The UK's International Tax Competitiveness
2022 Update

By Tom Clougherty

- The events of the last few weeks have been dramatic. But they have also had dramatic consequences for the UK's tax competitiveness.

- This week the US-based Tax Foundation published its annual International Tax Competitiveness Index. The UK ranked 26th out of 38 OECD countries, up one place from 2021.[1] It came 10th for corporate taxes, 24th for individual taxes, and 34th for both consumption taxes and property taxes, although it did rank first for its cross-border tax rules.

- However, the rankings were carried out while the investment super-deduction was in place and the headline rate of corporation tax was at 19%. As things stand, corporation tax will rise to 25% in April and the super-deduction will expire without a satisfactory replacement.

- Factoring in those changes causes the UK to fall to 33rd in the competitiveness rankings for corporate taxation (down 23 places) and to 33rd place overall.

- Obviously the Government's overriding priority must be to restore market confidence. But there is an urgent need once the current storm has passed to address the competitiveness of the UK tax system and the country's attractiveness as an investment destination.

- This is not just about cutting taxes. Many of the countries above the UK in the Index have higher taxes, but raise revenue in a more growth-friendly manner. It would be possible to boost the UK's tax competitiveness in a revenue-neutral (or even revenue-positive) way – but doing so would involve difficult political trade-offs, especially in a context of low growth and high inflation.

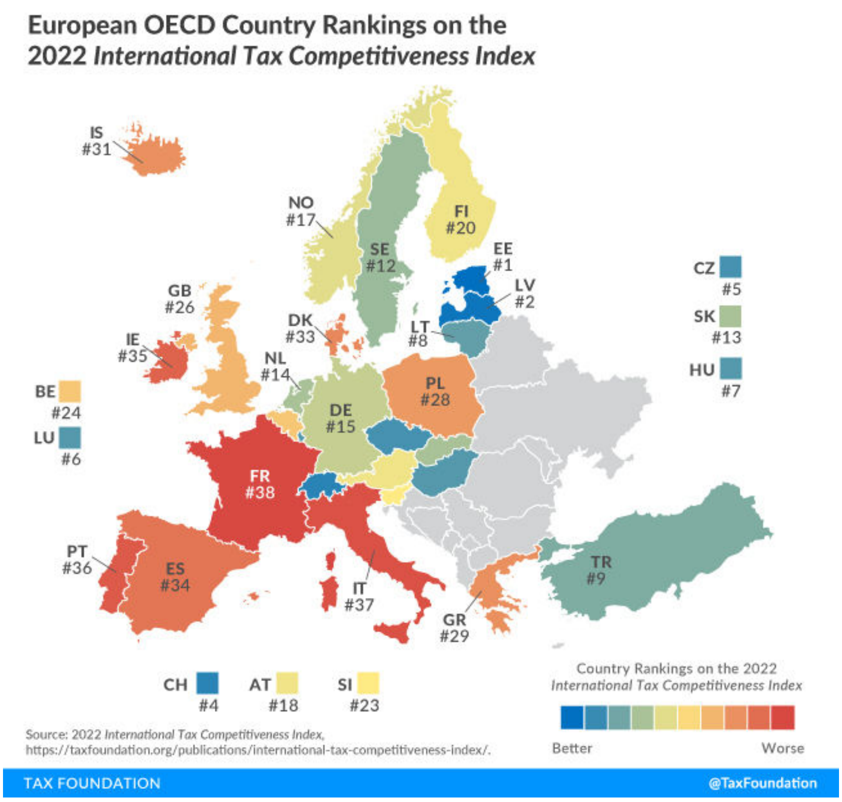
[1] An update to the International Tax Competitiveness Index methodology means that scores and rankings from previous years have been revised for consistency

Introduction

The Tax Foundation's International Tax Competitiveness Index is an annual ranking of 38 OECD countries based on how pro-growth their tax systems are.[2] 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 2022 edition of the Index, published this week, the UK ranked 26th overall, up one place from 2021. Compared with other G7 economies, we fell well short of Germany and Canada (at 15th and 16th place respectively), somewhat behind Japan and the United States (21st and 22nd respectively), but still ahead of Italy and France, which claimed the bottom two spots on the ranking.

Estonia topped the rankings for the ninth year in a row, followed by Latvia. New Zealand came third, with Switzerland in 4th place. The highest-ranked G20 country on the Index was Australia, which came 11th. In total, 16 European countries scored better than the UK in the 2022 Index – including famously high-tax Sweden in 12th place.



[2] Daniel Bunn, 'International Tax Competitiveness Index 2022', Tax Foundation, Oct 2022

UK ranking on 2022 International Tax Competitiveness Index

Overall	Corporate tax	Individual taxes	Consumption taxes	Property taxes	Cross-border tax rules
26th	10th	24th	34th	34th	1st

A country's ranking on the International Tax Competitiveness Index is based on how it scores on 41 different tax policy variables, spread across five categories: corporate taxes, individual taxes, consumption taxes, property taxes, and cross-border tax rules.

As usual, the UK scored well for its cross-border tax rules, topping the ranking for the fourth consecutive year. This reflects the fact that the UK's network of tax treaties – which it has in place with 130 countries – is the broadest in the OECD.

The UK also scored well on corporate taxation, coming 10th. Its 19% headline tax rate was among the lowest in the OECD (the UK came 4th in this sub-category). Importantly, the temporary super-deduction, which gives an up-front tax deduction worth 130% of any qualifying investment in plant and machinery, addressed a significant comparative weakness of the UK's business tax system. In previous editions of the Index, the UK ranked near the bottom for 'cost recovery', suggesting that it had one of the least generous systems of investment allowances in the OECD. But this year it ranked 8th in that sub-category – a massive improvement.

The UK fared less well on the rest of the Index categories. Its rank for individual taxation (24th) reflected a high top rate of tax on earnings, and an especially high top rate of tax on dividends relative to other OECD countries (only three countries – Denmark, Korea, and Ireland – tax dividends more heavily than us).

The UK's property and consumption tax systems were, as previously, a significant drag on its International Tax Competitiveness. It ranked 34th in each category. For property taxes, this reflected three factors: first, recurrent property taxes impose a heavier burden (measured as a percentage of the capital stock) in the UK than in any other OECD country; second, business rates are structured in a way that discourages investment; and third, we rely more than most other countries on economically distortionary transaction taxes like stamp duty.

In terms of consumption taxes, the fundamental problem is that the UK has the narrowest VAT base (or equivalent) of any OECD country. Our VAT registration threshold is very high by international standards, and we exclude a wider range of goods and services from VAT than most of our competitors.

This narrow tax base has two unfortunate consequences. First, it creates complexity and distorts economic decision-making (see, for example, the obvious bunching of firms just under the VAT registration threshold). Second, relying less on VAT, a relatively benign tax from a growth perspective, means that other, more economically damaging taxes have to be higher to raise the same amount of revenue.

UK ranking on 2022 International Tax Competitiveness Index (post-Hunt announcements)

Overall	Corporate tax	Individual taxes	Consumption taxes	Property taxes	Cross-border tax rules
33rd ⇩7	33rd ⇩23	24th	34th	34th	1st

As mentioned above, the UK's ranking on the Index was based on the tax system that was in place when the calculations were made. However, in recent weeks there have been major changes to the UK tax base, first with Kwasi Kwarteng's mini-Budget package and then with Jeremy Hunt's repudiation of large chunks of the same.

In other words, when it comes to the UK, the Index assumes a 19% headline rate of corporation tax and a 130% up-front tax deduction for investment in plant and machinery – two things that we now know will not be the case once the new tax year begins in April 2023. Instead, the corporation tax rate will increase by nearly a third, to 25%, and the super-deduction is currently set to expire without a meaningful replacement, meaning that the UK's tax treatment of business investment would return to the (notably stingy) *status quo ante*, albeit with the Annual Investment Allowance permanently (rather than temporarily) set at £1 million.

The Tax Foundation has calculated the impact at the Centre for Policy Studies' request, and found that with these changes in place, the UK is set to fall 23 places in the corporate taxation category, from 10th to 33rd.[3] Our overall tax competitiveness ranking will fall from 26th to 33rd.

Obviously the priority must be to restore market confidence in the UK, by curbing borrowing and imposing strict fiscal discipline. But these findings imply that the UK will soon have corporate, consumption, and property tax regimes that are among the least supportive of economic growth in OECD countries. Our individual tax regime will be below average from a competitiveness standpoint. The only thing buoying our overall standing will be our admirable commitment to maintaining a wide network of tax treaties.

[3] This assumes that there are no tax policy changes in other countries that would also affect the rankings

Conclusion

The brutal realities of the bond market have forced the Government into its current position on tax. But it is hard to escape the conclusion that our tax system is going to be a hindrance, not a help, to our growth prospects going forward.

The new Chancellor has already said that taxes are more likely to go up than come down. However, if there is any fiscal headroom at all we would urge him to investigate and revive his predecessor Rishi Sunak's plans for reforming investment allowances – which as Tax Foundation/CPS modelling has shown could have a strong growth impact.[4] Indeed, with corporation tax at 25% and inflation stubbornly elevated, the importance of investment allowance reforms such as full expensing becomes considerably higher.

There are of course routes to building a more growth-friendly tax system that do not involve giving up revenue. It is worth noting that 13 of the 25 OECD countries that rank above the UK in the published version of the International Tax Competitiveness Index 2022 raise more tax revenue as a percentage of GDP than we do. But the sad truth is that achieving such an objective is fraught with political and distributional difficulties.

It would involve coupling a much broader VAT base (which could raise tens of billions a year) with targeted reforms to business rates and capital allowances.[5] Stamp duty land tax could be abolished over time as properties change hands, as part of a transition to a more rational residential property tax system.[6] And the income tax system could be reformed to smooth the structure of effective marginal tax rates and better offset the 'double taxation' that occurs when income is taxed at both the corporate and personal level.[7]

None of this is easy, however, unless you can afford to cut the taxes (or raise the benefits) of those who might lose out. Which is why the Government's immediate priority will surely be to put out the fiscal fire, ideally while shifting the focus of its pro-growth agenda to long overdue regulatory and supply-side reforms.

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[4] See Tom Clougherty et al., 'After the Super-Deduction: Assessing Proposals for the Reform of Capital Allowances', Centre for Policy Studies & Tax Foundation, Sept 2022

[5] For a thorough examination of these and other reforms, see Tom Clougherty et al., 'A Framework for the Future: Reforming the UK Tax System', Centre for Policy Studies & Tax Foundation, Oct 2020

[6] John Myers, 'A fair, efficient "mansion tax" is possible – here's how', CapX, Feb 2020

[7] On effective marginal tax rates, see Tom Clougherty, 'Make Work Pay: A New Agenda for Fairer Taxes', Centre for Policy Studies, Nov 2018