The UK's International Tax Competitiveness

by Tom Clougherty & Daniel Bunn

- The UK ranks 22nd out of 37 OECD countries in the 2021 edition of the International Tax Competitiveness Index, published annually by the US-based Tax Foundation.

- The UK ranks first for its international tax rules, but comes 18th on corporation tax, 22nd on consumption taxes, 23rd on personal income taxes, and 33rd on property taxes.

- Factoring the super-deduction into the Index improves the UK's corporate tax ranking from 18th to 11th, and its overall ranking from 22nd to 21st. On current tax plans, however, that improvement would be short-lived. In 2023, when the super-deduction expires and the headline corporation tax rate rises from 19% to 25%, the UK will go overnight from having one of the more competitive corporate tax regimes in the OECD, to being ranked 31st out of 37 for corporate taxes.

- Meanwhile, the introduction of the health and social care levy from April 2022 will increase marginal tax rates on earnings and dividends, and mean that the UK slips to 31st on the personal income tax ranking, and 24th overall.

- Overall, once all the planned tax rises come in, the UK will fall to 30th place on the International Tax Competitiveness Index, well behind competitors such as the United States, Germany, Canada, and Japan.

- The UK cannot afford to fall behind its international competitors in this way. The government needs to rethink planned tax increases and adopt a renewed focus on pro-growth policy reforms going forward.

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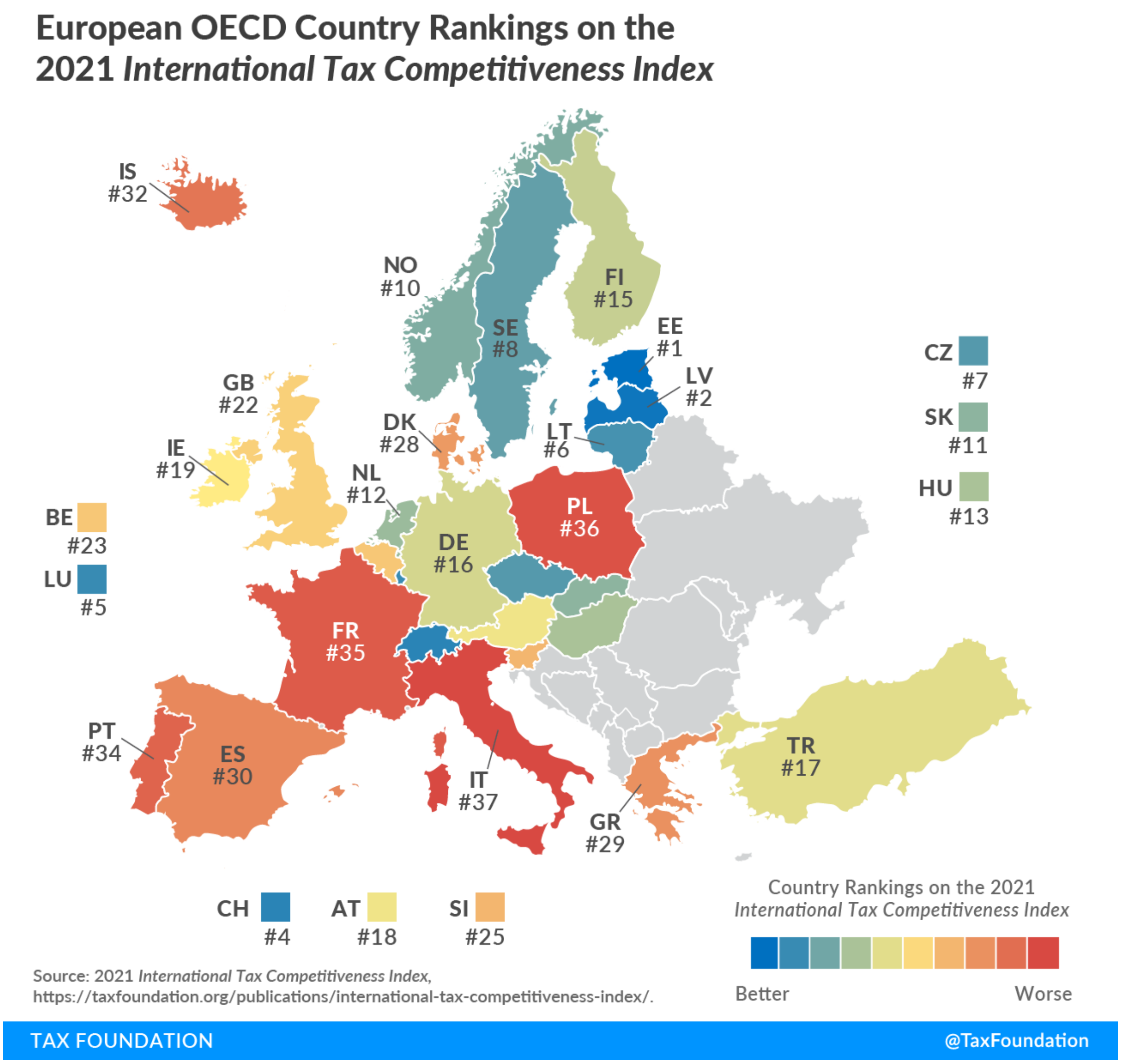
Introduction

The Tax Foundation's International Tax Competitiveness Index is an annual ranking of 37 OECD countries based on how pro-growth their tax systems are.[1] It isn't simply a comparison of marginal tax rates; it also puts a lot of weight on the underlying structure and quality of the tax system, examining more than 40 different tax policy variables in order to assess how supportive each country's tax system is of economic growth – or the reverse.

In the 2021 edition of the Index, published this week, the UK ranks 22nd overall, finishing just behind the United States (21st) and Canada (20th). The top ranked G7 country is Germany, which comes in 16th place. The highest placed G20 country, meanwhile, is Australia (9th). Fifteen European countries score better than the UK in the 2021 Index, including famously high-tax Sweden, which claims 8th place.



[1] Daniel Bunn & Elke Asen, '[International Tax Competitiveness Index 2021](https://taxfoundation.org/publications/international-tax-competitiveness-index/)', Tax Foundation, 19 October 2021.

This note provides an overview of how the UK performs on the latest edition of the International Tax Competitiveness Index, highlighting the key areas of poor tax design that hold the UK back. It also looks at the gloomy prospects for the UK's ranking in the years ahead, as various scheduled tax changes come into effect.

For a detailed look at how the UK can boost its tax competitiveness, readers can look at our 2020 report *A Framework for the Future: Reforming the UK Tax System*, which used the previous edition of the Index as a tool for designing a comprehensive set of pro-growth tax reforms for the UK.[2]

Corporate taxes

Overall rank	Rate rank	Cost recovery rank	Complexity rank
18th	5th	33rd	27th

The UK ranks 18th out of 37 OECD countries in the corporate taxes section of the International Tax Competitiveness Index – a lower finish than many observers might expect, given the UK's low headline rate of corporation tax (currently the fifth lowest in the OECD, at 19%).

However, while the UK ranks well on the Index for its headline rate, it does less well on measures that try to capture the underlying *structure* of the corporate tax system. Its poor rank for complexity largely reflects the introduction of a digital services tax, alongside various other narrowly-targeted taxes and reliefs that give particular companies or sectors special (or punitive) treatment.

A bigger problem, however, is the UK's very poor rank for 'cost recovery' – a sub-category that covers things like capital allowances, loss provisions, and inventory.

The UK's relatively ungenerous tax treatment of capital investment is a long-standing issue when it comes to our tax competitiveness. Capital allowances and the Structures and Buildings Allowance have traditionally spread the deductions of capital costs over such long periods that they lose a significant amount of their value. This can – as the Centre for Policy Studies has repeatedly pointed out in recent years – act as a big disincentive to business investment, and also mean that the tax system is biased against capital-intensive industries such as manufacturing.

The Government is aware of this, of course: it's why the Chancellor introduced the temporary super-deduction in his March 2021 Budget, giving an unlimited 130% corporation tax deduction for all qualifying business investment. For the time being, this has dramatically altered the UK's tax treatment of capital investment – for the better. Because of a data lag, it does not factor into the current edition of the International Tax Competitiveness Index. If it did, the UK's corporate tax rank would improve from 18th to 11th, and its overall rank from 22nd to 21st: a sign of how powerful the measure could be.

[2] Tom Clougherty et al., 'A Framework for the Future: Reforming the UK Tax System', Centre for Policy Studies & Tax Foundation, 25 October 2020.

Sadly, as welcome as it is, the super-deduction is an imperfect policy. The point of 'full expensing' is to *permanently* increase investment, and in so doing promote productivity and growth. But since the super-deduction is only *temporary*, it is likely to bring planned investment forward without actually increasing it much in the long run.[3]

Personal income taxes

Overall rank	Income tax rank	Complexity rank	Capital gains & dividends rank
23rd	22nd	15th	28th

The UK comes 23rd out of 37 OECD countries in the individual taxes section of the International Tax Competitiveness Index. In other words, we are slightly below average when it comes to the competitiveness of our individual taxes.

What stands out when you compare us to other OECD countries is that we have a relatively high top rate of tax on ordinary income (47% if you combine income tax and employee National Insurance Contributions) and a very uncompetitive top rate of tax on dividends (38.1% compared with an OECD average of 24.1%). Only four OECD countries levy a higher top rate on dividends.

By contrast, while the current capital gains tax regime could do with simplification, it is fairly competitive by OECD standards. It is worth noting, however, that aligning capital gains and income tax rates – often suggested as a tax-raising solution for the Chancellor – would leave the UK with the highest capital gains tax rate on shares of any country in the OECD. That is something Rishi Sunak should bear in mind as he considers the Government's response to the Office for Tax Simplification review of capital gains tax.

Consumption taxes

Overall rank	Rate rank	Base rank	Complexity rank
22nd	15th	37th	7th

The consumption taxes section of the International Tax Competitiveness Index focuses on VAT, and ranks the UK 22nd out of 37 OECD countries. In this case, the sub-category ranks listed above more-or-less speak for themselves.

Our headline rate of VAT isn't too onerous by international standards, and compliance is less burdensome than in many other countries. On the other hand, we come dead-last in the rankings for our VAT tax base. Put simply, our VAT base is narrower than everybody else's – we apply exemptions

[3] For more on full expensing, see Centre for Policy Studies, 'A Budget for No Deal', 8 March 2019, pp. 16–19 and Stephen J. Entin, 'Boosting Growth as the UK Leaves the European Union', Centre for Policy Studies, 6 March 2020. For a detailed assessment of the super-deduction, see Daniel Bunn & Kyle Pomerleau, 'Marginal Effective Tax Rates and the 2021 UK Budget', Tax Foundation, 23 March 2021.

and zero- or reduced-rates to a wider range of businesses, goods, and services than any of our competitors.

Of course, our narrow VAT base does have some superficial benefits: it reduces the impact of VAT on poorer households – who spend a large share of their income on 'essentials' – and means that many 'micro-businesses' don't have to worry about VAT compliance at all.

But there are also significant costs: the application of different rates and exemptions distorts spending decisions and is actually a very poorly-targeted way to help the least well-off. A narrow tax base also means that the headline tax rate needs to be higher for any given amount of revenue. Most importantly, anything that undermines the revenue-raising efficiency of VAT is likely to result in other, more economically damaging taxes being more onerous. (Of all the big sources of tax revenue, VAT is probably the most growth-friendly.[4])

Unfortunately, there is little prospect of the UK moving towards a broader VAT base in the years ahead – if anything, the direction of travel seems to be in the opposite direction.

Property taxes

Overall rank	Real property taxes rank	Wealth & estate taxes rank	Capital & transaction taxes rank
33rd	36th	10th	26th

The UK ranks 33rd out of 37 OECD countries in the property taxes section of the International Tax Competitiveness Index, suggesting that its property taxes significantly hinder its competitiveness and growth prospects.

The problems are not hard to diagnose. Fundamentally, the UK raises a lot of money from property taxes (more, as a percentage of GDP than any other OECD country) but does so in a way that is calculated to do as much economic damage as possible. There are three particular issues:

- The business rates tax base is structured in a way that discourages investment. This, coupled with the heavy burden that business rates impose, puts us in 36th place on the Index for 'real property taxes' – only Iceland does worse.
- Stamp Duty Land Tax hugely distorts the housing market, discouraging transactions, and preventing homes from being owned by people who value them the most. This has a serious negative impact on both welfare and growth.[5]
- Stamp taxes on shares depress share prices, raise financing costs, and distort the wider market for financial assets.[6] The UK opposed a financial transaction tax at the European level, yet it is among the minority of OECD countries that levy one at home.

[4] See Asa Johannson et al., 'Tax and Economic Growth', OECD, 11 July 2008.
[5] See Clougherty et al., 'A Framework for the Future', pp. 59–61.
[6] See Oxera, 'Stamp duty: its impact and the benefits of its abolition', May 2007.

The Government's 2019 general election manifesto committed it to a fundamental review of business rates, so we can only hope that we see some improvement on this front in the years ahead.

International tax rules

Overall rank	Dividend/capital gains exemption rank	Withholding taxes rank	Tax treaties rank	Anti-tax avoidance rank
1st	1st	9th	1st	25th

As in previous years, the UK's comes top in the cross-border tax rules section of the International Tax Competitiveness Index. The UK's high score is driven by our territorial tax system, which exempts foreign-earned dividends and capital gains from corporation tax, and the fact that we have the broadest network of tax treaties of any OECD country. This is significant strength of the UK tax system when it comes to attracting internationally-mobile investors and multinational businesses.

One downside of territorial taxation – which generally encourages investment and growth by preventing double taxation – is that it can make it easier for corporations to shift their income to lower tax jurisdictions, and therefore lower their overall tax bill. As a result, the UK also has a number of anti-tax avoidance rules designed to limit profit-shifting.

Such policies can increase complexity and compliance burdens, so it is important that they are proportionate to the problem they are trying to solve. We therefore need to keep measures like the Diverted Profits Tax under review, especially as a common approach to tackling tax avoidance is developed at the international level.

UK tax competitiveness: outlook negative

The UK finishes in the bottom half of the 2021 tax competitiveness league table. Its tax system has some obvious strengths, like a low headline rate of corporation tax and best-in-class international tax rules, but also some obvious weaknesses – like a burdensome and poorly designed property tax system and relatively high dividend tax rates.

Unfortunately, the outlook for the UK's tax competitiveness is extremely negative.

First, the personal income taxes picture will worsen once the recently announced 'health and social care levy' takes effect. This measure adds 1.25 percentage points to marginal rates on earnings and dividends, making the top rates 48.25% and 39.35% respectively. This would drop the UK from 23rd to 31st place on the personal income tax ranking – and from 22nd to 24th place overall.

Worse is to come a year later, in April 2023, when the expiry of the super-deduction is set to be accompanied by a big increase in the headline corporation tax rate, from 19% to 25%. The combined effect of this change will be to send the UK plunging down the tax competitiveness rankings: its corporate tax rank will fall from 11th to 31st out of 37 OECD countries, and it will slide to 30th place in the International Tax Competitiveness Index overall.

This prospect, summarised in the table below, represents a step-change in the UK's attractiveness to internationally-mobile business and investment, and should be a matter of serious concern for any growth-oriented policymaker.

The UK's international tax competitiveness, projected rankings for 2023

Overall	**Corporate taxes**	**Personal income taxes**	**Consumption taxes**	**Property taxes**	**International tax rules**
30th ⇩9	31st ⇩20	31st ⇩8	22nd	33rd	1st

N.B. This projection assumes that other OECD countries' tax systems do not change and uses a modified version of the 2021 International Tax Competitiveness Index, which factors in the super-deduction, as its baseline.

Conclusion

In the wake of Brexit and a deep, pandemic-induced recession, it is more important than ever that we get the economy growing strongly. Without robust growth in the years ahead, there is simply no way the Government will be able to deliver the things it is committed to: higher real wages, better public services, and sound public finances – not to mention stronger regional development and the transition to Net Zero. Economic growth is the crucial ingredient that makes everything else possible.

Having an internationally competitive tax system is one of the key ways the Government can help the UK to attract more business and investment, spur domestic enterprise and entrepreneurship, and generally encourage a dynamic and growing economy. Yet as this note has shown, the UK isn't starting from a *great* place when it comes to its tax competitiveness, and things are only likely to get worse over the next few years as ill-advised tax increases take effect.

In particular, the looming collapse in the attractiveness of the UK's corporation tax regime, which will see us plummet from 11th to 31st in the business tax rankings in April 2023, represents a serious and easily avoidable self-inflicted wound. It is not too late to think again, and come up with a plan that would permanently improve our approach to capital investment, while also maintaining a competitive headline tax rate.

Ultimately, if we want to the see the UK rising up the tax competitiveness rankings – and creating the best possible conditions for private sector growth – the same approach needs to be replicated across the board. The UK has clear weaknesses in *every* area of domestic taxation. That's a depressing finding, but also perhaps a hopeful one: it means that a powerful pro-growth tax agenda is well-within our grasp. We just need the Government to act. Next week's Budget is the perfect time to start.