trading, starting in the EU, is the essential way forward to carbon pricing.

An effective permit market will take time to develop. Yet as highlighted in the Stern report, there is a strong economic case for taking action early and a clear political consensus for the UK to lead. There is also a case for some level and form of 'green taxation', making the economic environment more certain for early movers and long-term investment. This is happening now through a mix of instruments, from the climate change levy to the Government's justification for air passenger duty. But HM Treasury still needs to ensure such taxes are as effective as possible and appropriate for the UK environmental and economic goals.

b. Carbon taxes and achieving behavioural change

It is purely the targeting of behavioural change to reduce environmental damage that makes a tax (or tax increase) a ‘green tax’. Making the polluter pay and raising revenue for Government may also be an outcome of a green tax, but a successful ‘green tax’ may reduce revenue.

Where in the market the ‘green tax’ is applied will influence the cost-effectiveness of pollution cuts as will the long term certainty of tax levels of tax rates. Applied at the level of large major suppliers, the actual level of CO2 produced or some calculation of it may be taxed. That is currently impractical for a mass market of consumers or small businesses and so a less directly related activity, such as owning a SUV, is taxed instead. But if the end user is taxed, it may not lead to any incentive for suppliers to innovate to reduce carbon emissions, beyond demand for certain goods being impacted. Behaviour change will be maximised and cost minimised if all levels of the market are able to exercise options to change behaviour and innovate to reduce carbon emissions.

c. Carbon taxes and fairness

Introducing a price of carbon emissions or equivalent activity via tax will almost inevitably have implications for fairness. Yet varying carbon taxes to be fairer reduces the incentive to change and leads to complexity. The ability to change behaviour, to minimise tax, may also vary with level of income or turnover. Someone with an SUV can swap to a smaller car, someone who can only afford a small car may not have an alternative. Small businesses and low income groups may not have the disposable income to invest in low carbon capital or be unwilling to take on debt, even when financially worthwhile.

Furthermore, as the Treasury-commissioned KPMG study of the administrative burden[7] of the UK tax system makes clear, tax administration is often highly regressive to small business, 86% of the admin burden falls on companies with under 10 employees, despite only having 22% of UK business turnover[8]. New green taxes on business would probably impact unfairly impact on small business entrepreneurs. Finally, if tax rates go too high, then UK business could be in an unfair position in an increasingly global market, out-competed by higher carbon alternatives. Selectively taxing specific luxury goods may be a response but this may not effectively tackle the mass of carbon emissions.

d. The practicality of carbon taxes

If the impact of tax on the consumer can be ameliorated by innovation and change in the supply chain, then it will be politically easier to adjust tax to achieve future carbon targets. As markets come under pressure from effective permit trading markets, Government may have to alter tax levels in order that consumers and business are not over penalised. At the point of transition this could be quite complex and so be difficult if the tax is imposed on a mass market of consumers.

The level in the market at which the tax is implemented will impact on both the ability to tax proportionately to the level of carbon pollution and the extra administrative cost to those being taxed. However, who is taxed in any market will also impact upon Government’s ability to raise tax levels in the future.

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[7] Administrative Burdens, HMRC Measurement Project, 20th March 2006
[8] SME statistics 2005, Published by the SBS, August 2006

Recommendations:

- HM Treasury should only classify a tax or tax increase as a 'green tax', if it is demonstrably focused on reducing environmental pollution. Other policy goals, such as revenue raising, will only result in tension between environmental goals and other considerations

- HM Treasury and Department for the Environment and Rural Affairs should make clear that international emission trading, starting with the EU, is the absolute priority for the UK's aspirations to price carbon. Ensuring joint member state action at this level will not penalise UK business working in a global market

- Government and other key stakeholders should acknowledge that despite the case for some green taxation the ability to carbon tax business will be highly constrained and is in no way a substitute for effective emission trading

- Taxes that cost-effectively tackle carbon emissions are likely to impact unfairly on low income families and low turnover business. Government should deal with this simply, by returning revenue through progressive cuts in other taxes

- The level of the market where a green tax is imposed will affect the incentive to change behaviour, the ability to target the problem, the political ability to vary the tax to achieve future goals, fairness, the administrative cost and the cost impact on the consumer. Higher-up the supply chain may be the way forward

- Prior impact assessments should be undertaken by Government, to ensure green taxes, or green tax increases, achieve the greatest environmental benefit for the least cost. It should be clear where the revenue will go and how the tax will merge into permit trading in the future. This is important for the credibility of green taxes and consistency with other efforts and policies to tackle the problems

- The recent increase in Air Passenger Duty needs to be reconsidered against these criteria. It does not demonstrably focus on achieving behaviour change and therefore is not a 'green tax'. Though potentially bringing air travel more into line with car travel, a chance to more effectively tackle emissions may have been missed.

- HM Treasury should conduct a full impact assessment of Air Passenger Duty and the alternative option of an Aircraft Duty, where the fee paid for take-off rises with the carbon emissions of the aircraft and the length of the flight (potentially using road-tax like classifications). HM Treasury might offer more incentive for airlines to utilise more fuel efficient aircraft over existing aircraft and still raise the same revenue. It may also be more practical in regard to future permit trading for aircraft emissions.

6. Delivering efficient and high quality HM Revenue & Customs (HMRC) services

HMRC announced last November details of its Change Programme which will reorganise service delivery nationally, following the creation of HMRC from the merger of Inland Revenue and Customs & Excise. The overall aim is to deliver a more efficient and effective service to businesses and individuals. However, the process will involve cutting 12,500 staff and dramatically reducing the number of sites from which HMRC operate to save property costs by £30m annually.

We have already reported on ICAEW member concern over a substantial fall in the level of HMRC customer service. There appears to be far reaching reform now without the investment necessary to maintain service with less staff. The result is that, on the ground, services have deteriorated after the closure of local offices and the increased reliance on call centres. HMRC's local support structure has been dismantled but no mechanisms have been put in place to replace it. These developments have led to considerable frustrations for taxpayers and their agents and advisers, and are probably the largest single cause for complaints that the ICAEW Tax Faculty receives.

The ICAEW has made representations to HMRC and the House of Commons Treasury Select Committee on this issue. The view of the Institute was raised in the Treasury Select committee's report on the Pre-Budget Report, the relevant section of which is below:

'The Institute of Chartered Accountants in England and Wales suggested to us that the efficiency programme in HM Revenue & Customs had led to a deterioration in the quality of service which HM Revenue & Customs provided to its customers. When we asked Treasury officials whether the risk of efficiency savings leading to lower quality services had materialised, we were told:

"The answer to that must be no, because the precautions we have taken have been to include measures of service quality as part of the assessment that is made when the Office of Government Commerce are assessing whether an efficiency saving has been made. So in order to know whether an efficiency saving has been made rather than a service cut been delivered, that will be clear."'[9]

The ICAEW does not believe that relying on OGC efficiency saving performance measures amount to appropriate measurements of customer service for businesses and their agents. The ICAEW's membership represents the largest number of qualified tax advisers in the UK, many of whom deal with HMRC on a very regular basis. We would like to work with HMRC to develop ways to monitor customer service.

Recommendations:

- If customer services are to be improved, there needs to be greater transparency about HMRC's reorganisation and restructuring and plans to maintain and improve existing services

- This process needs input from tax professionals and its customers. Whilst returning to the former 'district' structure may no longer be possible, practical steps can be taken to improve local dialogue and accountability

- HMRC is working on a number of initiatives, for example by nominated staff 'owning' particular issues and by the nomination of named staff as a contact point for tax agents, but this needs to be translated into sustained action on the ground and a willingness to work more closely with agents

- There also needs to be recognition that year-on-year reductions in department budgets may not be realistic if services are to be improved. A year-on-year budget reduction of 5% may not reflect the longer lead-time needed for investment in new technology to lead to cost savings. A commitment to a savings in the medium term would focus attention on the necessary investment required to feed through to improvements rather than short-term cost-cutting

7. Missing Trader Intra-Community fraud (MTIC) or 'carousel fraud'

The ICAEW has argued that MTIC fraud is a criminal and not purely a fiscal matter and that it should be treated as such. MTIC fraud thrives on the lack of co-operation between EU member states and we have made the point that there needed to be a substantial involvement both of Serious Organised Crime Agency (SOCA) and Europe-wide enforcement agencies. The ICAEW recently gave evidence to the Lords European Union sub-committee making this exact point and consequently we are delighted that the Rt Hon Dawn Primarolo MP has announced that:

[9] http://www.publications.parliament.uk/pa/cm200607/cmselect/cmtreasy/115/115.pdf

- There will be designated contact points with each member state on criminal and civil investigations
- member states will exchange information better and faster
- member states must develop a common approach to civil interventions under EU VAT law and to improve the quality and speed of response
- Europol to develop an MTIC fraud threat assessment to support prioritisation and targeting of criminal interventions[10]

We are also cautiously optimistic following the Paymaster General's statements to the Lords EU sub-committee, that the losses to the UK Treasury from MTIC fraud may have been stemmed. However, we note that success to date has been achieved in large part due to administrative measures, some of which, such as VAT registration, have had a serious impact on businesses far removed from any possible fraud. **Moreover the fundamental problem of the single market and the application of VAT on cross-border trade has still to be addressed and closer co-operation has yet to be experienced**.

Moving forward we are concerned about the resource currently deployed in combating this fraud at HMRC and the effect on other areas of tax administration, especially at a time when staff numbers are being so heavily cut. We are also concerned that MTIC fraudsters will revive as and when the intensive resource currently deployed stands down. For this reason we think one short term measure may be useful:

Recommendation:

- The imposition of a limit on the amount of input tax that each VAT-registered business could reclaim in an accounting period. It would be set at an amount that in the normal course of events the business would not reach, with a fast-track clearance procedure for abnormal transactions such as a property purchase

We intend to participate fully in Europe and the UK in seeking the solution to the problem of trade simplification and the application of an acceptable and efficient common system of VAT within the single market. We remain concerned that the proposed measures do not address the root cause of the problem. As we said in our PBR submission, the UK Government needs to work with other member states and combat MTIC fraud by addressing the opportunity for fraud. The proposed derogation to impose a reverse charge mechanism due to its conditions and the low level at which it will apply will place a significant additional compliance burden on almost every VAT-registered business in the country. It is in our view only a short-term fix and in any event there remains the possibility that the derogation will not be obtained, which would take the UK back to square one.

Recommendation:

- We consider that the origin system, amended to ensure that VAT remains where it is charged, is the best way to proceed. For business there is local simplicity of application and for member states' revenues there is an automatic allocation of tax corresponding with the flow of trade and direct taxation. In such a system there is no need for a clearing house for tax equalisation and there is adherence to the underlying principles of a single market

[10] EU tackles VAT fraud, HMRC Press Notice, 21st February 2007, http://www.gnn.gov.uk/Content/Detail.asp?ReleaseID=266035&NewsAreaID=2

Conclusion

In this submission we have highlighted actions that government can take to improve the conditions for UK business to grow and succeed in an increasingly globalised economy. It is clear that government is not moving as fast as it would like to improve productivity growth, but it does have strategies in place to address this in the longer term. However there is a need for action now. As business has to adapt and innovate to compete, government must be willing to react quickly to changing business needs. We would urge government to adopt a greater sense of urgency and call for immediate action in the areas we have suggested in this submission.

About the ICAEW

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