

A FRAMEWORK FOR THE FUTURE REFORMING THE UK TAX SYSTEM

BY TOM CLOUGHERTY, DANIEL BUNN, ELKE ASEN, AND JAMES HEYWOOD



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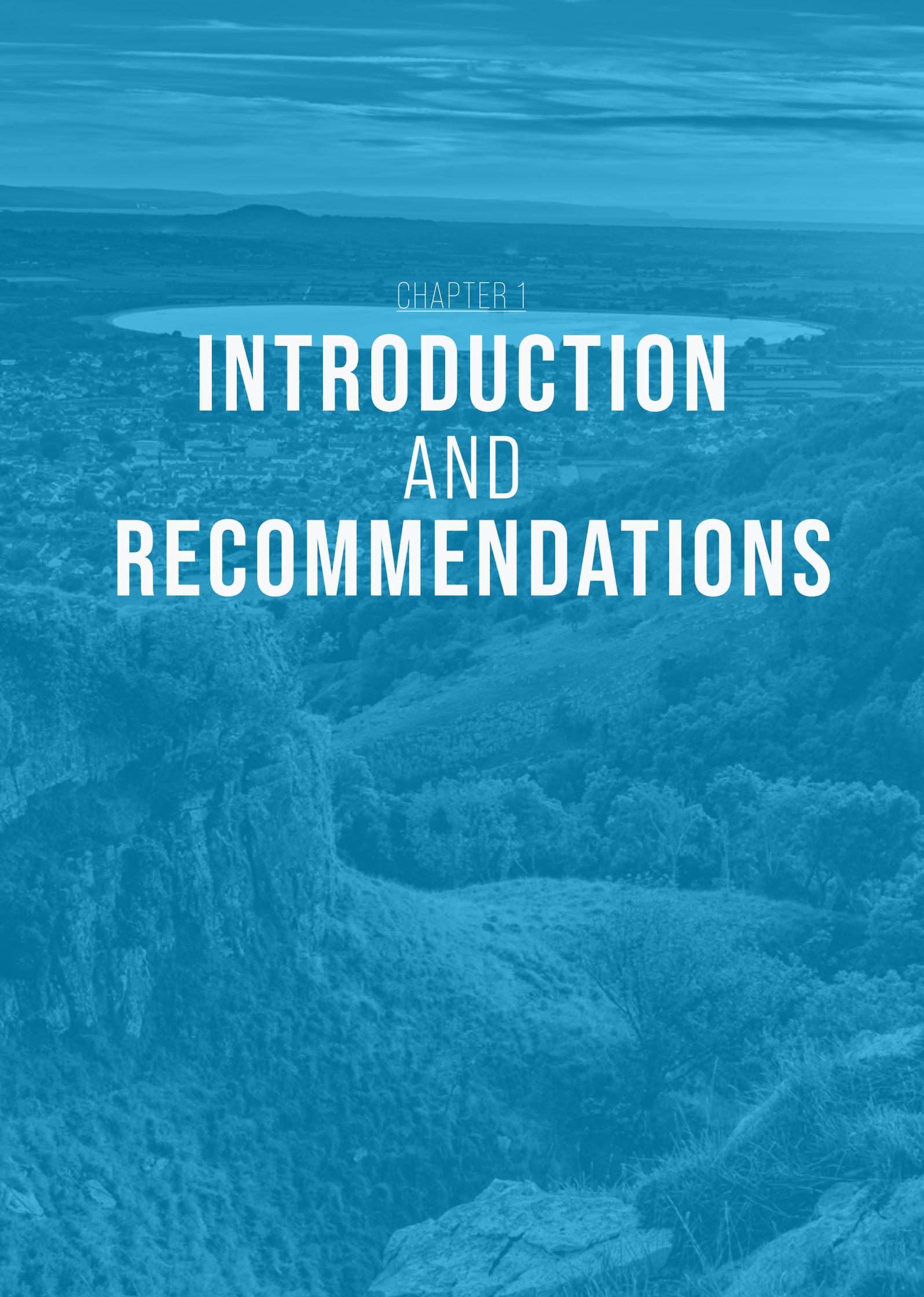
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A blue-tinted landscape photograph showing a valley with a lake in the distance, mountains, and a rocky foreground. The text is overlaid on the image.

CHAPTER 1

INTRODUCTION AND RECOMMENDATIONS

INTRODUCTION

This report is being published during a global pandemic that has wrought havoc on the British economy—as well as on the government’s balance sheet. It is too soon to say exactly where we will end up, but as things stand the OECD forecasts a 14 percent economic contraction for calendar year 2020.¹ Tax revenues have plummeted, and the government’s debt is set to rise above 100 percent of GDP.² There is not much anyone could have done to avoid this downturn, or to significantly diminish its severity, but the grim economic numbers confronting the government do throw the challenge ahead into sharp focus.

Once the public health situation is brought under control, that challenge is principally one of restoring economic growth. Only economic growth can get unemployed Britons back to work, put UK plc on a firmer fiscal footing, and give the government of the day any chance of delivering on its wider domestic agenda. But while an initial spurt of “bounce back” economic growth will surely follow any safe removal of COVID-19 restrictions, robust, long-term, and sustainable economic growth will not come from nowhere. It will take hard work and good policy choices.

After all, even before the coronavirus struck in the early months of 2020, the British economy had noticeable weakness, and faced difficult headwinds. Average GDP growth per capita averaged just 1.1 percent a year in the 2010s, compared with 2.5 percent in the 1980s

and 1.9 percent in the 1990s.³ What growth there was rested largely on more hours being worked across the economy as a whole, with productivity growing at just 0.3 percent a year across the decade.⁴ Average wages remain lower in real terms than they were before the financial crisis,⁵ and business investment has continued to disappoint. Indeed, the Office for National Statistics estimates that from 1995 to 2015, the UK had the lowest average business investment of any OECD nation.⁶

More recently, political uncertainty—not least around Brexit—has had a chilling effect on Britain’s growth prospects. And while the UK’s departure from the European Union certainly presents a lot of opportunities, there are economic challenges to overcome as well. In short, UK policymakers had a difficult enough task before the global pandemic; today, raising Britain’s trend growth rate looks doubly difficult.

It is vital, however, that the government does not take lacklustre growth as a given—as something they have to put up with and adapt to but cannot fundamentally affect. On the contrary: all governments have tools at their disposal that can increase economic growth. They may involve controversial policy choices and difficult political trade-offs, but they are there, if only the government is bold enough to grasp them.

Tax reform is one of the main levers government can pull in its quest to boost the economy

1 OECD, “Economic Outlook No 107 - June 2020 Double Hit Scenario: Gross domestic product, volume, growth,” <https://stats.oecd.org/Index.aspx?DataSetCode=EO>.

2 Office for Budget Responsibility, “Fiscal sustainability report,” July 2020, https://cdn.obr.uk/OBR_FSR_July_2020.pdf.

3 Data from World Bank, “GDP per capita growth (annual %),” <https://data.worldbank.org/indicator/NY.GDP.PCAP.KD.ZG>. The 2000s saw average GDP growth per capita of 1.2 percent, despite the impact of the financial crisis.

4 Royal Statistical Society, “RSS announces Statistics of the Decade,” Dec. 23, 2019, [https://rss.org.uk/news-publication/news-publications/2019/general-news-\(1\)/rss-announces-statistics-of-the-decade](https://rss.org.uk/news-publication/news-publications/2019/general-news-(1)/rss-announces-statistics-of-the-decade).

5 Office for National Statistics, “Annual Survey of Hours and Earnings time series of selected estimates,” Oct. 29, 2019, <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/ashe1997to2015selectedestimates>. The data have been adjusted for inflation using the Consumer Prices Index, including owner occupiers’ housing costs (CPIH).

6 Office for National Statistics, “An analysis of investment expenditure in the UK and other OECD nations”, May 3, 2018, <https://www.ons.gov.uk/economy/grossdomesticproductgdp/articles/ananalysisofinvestmentexpenditureintheukandotherorganisationforeconomiccooperationanddevelopmentnations/2018-05-03>.

over the long run. Improving a country's tax system can attract business and investment, can encourage entrepreneurship and work, and can eliminate deadweight costs that hold back growth. Tax reform is not the only thing that matters, of course, but it is one of the most important and consequential things that the government has directly under its control.

Yet overhauling the tax system is not a straightforward task. We need to identify the parts of the tax system that need the most attention. We need to decide which reforms will do the most to encourage growth. And we need to work out how tax reform can be implemented when significant cuts to the overall tax burden look unlikely, if not impossible. These are all difficult issues. Addressing them is the primary purpose of this report.

A Pro-Growth Approach to Tax Policy

So what does a pro-growth tax system look like? Fundamentally, there are three distinct ways to answer that question. The first is to look at marginal tax rates. All things being equal, lower marginal tax rates are better for economic growth than higher ones, because they do less to discourage economic activity. Put simply, the less you tax something, the more of it you tend to get, and vice versa.

Marginal tax rates are also an important determinant of a country's tax competitiveness—of how attractive it is to businesses and investors relative to other countries. In today's globalized world (notwithstanding the impact of COVID-19), capital is highly mobile, and businesses can choose to invest in any number of countries to maximize their after-tax rate of return. If marginal tax rates are too high in the UK compared to other developed economies, investment is likely to go elsewhere, and economic growth is likely to suffer.

Another way to approach pro-growth tax reform is to focus on *neutrality*—on the extent to which the tax system lets businesses and individuals make decisions based on their economic merits, rather than for tax reasons. Absolute neutrality might not be a practical objective: all taxes affect behaviour to some degree, and sometimes that is actually the point (as with an environmental tax designed to discourage pollution). Nevertheless, you generally want a tax system that does not distort the way people choose to work, save, or spend. The economy will do better, and consumer welfare will be higher, when those decisions are left to the market, instead of being unduly influenced by government.

In practice, neutrality often means combining lower tax rates with broader tax bases. Taxes should apply as equally as possible across the economy, without targeted tax breaks (or special tax regimes) for particular products, sectors, or groups of individuals. There is an important qualification here though: in a few cases, a broader tax base can actually cause economically damaging distortions of its own. For example, a corporation tax base that does not allow the deduction of investment costs creates a bias against capital-intensive industry. Similarly, a personal income tax that does not distinguish between ordinary earnings and investment income is likely to be biased against saving. In other words, “broaden the base, lower the rate” is a useful rule of thumb but is not an iron-clad guide to a neutral, pro-growth tax system.

The third way of approaching pro-growth tax reform is by looking at the balance among different sources of revenue. This is important because we know that some taxes are much worse for growth than others. A pro-growth tax system would therefore seek to maximize revenue from the least distortive taxes, while minimizing reliance on the most harmful ones.

For example, widely cited research by the OECD suggests that corporate income taxes are the most damaging type of tax in terms of GDP per capita, followed by taxes on personal income.⁷ Recurrent taxes on immovable property are the least economically damaging source of revenue, followed by consumption taxes and other forms of property tax.

Needless to say, the devil is very much in the detail. Another study, this one by the Australian Treasury, suggests that a particular type of property tax—“stamp duty on conveyances”—is considerably more harmful than corporation tax (its other findings are very much in line with those of the OECD).⁸ Moreover, it is quite possible to design income taxes so that they function a lot like consumption taxes—Estonia offers one real-world example.

Nevertheless, it is fair to say that shifting the tax burden away from corporate and personal income taxes and towards well-designed property and consumption taxes will make the tax system as a whole more supportive of economic growth. Put this together with competitive marginal tax rates and a neutral tax structure and you have a good recipe for a programme of pro-growth tax reform.

An Audit of the UK’s Tax Competitiveness

For the last seven years, the Tax Foundation—one of the world’s leading tax policy think tanks—has been assessing every tax system in the OECD against more than 40 policy criteria. It has used the results to develop a comparative ranking of how pro-growth each national tax system is.

Alongside the development of its latest *International Tax Competitiveness Index*,⁹ researchers at the Tax Foundation and the Centre for Policy Studies have worked together on a comprehensive study of Britain’s tax system. This report is the result of that effort.

The aim is not to set out recommendations for the overall size of the tax burden in Britain. Rather, it is to evaluate how you could restructure the tax system to generate the greatest amount of economic growth, while raising roughly the same amount of revenue as now.

Some of the resulting proposals will be more politically acceptable than others. But we hope that even if politicians are unable to act on every suggestion here, they will take inspiration from the measures we propose, and act in the spirit we suggest.

It is impossible to maximize the UK’s prosperity, we argue, without ruthlessly evaluating its tax system’s strengths and weaknesses—particularly in comparison with other developed economies that are competing with Britain for business, jobs, and investment. It is easy to talk about pro-growth tax reform in the abstract, to imagine what you might design if you were starting with a blank sheet of paper, but the real challenge is to take the tax system as it actually exists and come up with practical ways to improve it.

Crucially, the Tax Foundation’s annual *Index* is not just a comparison of marginal tax rates. It also involves a detailed examination of the underlying *structure* of different tax systems, to see how neutral they are, or how much they distort economic decision-making. The *Index* covers five main categories—corporation tax, personal income taxes, consumption taxes,

7 Asa Johansson et al., “Tax and Economic Growth”, OECD, Jul. 11, 2008, <https://www.oecd.org/tax/tax-policy/41000592.pdf>.

8 Liangyue Cao et al., “Understanding the economy-wide efficiency and incidence of major Australian taxes,” Apr. 7, 2015, <https://treasury.gov.au/publication/understanding-the-economy-wide-efficiency-and-incidence-of-major-australian-taxes>.

9 Daniel Bunn and Elke Asen, *2020 International Tax Competitiveness Index*, Tax Foundation, Oct. 14, 2020, <https://taxfoundation.org/publications/international-tax-competitiveness-index>.

property taxes, and international tax rules—with numerous sub-categories and individual pieces of data included under each heading.

In essence, what we have done in this report is use the *Index* to audit the UK tax system from an economic growth perspective, to see where in particular the UK lags its international competitors, and to identify the most promising avenues for reform.

As will become clear across the chapters that follow, Britain's current tax system leaves plenty of room for improvement. Overall, the UK ranks 22nd out of 36 OECD countries in the latest edition of the *Index*; but while it finishes in first place for its international tax rules, it comes in 17th for corporation tax, 22nd for consumption taxes, 24th for personal income taxes, and 33rd for property taxes.

Yet even these broad category ranks conceal considerable variation in the pro-growth qualities of different parts of the UK tax system. For example, while the UK has the fourth-lowest corporation tax rate in the OECD, on measures of cost recovery (how the tax system treats investment costs, losses, and so on) it ranks second from last. And while Britain has one of the better capital gains tax regimes in the OECD (for now at least), its top tax rate on dividends is among the highest in the developed world.

The *Index* also highlights the problematic nature of England's property tax regime, with its reliance on distortionary stamp duties and poorly structured business rates, and reveals the deficiency of the UK's consumption tax base. Huge carveouts undermine the efficiency of VAT and mean that much more revenue must be raised from other taxes that have a worse impact on economic growth.

These findings flow naturally from the *International Tax Competitiveness Index*, and they give us a framework within which to develop a

realistic set of pro-growth tax reform proposals for the UK. The *Index* also offers a tool with which we can assess the proposals we come up with. In straightforward terms, the more pro-growth our recommendations are, the more the UK's standing on the *Index* will improve—both within and across categories.

A Road Map for Tax Reform

Taken together, the reform proposals set out in this report would move the UK from 22nd to 9th on the *International Tax Competitiveness Index*—giving Britain one of the 10 most pro-growth tax systems in the OECD.

Our core set of recommendations is summarised in the following section, and each individual policy is examined in detail later in the report. Nevertheless, it is worth setting out here a few of the main principles underlying our approach.

First, as mentioned above, we decided not to assume any reduction in public spending to “pay for” tax reform. Instead, our goal has been to come up with recommendations for a tax system that would raise roughly the same amount of revenue as the current one, but do so in a way that was much more supportive of economic growth.

That is not to say that a lower overall tax burden would not have economic benefits of its own, or make the whole task of reform easier by ensuring there were far more winners than losers. But the truth is that there are good and bad ways for governments to raise any given amount of revenue—and that means you can dramatically improve the structure of a tax system without leaving the government short of funds.

Indeed, if you make a tax system more pro-growth without cutting the overall tax burden, the chances are that in the long run, tax receipts will be much higher than they otherwise would have been. Right now, the UK needs more revenue *and* more growth: over time, our proposals are designed to deliver both.

Second, we have taken a resolutely long-term view in our analysis and recommendations. The goal of our proposed reforms is not simply to boost the economy in the short term—this is not meant as a “fiscal stimulus”—but rather to improve the UK’s underlying economic fundamentals over the long run. We want to permanently remove economic distortions, make the tax system as a whole more efficient, and sustainably boost investment within and into the UK.

One side effect of this approach is that, while we would love for our recommendations to be adopted by government straight away, nothing we propose in this report will go out-of-date any time soon. This is a long-term plan and, as such, we hope that policymakers and would-be reformers will be able to review and rely upon it in the years ahead.

Third, one of the goals of this project has been to develop a comprehensive package of reforms, cutting across personal, corporate, property, and consumption taxes, while keeping an eye on the international side of things.

British tax policy is usually made piecemeal, budget by budget, with little sense of any overarching strategy. And that is part of the problem: it is easy for economic distortions to accumulate, and for short-term revenue considerations to trump all else, when no one involved in running the tax system has the opportunity to take a broader view. We therefore hope that our research can help kickstart a wider conversation about thoroughgoing tax reform. It is long overdue.

None of that means, of course, that our individual recommendations cannot stand alone. On the contrary: everything we suggest in this report represents a step towards a better and more pro-growth tax system in its own right. We are aware, too, that some of our proposals (like abolishing stamp duty) would be more popular, and more in line with current political thinking, than others. So be it. Our point is simply that the greatest rewards in terms of economic growth will come from a comprehensive approach; that does not preclude incremental reform that moves things in the right direction.

Finally, it is worth stressing that while this report is an entirely independent piece of research, we also believe that the policies we set out here are consistent with the current government’s broader economic programme. Our business tax reforms would be a significant boon to the “levelling up” agenda, boosting manufacturers, easing the tax burden on struggling areas, and incentivising greater private infrastructure investment. Our uncompromising stance on abolishing transaction taxes, meanwhile, would make Britain’s housing market less dysfunctional, and give many more people a chance to own a home that really suits their needs.

More fundamentally, our whole objective of making the UK more internationally competitive is at one with the government’s vision of post-Brexit Britain: of a dynamic, confident country that is open for business and committed to genuine, broad-based growth and widespread economic opportunity.

In the end, that is what this report is *really* all about: getting the British economy growing again, faster and more sustainably than before the global pandemic. If we are serious about going for growth—about creating jobs, boosting wages, and driving investment—then ambitious tax reform is the perfect place to start.

RECOMMENDATIONS

Individual Income Taxes

Taxes on individual income from wages and dividends should be reformed to minimize complexity and double taxation. Current individual taxes are embedded with high effective marginal tax rates due to the introduction and withdrawal of various reliefs that make it difficult for individuals who are moving up the earnings ladder to realize the benefits of higher wages.

Lowering and Flattening Rates. The current Additional Rate should be abolished to improve competitiveness and remove negative incentives for individuals as they earn higher wages.

Adjusting Dividend Tax Rates to Reflect Corporation Taxes. Dividend taxes are a second layer of tax on business profits, and the rate should be adjusted to reflect this reality. The combination of corporation tax and dividend taxes should not be higher than the top rate on individual income. With a two-band system, the top dividends tax rate should be 26 percent.

Addressing Effective Rate Cliffs. Britain's personal tax system is shot-through with complicated provisions that cause effective marginal tax rates to spike to punitive levels at various "pinch points" in the earnings distribution. Short-sighted measures like the high-income child benefit charge, the withdrawal of the personal allowance, and the tapering of pension tax reliefs should be reviewed and reformed.

Property Taxes

A property tax can be a simple and efficient way for a government to raise revenue. The UK, however, relies on property and transaction taxes that distort markets and create double taxation. By shifting toward taxing the value of land and removing transaction taxes, the UK property tax system can achieve greater efficiency.

Base Business Rates on Underlying Site Values. The current business rates system is both outdated and inefficient. Businesses should not face a tax hike when they improve their properties through renovations or new construction. A reformed tax base should reflect the value of the underlying site given its permitted use, but should exclude buildings, plant and machinery, and any other improvements a business might make.

Repeal Stamp Duty Land Tax (SDLT). Transaction taxes inhibit transactions and can lead to serious distortions in markets. SDLT creates an extra burden at the time of sale of one's home and can result in homeowners choosing not to sell their properties. Reduced turnover in the housing market means that SDLT is likely raising less revenue than previously thought, and removing this distortion could increase the dynamism of the UK housing market.

Repeal Stamp Duty on Shares. Stamp duty on shares equates to a financial transaction tax which directly increases the costs of buying and selling equities in the UK. The burden of the tax accumulates as shares are traded. Portfolio rebalancing thus becomes an exercise in increasing the taxes on one's savings.

Consumption Taxes

The UK's Value-Added Tax (VAT) is a critical source of revenue, but it underperforms relative to VAT systems in other countries. It has carveouts for large swaths of consumption; this undercuts potential revenues and is an extremely inefficient way of addressing concerns about regressivity. Broadening the VAT base would generate revenue to fund other tax reforms, and to compensate low-income households.

Broadening the VAT base. The UK has one of the narrowest VAT bases among OECD countries. Broadening the base by limiting the amount of consumption that qualifies for reduced and zero rates would be a move toward a more neutral tax system.

Corporation Tax

Though the corporation tax rate is quite competitive among developed countries, the UK has a corporate tax base that is ripe for reform. The UK should work to eliminate biases against investment, reinforce countercyclical policies, and evaluate targeted tax reliefs that can introduce a variety of distortions in behavior and economic activity.

Improving Treatment of Capital Investment.

Capital investment is a central driver of long-term growth, higher wages, and better jobs. The UK tax code is biased against new investment and particularly against equity-financed investments. A more neutral tax code would allow corporations to fully deduct the cost of their investments in the first year.

Building a Countercyclical Corporation Tax.

During times of economic stress, businesses can run serious losses. Limits on loss carryforwards increase the taxes that businesses pay when they become profitable again. Tax policy should not exacerbate the challenges that businesses face as they return to generating profits, and loss carryforwards should be uncapped.

Reviewing Targeted Business Tax Reliefs. The UK has numerous targeted tax reliefs embedded in its corporation tax code. These programs should be periodically reviewed to assess whether the return on investment is advisable relative to other uses of revenue.

International Tax Rules

The UK international tax system is broadly competitive given its territorial nature and the UK's wide network of tax treaties, the most extensive among OECD countries. However, the government's approach on the Digital Services Tax (DST) runs counter to global cooperation on efforts to reform international tax rules. The UK risks being part of a harmful tax and trade war with the DST as part of its efforts to raise tax from foreign multinationals. Narrow policies are ripe for distortions and the DST introduces several by both selectively taxing certain business models and basing the tax on gross revenues rather than profits.

Repeal the Digital Services Tax. The UK should reverse course on the DST and focus its work on an internationally agreed-upon solution for taxing multinational businesses rather than a narrow, distortive policy.

Comprehensive Reform

The UK has an opportunity to make reforms that will dramatically improve its competitiveness relative to major competitor countries. Most of our proposals can stand on their own, providing policymakers with discrete ways of improving the competitiveness of each element of the UK's tax code. Often, however, successful tax reform is more comprehensive in nature, which is not only good policy but often good politics, including additional stakeholders and facilitating a broader rebalancing of the tax system.

In some cases, moreover, comprehensive reform may be strictly necessary: reduced reliance on a counterproductive tax may require offsets elsewhere in the system. Therefore, while we intend this report to facilitate conversations about priorities within each tax type, it is also important to illustrate the ways that they can complement each other. A broader VAT base, for instance, would raise additional revenue, which could be used to pay for reforms to other taxes.

Below, we offer a comprehensive package of reforms—an aggressive overhaul of the country's tax system—with ideas drawn from the pages that follow. This is only one of many possible permutations, but it illustrates how a comprehensive plan could come together. We also offer projections for how the plan would improve the UK's ranking on the *International Tax Competitiveness Index*. Our reforms can be adjusted to be roughly revenue neutral although that neutrality will depend significantly on willingness to expand the VAT base.

The key theme running through these proposals is that they would improve the ability for businesses to take on new investments, individuals to keep more of what they earn, eliminate inequalities in the VAT system, and introduce new efficiency in UK property markets.

Policies for a More Competitive Tax System

Our preferred approach is a radical one that would require significant political will. It contemplates making business investment costs immediately deductible, making the UK the most competitive country in the G7 on its corporate tax base. It simplifies and cuts individual income tax while lowering dividend tax rates. This plan would also include a serious reform of the UK property tax system, removing distortive transaction taxes and shifting business rates to a site value basis. These reforms would be paid for by VAT base broadening.

Personal tax

- Eliminate the additional rate of income tax, returning to the two-band system that existed prior to 2010.
- Reduce dividend tax rates to fully reflect corporation tax. Basic-rate taxpayers would pay no tax on dividends; higher-rate taxpayers would face a 26 percent rate.

Property tax

- Overhaul business rates so that they are based on underlying site values.
- Abolish Stamp Duty Land Tax.
- Abolish stamp taxes on shares.

Consumption tax

- Reform the UK's VAT base so that it is as broad as the OECD average, while introducing measures to offset the impact on low-income households.

Corporation tax

- Remove the 50 percent limit on loss carryforwards.
- *Either* make the Annual Investment Allowance unlimited while introducing “neutral cost recovery” for structures and buildings.
- *Or* make the temporary £1m Annual Investment Allowance permanent while introducing neutral cost recovery for all other capital expenditure.

International tax

- Repeal the Digital Services Tax.

The above options would result in the following changes to UK’s rankings in the Tax Foundation’s *International Tax Competitiveness Index*, compared to the current system.

	Baseline	Reform
Overall Rank	22	9
Individual Taxes Rank	24	17
Property Taxes Rank	33	25
Consumption Taxes Rank	22	20
Corporation Tax Rank	17	7
International Tax Rules Rank	1	1

Our Objective

We hope these solutions contribute to the tax conversation in the UK by providing a framework upon which lawmakers and citizens can base future decisions. The reform options we present would ensure that the country builds a tax system for a diversified economy and positions itself as a destination for investment, entrepreneurs, and talented individuals in the years ahead.

CHAPTER 2

ECONOMIC SITUATION

KEY FINDINGS

- The UK economy is forecast to contract by as much as 14 percent due to the COVID-19 crisis.
- Capital investment has been a declining contributor to GDP growth in recent years.
- To overcome headwinds from COVID-19 and Brexit, the UK must work to build and maintain an internationally competitive tax system.

The United Kingdom—along with most countries around the world—has been experiencing a rapid decline in economic activity due to COVID-19. While GDP is estimated to plummet by 14 percent in 2020, unemployment rates are predicted to jump from 3.8 percent to 10.4 percent, leading to enormous economic challenges.¹⁰

Prior to COVID-19, the economic environment in the United Kingdom was one of modest growth and relatively low unemployment. However, investment levels have consistently been low in recent years, and political uncertainty—much of it connected with Britain’s exit from the European Union—has acted as a drag on economic growth.

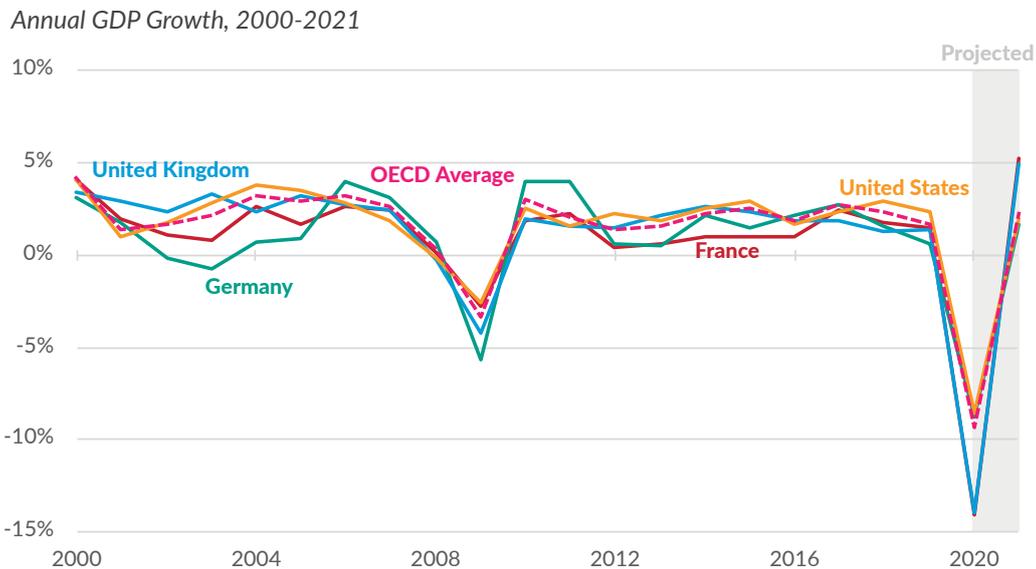
Economic Growth

COVID-19 has caused a sharp economic contraction in 2020, forecast at approximately 14 percent in the UK, and roughly 9 percent in the OECD at large. For 2021, current indicators predict economic growth rates of approximately 5 percent and 2 percent for the UK and the OECD, respectively.

Between 2000 and 2019, the United Kingdom’s economy experienced an average GDP growth rate of 1.8 percent, slightly below the OECD average of 2 percent.¹¹ Apart from the 2008-09 recession, GDP increased every year, growing the economy from £1.5 trillion in 2000 to £2.1 trillion in 2019.¹²

FIGURE 2.1

Between 2000 and 2019, the UK had an Average GDP Growth Rate of 1.8 Percent, Slightly Below the OECD Average of 2 Percent



Source: OECD, “Economic Outlook No 107 - June 2020 Double Hit Scenario: Gross domestic product, volume, growth,” <https://stats.oecd.org/Index.aspx?DataSetCode=EO>.

10 OECD, “Economic Outlook No 107 - June 2020 Double Hit Scenario: Gross domestic product, volume, growth,” <https://stats.oecd.org/Index.aspx?DataSetCode=EO>; and OECD, “Unemployment rate forecast,” <https://data.oecd.org/unemp/unemployment-rate-forecast.htm#indicator-chart>. The OECD provides estimates for two potential COVID-19 scenarios in the second half of 2020, namely a double-hit and a single-hit scenario. OECD estimates shown in this chapter represent the double-hit scenario, as that is the OECD’s default setting.

11 OECD, “Economic Outlook No 107 - June 2020 Double Hit Scenario: Gross domestic product, volume, growth.”

12 Office for National Statistics, “Gross Domestic Product: chained volume measures: Seasonally adjusted £m,” June 30, 2020, <https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/abmi/qna>.

Drivers of Economic Growth

Productivity is a key driver of economic growth and changes in living standards. Multifactor productivity (MFP) reflects the overall efficiency with which labour and capital inputs are used together in the production process. Changes in MFP reflect the effect of changes in factors such as adjustment costs, management practices, economies of scale, or imperfect competition.¹³

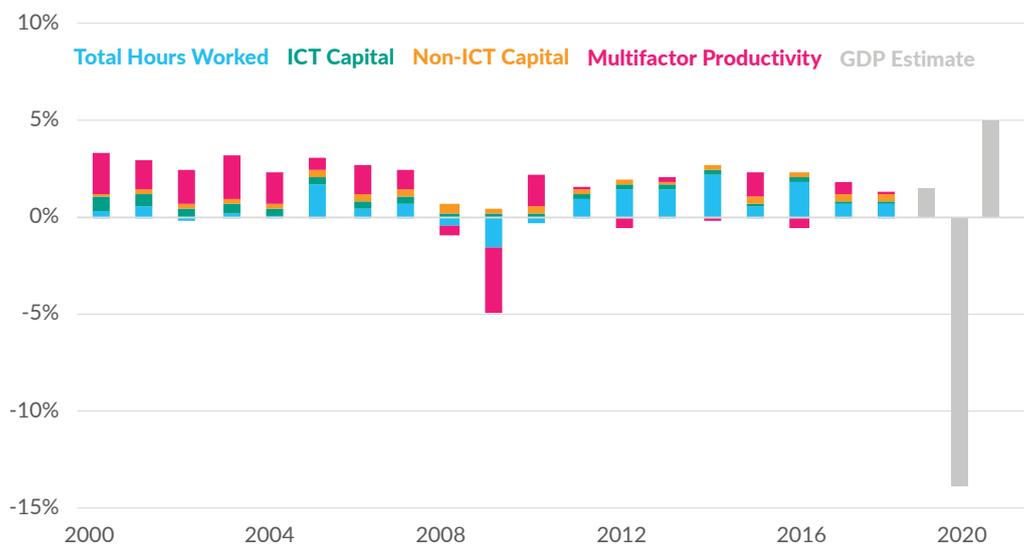
Between 2000 and 2007, in six out of eight years more than half of GDP growth could be attributed to increases in MFP. During the same time period, increases in labour input (total hours worked) made only slight positive contributions to GDP growth. Following the 2009 recession, however, increases in total hours worked in the UK have accounted substantially for GDP growth. Germany and the

United States have seen a similar development for labour input—small positive contributions to GDP prior to the 2009 recession, followed by an uptick over the last decade.¹⁴

The contribution of capital investment to UK GDP growth has been on a downward trend, declining from 0.9 percent in 2000 to 0.5 percent in 2018, with on average higher contributions to GDP prior to the 2009 recession relative to the decade that followed. France, Germany, and the United States have also experienced an on average lower contribution of capital investment to GDP growth following the 2009 recession.

While information and communication technology (ICT) investment in the UK accounted for more than half of total capital investment's contribution to GDP growth before the recession, non-ICT investment has played

FIGURE 2.2
Drivers of GDP Growth in the UK
Decomposition of Real Annual GDP Growth, 2000-2018



Note: Due to COVID-19 extraordinary uncertainty, the OECD's Economic Outlook presents two possible scenarios, one scenario in which a second outbreak occurs in most economies towards the end of this year (double-hit scenario) and an alternative scenario where the second outbreak is avoided (single-hit scenario). The outlook data used in this chart is based on the double-hit scenario.
Source: Years 2000-2018: OECD, "Growth in GDP per capita, productivity and ULC: Contributions to GDP Growth," updated May 2020, https://stats.oecd.org/Index.aspx?DataSetCode=PDB_GR#; and years 2019-2021: OECD, "Economic Outlook No 107 - June 2020 Double Hit Scenario," <https://stats.oecd.org/Index.aspx?DataSetCode=EO>.

13 OECD, "Multifactor productivity," <https://data.oecd.org/lprdy/multifactor-productivity.htm>.

14 France shows less of a clear pattern for labour input's contribution to GDP growth between 2000 and 2018.

the more significant role in recent years. A similar development took place in Germany. In France, however, ICT investment has become relatively more important following the 2009 recession, and the United States has seen little change in ICT vs. non-ICT investments' relative contribution to GDP growth.¹⁵

Investment

In the long run, the growth capacity of an economy is strongly related to the accumulation of a productive capital stock.¹⁶ The capital stock grows when individuals and companies invest in machines, buildings, and technology that make their work more productive. As these assets can degrade or become less productive over time, investment is necessary to replace or update them.

In 2019, investment accounted for only 17 percent of GDP in the UK, the third lowest share in the OECD (only Greece and Lithuania have

a lower share) and 5 percentage points lower than the OECD average of 22 percent.¹⁷ Over the last two decades, investment as a share of GDP has consistently been substantially lower than in France, Germany, and the United States, and below the OECD average.

Labour Market

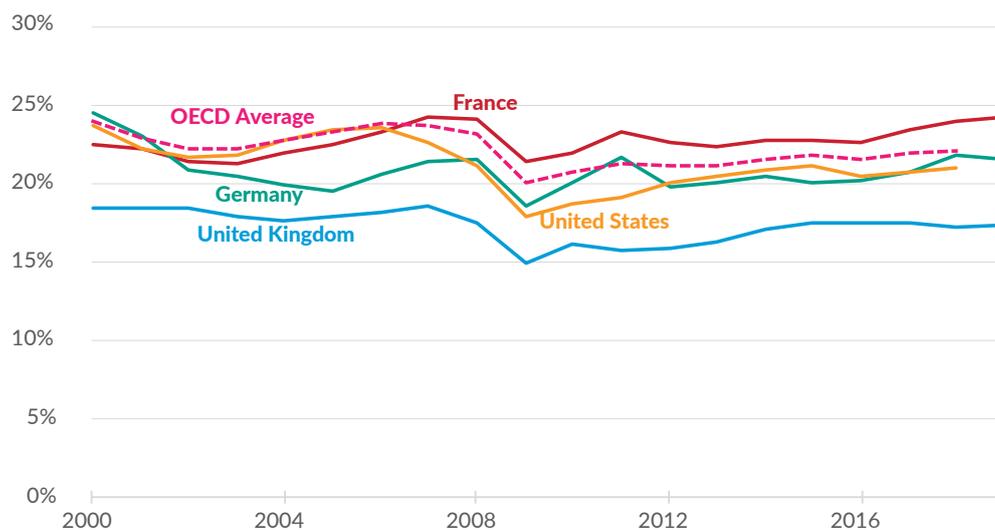
One of the immediate effects of COVID-19 has been a rapid rise in unemployment. It remains to be seen whether the unemployment picture will worsen significantly as economic support measures (such as the furlough scheme) are wound down, or whether improvements in the public health situation will facilitate a rapid bounce-back in employment.

Prior to COVID-19, however, the United Kingdom had been seeing a steadily rising labour force participation rate, unemployment rates below 5 percent, and stagnant real wage growth.

FIGURE 2.3

Over the Last Two Decades, UK Investment as a Share of GDP has been Lower than in France, Germany, the U.S., and the OECD Average

Investment as a Percent of GDP, 2000-2019



Source: World Bank, "Gross capital formation (% of GDP)," <https://data.worldbank.org/indicator/NE.GDI.TOTL.ZS>.

15 OECD, "Growth in GDP per capita, productivity and ULC: Contributions to GDP Growth," updated May 2020, https://stats.oecd.org/Index.aspx?DataSetCode=PDB_GR#.

16 Philippe Aghion, and Peter Howitt, "Some Thoughts on Capital Accumulation, Innovation, and Growth," *Annals of Economics and Statistics*, 125/126 (June 2017): 57-78, https://www.jstor.org/stable/10.15609/annaeconstat2009.125-126.0057#metadata_info_tab_contents.

17 World Bank, "Gross capital formation (% of GDP) - United Kingdom, OECD members," https://data.worldbank.org/indicator/NE.GDI.TOTL.ZS?locations=GB-OE&most_recent_value_desc=false.

Employment

The labour force participation rate, measured as the sum of all workers who are employed or actively seeking employment divided by the working-age population, identifies the relative amount of labour resources available to produce goods and services in an economy. A growing share of working-age individuals that are part of the labour force positively impacts economic growth.¹⁸

In 2019, the labour force participation rate of prime-age labour (25 to 54 years old) stood at 86.7 percent, above the United States (82.5 percent) and the OECD average (82.8 percent) but below Germany (88.0 percent) and France (87.4 percent). The prime-age labour force participation rate has been rising steadily over the last two decades, starting at 83.9 percent in 2000.¹⁹

Unemployment

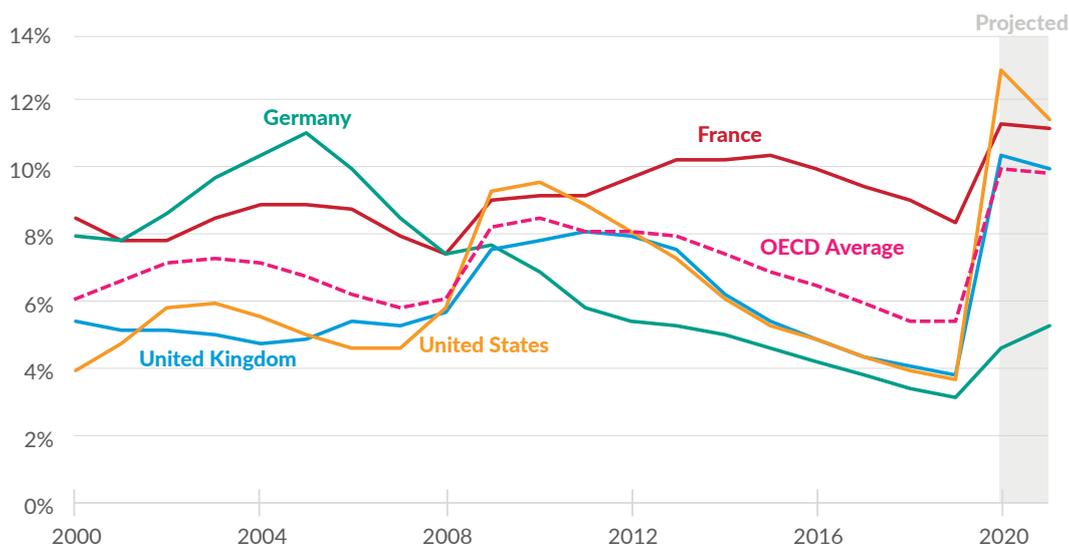
The unemployment rate signals that not all labour force participants are currently able to find work. The OECD estimates that the unemployment rate will continue to rise throughout 2020 due to COVID-19, reaching 14.8 percent in the fourth quarter of the year. Projections for 2021 indicate a decline in unemployment to 10 percent—close to the OECD average of 9.9 percent but considerably higher than pre-crisis levels.

Between 2000 and the start of the recession in 2008, unemployment was relatively stable at an average rate of 5.2 percent of the labour force. After peaking in 2011, it had been declining every year from 8.1 percent in 2011 to 3.8 percent in 2019.

FIGURE 2.4

In the Past Two Decades the UK Unemployment Rate has Generally Been Below the OECD Average

Percent of Labour Force Unemployed, 2000-2021



Source: OECD, "Unemployment rate forecast," <https://data.oecd.org/unemp/unemployment-rate-forecast.htm#indicator-chart>.

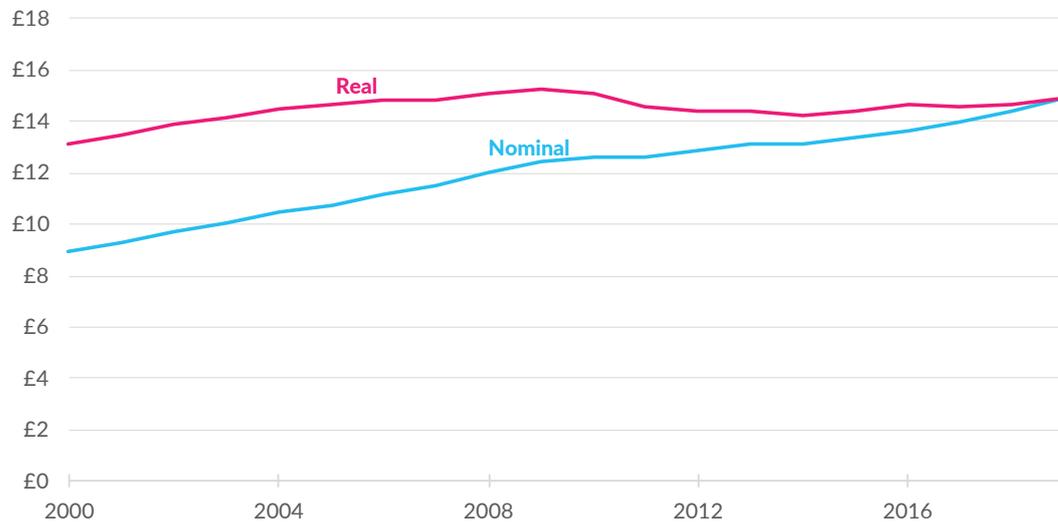
18 Michael Dotsey, Shigeru Fujita, and Leena Rudanko, "Where Is Everybody? The Shrinking Labor Force Participation Rate," Federal Reserve Bank of Philadelphia, *Economic Insights* Q4 (2017): 17-24, https://www.philadelphiafed.org/-/media/research-and-data/publications/economic-insights/2017/q4/eiq4_where-is-everybody.pdf?la=en.

19 OECD, "LFS by sex and age - indicators," https://stats.oecd.org/viewhtml.aspx?datasetcode=LFS_SEXAGE_I_R&lang=en.

FIGURE 2.5

Nominal Hourly Wages Increased from 2000-2019, While Real Wages have been Either Declining or Stagnating in the Last Ten Years

Real and Nominal Median Gross Hourly Earnings for Full-Time Employees, 2000-2019



Note: The data have been adjusted for inflation using the Consumer Prices Index, including owner occupiers' housing costs (CPIH).
Source: Office for National Statistics, "Annual Survey of Hours and Earnings time series of selected estimates," Oct. 29, 2019,
<https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/ashe1997to2015selectedestimates>.

Wage Growth

In 2019, median hourly earnings grew by 3.5 percent in nominal terms to £14.88, which translates to a 1.5 percent increase in real terms. While nominal hourly wages have been increasing throughout the last two decades, real wages have been either declining or stagnant for most of the last 10 years.

Government Debt

According to the Office for Budget Responsibility, substantial revenue shortfalls combined with a sharp increase in spending due to COVID-19 will—depending on various factors—likely lift debt above 100 percent of GDP.²⁰

During the financial crisis, government debt doubled from 41.5 percent of GDP in 2007 to 80.1 percent of GDP in 2011. Between 2012

and the first quarter of 2020, the ratio remained relatively stable at around 85 percent of GDP.

At 85 percent of GDP, the UK's government debt stood above the EU average of approximately 80 percent in 2019.²¹

Government debt first exceeded the 60 percent Maastricht reference value in 2009, when it reached 63.3 percent of GDP.²²

Trade, FDI, and Brexit

Openness to trade and investment strengthens the productive potential of an economy. COVID-19 has led to a collapse in global trade. Global merchandise trade is estimated to have fallen by 5 percent in the first quarter of 2020, followed by a 27 percent drop in the second quarter. Forecasts show an annual decline of approximately 20 percent for 2020.²³

20 Office for Budget Responsibility, "Fiscal sustainability report," July 2020, https://cdn.obr.uk/OBR_FSR_July_2020.pdf.

21 Eurostat, "General government gross debt - quarterly data," last updated July 22, 2020, <https://ec.europa.eu/eurostat/databrowser/view/teina230/default/table?lang=en>.

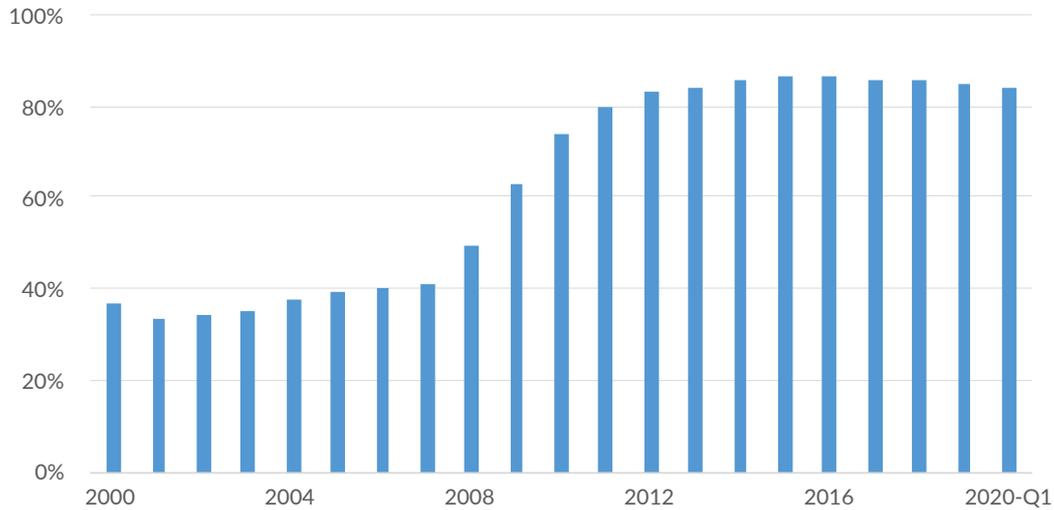
22 Office for National Statistics, "GG Gross consolidated debt as a percentage of GDP (Maastricht ESA 10)," July 17, 2020, <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicspending/timeseries/yeqj/edp1>.

23 UNCTAD, "Global trade continues nosedive, UNCTAD forecasts 20% drop in 2020," June 11, 2020, <https://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=2392>.

FIGURE 2.6

From 2000 to 2012 UK Government Debt as a Percentage of GDP More than Doubled

General Government Gross Consolidated Debt as % of GDP (Maastricht ESA 10)



Source: Office for National Statistics, "GG Gross consolidated debt as a percentage of GDP (Maastricht ESA 10)," July 17, 2020, <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicspending/timeseries/yeqj/edp1>.

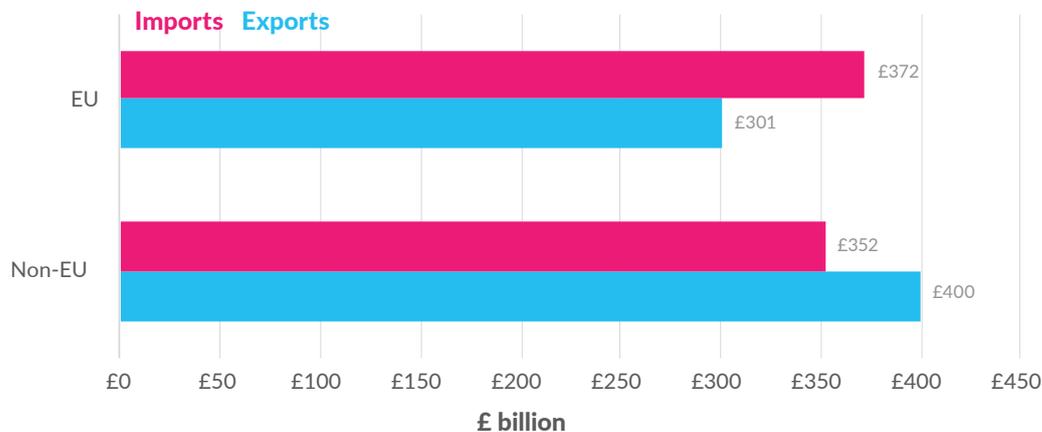
The negative economic effects of this significant decline in global trade could be compounded for the UK if the Brexit negotiations result in higher trade barriers. Since the United Kingdom joined the European Communities (a predecessor of the European Union) in 1973, close economic

ties have been built between the UK and the EU. In 2019, the UK exported £301 billion in goods and services to the EU and imported £372 billion, making the EU the UK's most important trade partner at 43 percent of all exports and 51 percent of all imports.²⁴

FIGURE 2.7

The EU is the UK's most important trade partner at 43 percent of all exports and 51 percent of all imports

UK Trade in Goods and Services, 2019



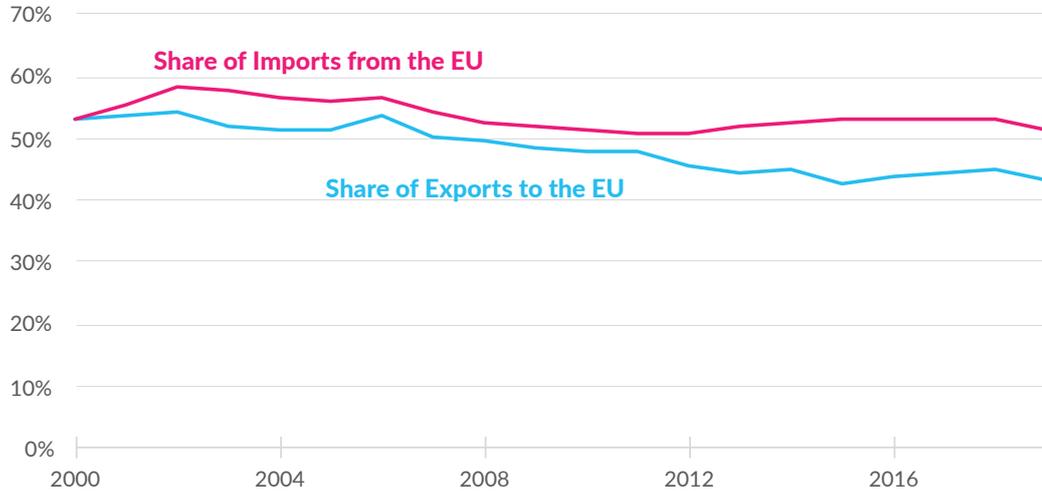
Source: Office for National Statistics, "Balance of payments," June 30, 2020, <https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/datasets/balanceofpaymentsstatisticalbulletintables>.

24 Office for National Statistics, "Balance of payments," June 30, 2020, <https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/datasets/balanceofpaymentsstatisticalbulletintables>.

FIGURE 2.8

From 2000 to 2019, the Share of Total Exports and Imports with the EU Declined 10 and 2 Percent Respectively

Share of Trade in Goods and Services with the EU, 2000-2019



Source: Office for National Statistics, "UK total trade: all countries, non-seasonally adjusted," July 23, 2020, <https://www.ons.gov.uk/businessindustryandtrade/internationaltrade/datasets/uktotaltradeallcountriesnonseasonallyadjusted>.

However, over the last two decades, trade in goods and services with non-EU countries has been growing in importance. Between 2000 and 2019, the share of total exports going to the EU declined from 53.2 percent to 42.9 percent, and the share of imports from the EU is down by 2 percentage points as well, from 53.3 percent in 2000 to 51.4 percent in 2019.²⁵

The interconnectedness of the EU and UK economy is also reflected in their foreign direct investment (FDI) positions. In 2018, FDI positions from the EU made up 38 percent of all FDI positions in the UK and 43 percent of all UK FDI positions abroad were in the EU.²⁶ These FDI positions do not suggest any major change since the Brexit referendum in 2016.

Overall, the UK economy faces significant headwinds in the coming years—not just from the fallout from COVID-19, or the political economy challenges inherent in Brexit, but also from longstanding weaknesses on capital investment, real wages, and productivity growth. In this context, maintaining an internationally competitive tax system—one that attracts business, talent, and investment—is all the more important.

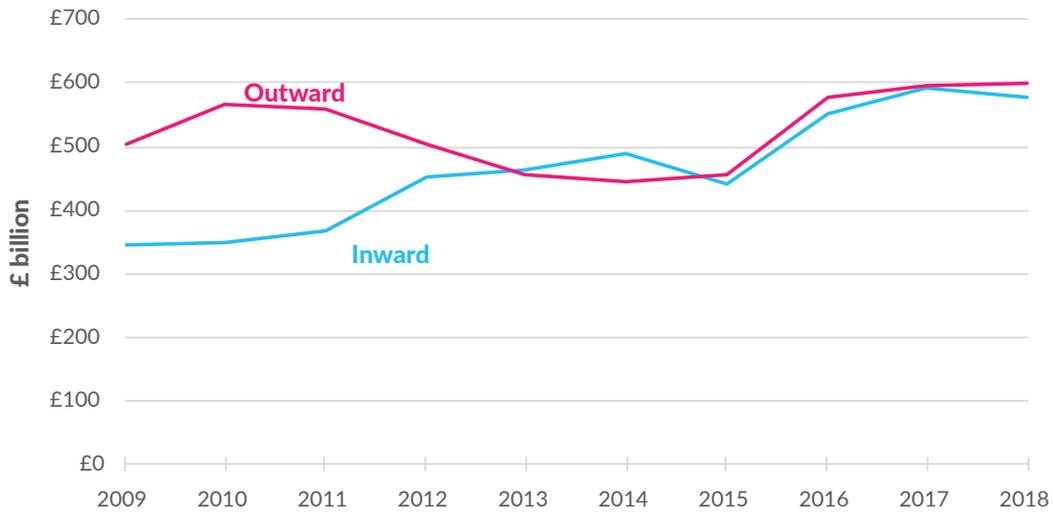
25 Office for National Statistics, "UK total trade: all countries, non-seasonally adjusted," July 23, 2020, <https://www.ons.gov.uk/businessindustryandtrade/internationaltrade/datasets/uktotaltradeallcountriesnonseasonallyadjusted>.

26 Office for National Statistics, "Foreign direct investment involving UK companies: inward," Feb. 6, 2020, <https://www.ons.gov.uk/businessindustryandtrade/business/businessinnovation/datasets/foreigndirectinvestmentinvolvingukcompanies2013inwardtables>; and "Foreign direct investment involving UK companies: outward," Feb. 6, 2020, <https://www.ons.gov.uk/businessindustryandtrade/business/businessinnovation/datasets/foreigndirectinvestmentinvolvingukcompaniesoutwardtables>.

FIGURE 2.9

Between 2016 and 2018, Inward FDI Positions from the EU and Outward FDI Positions to the EU have Been Relatively Stable

UK's FDI Investment Positions from and in the EU, 2009 to 2018



Source: Office for National Statistics, "Foreign direct investment involving UK companies: outward," Feb. 6, 2020, <https://www.ons.gov.uk/businessindustryandtrade/business/businessinnovation/datasets/foreigndirectinvestmentinvolvingukcompaniesoutwardtables>; and "Foreign direct investment involving UK companies: inward," Feb. 6, 2020, <https://www.ons.gov.uk/businessindustryandtrade/business/businessinnovation/datasets/foreigndirectinvestmentinvolvingukcompanies2013inwardtables>.

CHAPTER 3

SOURCES OF REVENUE AND COMPETITIVENESS

KEY FINDINGS

- Overall, the UK ranks 22nd out of 36 OECD countries on the 2020 *International Tax Competitiveness Index*.
- Nearly half of UK tax revenue is raised from individual income taxes and national insurance contributions.
- Tax revenues have fallen significantly due to COVID-19, with VAT receipts falling the most.

Sources of Revenue

The UK collected £735 billion in taxes (including national insurance contributions, or NICs) during the tax year 2018-19. Individual income taxes accounted for the largest share, at 27.4 percent of all tax collections. NICs and other payroll taxes and VAT were the second and third largest sources of government revenue, at 19.0 percent and 18.1 percent, respectively. Property taxes made up 11.9 percent of total tax revenue. Excise and environmental taxes and corporate taxes accounted for 10.7 percent and 8.1 percent, respectively.²⁷

A comparison of 2018-19 and 1999-2000 tax revenue sources shows that the reliance on individual income taxes and property taxes, measured as a share of total tax revenue, has seen little change. However, there has been

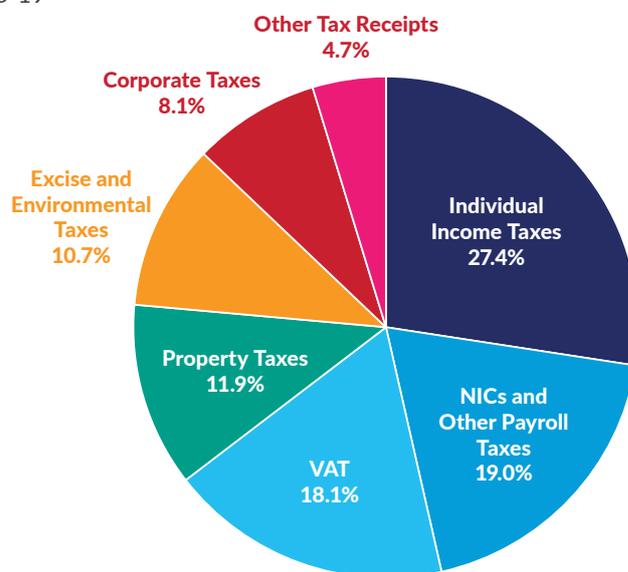
a relative shift from corporate and excise and environmental tax receipts to revenue from NICs and VAT.

Over the last two decades, the tax-to-GDP ratio has seen relatively small fluctuations, hovering around 32 percent. In tax year 2018-19, tax revenues as a share of GDP stood at 34.0 percent, compared to 31.8 percent in 1999-2000.²⁸

COVID-19 and its economic implications have had a significant impact on tax receipts. Total tax collections between April and July 2020 were £66.4 billion—or 30.7 percent—lower than in the same period in 2019. Following a VAT payment deferral policy enacted in March 2020, VAT collections have seen the sharpest decline, at 77.5 percent. Corporate tax collections have also declined significantly, at 42.4 percent.

FIGURE 3.1
UK Sources of Tax Revenue

Tax Year 2018-19



Source: HM Treasury, "Budget 2020: documents," Mar. 11, 2020, <https://www.gov.uk/government/publications/budget-2020-documents>.

27 HM Treasury, "Budget 2020: documents," Mar. 11, 2020, <https://www.gov.uk/government/publications/budget-2020-documents>. "Individual Income Taxes" includes Income Tax and Capital Gains Tax; "NIC and Other Payroll Taxes" includes National Insurance Contributions (NIC) and Apprenticeship Levy; "Corporate Taxes" includes Corporation Tax, Bank Levy, Bank Surcharge, Petroleum Revenue Tax, and Digital Services Tax (zero for 2018-19); "VAT" includes Value-Added Tax (VAT); "Excise and Environmental Taxes" includes Fuel Duties, Tobacco Duties, Alcohol Duties, Air Passenger Duty, Insurance Premium Tax, Climate Change Levy, Soft Drinks Industry Levy, Vehicle Excise Duties, Licence Fee Receipts, Environmental Levies, and EU ETS Auction Receipts; "Property Taxes" includes Business Rates, Council Tax, Inheritance Tax, Property Transaction Taxes, and Stamp Taxes on Shares; and "Other Tax Receipts" includes VAT Refunds, Other HMRC Taxes, and Other Taxes.

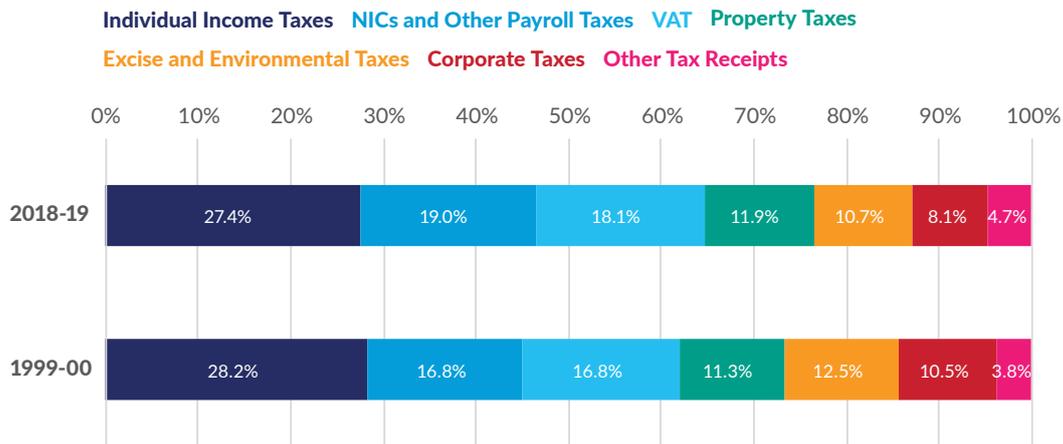
28 Ibid.; HM Treasury, "Budget: March 2001," Mar. 7, 2001, <https://www.gov.uk/government/publications/budget-march-2001>; and Office for National Statistics, "GDP - data tables," Aug. 12, 2020, <https://www.ons.gov.uk/economy/grossdomesticproductgdp/datasets/uksecondestimateofgdpdatatables>.

Although to a lesser extent, revenue from individual income taxes and NICs and

other payroll taxes has also contracted, at 15.3 percent and 8.0 percent, respectively.²⁹

FIGURE 3.2
Individual Income Taxes and Property Taxes as a Share of Total Tax Revenue Have Seen Little Change while NICs and VAT Increased

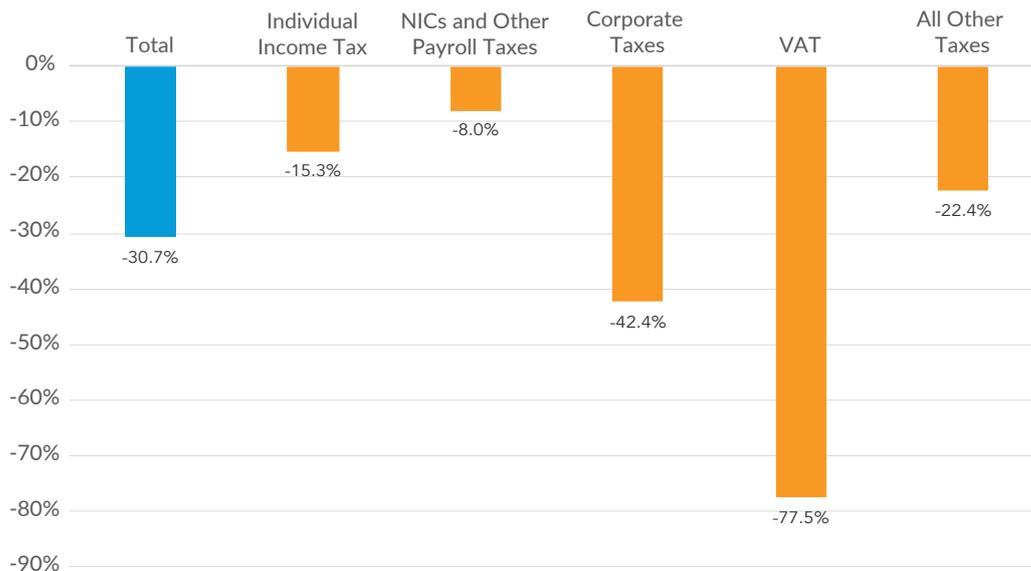
UK Tax Revenue Sources, 2018-19 and 1999-00



Source: HM Treasury, "Budget 2020: documents," Mar. 11, 2020, <https://www.gov.uk/government/publications/budget-2020-documents>; and HM Treasury, "Budget: March 2001," Mar. 7, 2001, <https://www.gov.uk/government/publications/budget-march-2001>.

FIGURE 3.3
UK Tax Revenues Have Fallen Significantly due to COVID-19

UK Tax Receipts in April-July 2020 Compared to April-July 2019



Source: HM Revenue & Customs, "HMRC tax receipts and National Insurance contributions for the UK/Tax and NIC receipts: statistics table (July 2020)," Aug. 21, 2020, <https://www.gov.uk/government/statistics/hmrc-tax-and-nics-receipts-for-the-uk>.

29 HM Revenue & Customs, "HMRC tax receipts and National Insurance contributions for the UK/Tax and NIC receipts: statistics table (July 2020)," National Statistics, Aug. 21, 2020, <https://www.gov.uk/government/statistics/hmrc-tax-and-nics-receipts-for-the-uk>. Importantly, the HMRC statistics used to calculate these numbers do not include the council tax, business rates, and certain other types of taxes. The tax categories are grouped as follows: "Individual Income Taxes" includes Total Income Tax and Capital Gains Tax; "NIC and Other Payroll Taxes" includes National Insurance Contributions (NIC) and Apprenticeship Levy; "Corporate Taxes" includes Total Corporation Tax, Bank Levy, Bank Surcharge, and Petroleum Revenue Tax, and Diverted Profits Tax; "VAT" includes Value-Added Tax (VAT); and "All Other Taxes" includes Hydrocarbon Oil (Fuel Duties), IHT, Shares, Stamp Duty Land Tax, Annual Tax on Enveloped Dwellings, Tobacco Duties, Spirits Duties, Beer Duties, Wines Duties, Cider Duties, Betting & Gaming, Air Passenger Duty, Insurance Premium Tax, Landfill Tax, Climate Change Levy, Aggregates Levy, Soft Drinks Industry Levy, Swiss Capital Tax, Misc, Customs Duties, and Penalties.

Taxes and Competitiveness

The structure of a tax system impacts its competitiveness and, in turn, economic efficiency and growth prospects.³⁰ Growth-oriented tax regimes avoid discouraging the supply of labour and investment and thus minimize the economic distortions taxes cause. Central to such an approach are relatively low marginal tax rates on the returns of labour and investment and a neutral tax treatment across industries and income sources.

As trade and capital markets have become increasingly open over the last decades, the relative attractiveness of each country's tax system and how it interacts with tax systems of other jurisdictions has also become more important. Since cross-border investors generally consider after-tax returns (instead of pretax returns), tax regimes and tax rates can impact decisions on the location of investment and production.

International Tax Competitiveness Index

The Tax Foundation's *International Tax Competitiveness Index (ITCI)* attempts to incorporate these concepts, ranking OECD countries on five areas of tax policy—corporate income, individual income, consumption, property, and international tax rules. The *ITCI*'s ranking is an assessment of whether tax policies in these areas are neutral and competitive and thus promote sustainable economic growth and investment while raising sufficient revenue for government priorities.

Among 36 OECD countries, the United Kingdom ranks 22nd overall in the 2020 edition of the *ITCI*. There are multiple measures that could make its tax system more competitive and neutral, including better tax treatment of capital

investment, a broader VAT base, and a simplified property tax system. These, and many other options, will be explored in more detail in this report.

After climbing three spots in 2019, the UK's rank fell by one spot in 2020. Many of the shifts since 2014³¹ reflect policy changes—such as lowering the corporate income tax rate, limiting loss carryforwards, reinstating a capital allowance for buildings, changing capital gains and dividends tax rates, and introducing new international tax rules. Other changes from year to year are due to various OECD countries changing their policies while the UK maintained the status quo in a policy area.

Tax Complexity

While policy decisions about the tax structure can influence individual and business decisions, tax complexity can also have an impact. Low administrative burdens require less time and resources spent on tax compliance, allowing them to be invested more productively.

The *Tax Complexity Index*, developed by academics at Paderborn University and the University of Munich, measures the complexity of a country's corporate tax system. The index compares the complexity of the tax code (complexity inherent in different tax regulations) and the complexity of the tax framework (complexity that arises from the features and processes of a tax system) of 100 countries around the world.

According to the *Tax Complexity Index*, the UK ranks 43rd overall, with subcategory ranks of 65 and 19 for the complexity of the tax code and the complexity of the tax framework, respectively. By comparison, France ranks 67th overall (89th on tax code complexity and 31st

30 OECD, "What is a Competitive Tax System?" June 30, 2011, <https://www.oecd.org/ctp/48193714.pdf>.

31 The *International Tax Competitiveness Index (ITCI)* was first published in 2014.

TABLE 3.1

UK's Rank on the *International Tax Competitiveness Index*

Year	Overall Rank	Corporate Tax Rank	Income Taxes Rank	Consumption Tax Rank	Property Taxes Rank	International Tax Rules Rank
2014	18	21	21	21	33	2
2015	20	17	25	22	32	2
2016	20	17	27	22	32	2
2017	23	19	23	22	32	3
2018	24	17	24	21	33	4
2019	21	16	23	22	33	1
2020	22	17	24	22	33	1

Note: Blue cells reflect an improvement over the prior year's ranking, and red cells reflect a lower ranking relative to the prior year.
Source: Tax Foundation, *International Tax Competitiveness Index 2020*.

on tax framework complexity), Germany ranks 54th overall (63rd on tax code complexity and 33rd on tax framework complexity), and the United States ranks 53rd overall (79th on tax code complexity and 21st on tax framework complexity).³²

32 Thomas Hoppe, Deborah Schanz, Susann Sturm, and Caren Sureth-Sloane, "Global MNC Tax Complexity Index," Paderborn University and University of Munich, 2016, <https://www.taxcomplexity.org/>.

CHAPTER 4

PERSONAL INCOME TAXES

KEY FINDINGS

- The UK ranks 24th out of 36 OECD countries on the 2020 *International Tax Competitiveness Index's* measure of personal income taxation.
- The piecemeal approach that governments have taken to reforming personal income taxes has resulted in a system with little overall coherence and efficiency.
- To improve the competitiveness of the UK's personal tax system, policymakers should abolish the additional rate of income tax and reduce tax rates on dividends to reflect taxes already paid at the business level.

Taxes on personal income make up one of the most significant parts of the UK tax system. They consistently raise more than 45 percent of total tax revenue, equivalent to about 15 percent of GDP.³⁰

Personal income taxes are also the most visible element of the tax system to ordinary taxpayers. This makes them subject to sustained political and media attention and—perhaps not coincidentally—frequent government tinkering.

At the same time, the level and structure of personal income taxes can have a significant impact on a country's competitiveness and economic growth prospects. Poorly designed personal income taxes tend to discourage work, saving, and investment. Good tax systems aim to avoid having these effects.

One notable feature of the UK tax system in general—and of its taxation of personal income in particular—is that it has developed piecemeal over time, budget-by-budget, with seemingly little thought given to its overall coherence and efficiency. The time may now be ripe for a more comprehensive approach to reform.

With that in mind, this chapter reviews the UK's personal income tax system and compares it with those of other OECD countries. It also details a range of policies aimed squarely at boosting the UK's international tax competitiveness.

An Overview of Personal Income Taxes in the United Kingdom

There are three main taxes on personal income in the UK: income tax; capital gains tax; and National Insurance. This section will outline the main characteristics of each tax in turn.

Income Tax

The UK has a progressive income tax, with three rates over a generous personal allowance. For 2020-21, the personal allowance stands at £12,500. Income within this allowance is not subject to income tax. The next £37,500 of income (up to the “basic rate limit”) is taxed at 20 percent. Beyond that point, income up to £150,000 is taxed at the higher rate, 40 percent. Finally, income over £150,000 is taxed at the 45 percent additional rate.

TABLE 4.1
Income Tax Rates, 2020-21

Tax Band	Income (£)	Tax Rate (%)
Personal Allowance	0–12,500	0
Basic Rate	12,500–50,000	20
Higher Rate	50,000–150,000	40
Additional Rate	150,000+	45

Source: Gov.uk, “Income Tax rates and Personal Allowances.”

However, there is one complication that Table 4.1 fails to capture. Since April 2010, the personal allowance has been tapered for high earners, so that you lose £1 of personal allowance for every £2 you earn over £100,000. In effect, this withdrawal of the personal allowance creates an extra tax band of 60 percent on income between £100,000 and £125,000.

Income tax also applies to savings interest. Taxable savings interest sits “on top” of earned income and is taxed at the applicable marginal rate. However, depending on your overall income, you will be able to exclude some portion of your savings interest from income tax.

People with incomes below £17,500 benefit from the “starting rate for savings.” This is a £5,000 tax-free allowance that is tapered by £1 for every £1 of income over the personal

30 Based on figures from OECD.Stat, “Revenue Statistics - OECD countries: Comparative tables,” <https://stats.oecd.org/Index.aspx?DataSetCode=REV>.

allowance. In addition, the “personal savings allowance” lets basic rate (20 percent) taxpayers exclude £1,000 of savings interest from income tax. Higher rate taxpayers can exclude £500, while additional rate taxpayers must pay income tax on all savings interest.

Dividend income in excess of £2,000 per year (the dividend allowance) is also subject to income tax. As with savings, dividends sit on top of earned income. The tax bands are the same. But in this case the applicable marginal rates are different: the basic rate is 7.5 percent, the higher rate is 32.5 percent, and the additional rate is 38.1 percent.

Capital Gains Tax

A capital gain occurs when you dispose of an asset that has increased in value since you acquired it. Capital gains tax (CGT) applies to the difference between the acquisition value and the disposal value. In the UK, CGT applies to most financial and business assets, to most personal possessions worth £6,000 or more, and to real property other than your primary residence.

In 2020-21, the first £12,300 of realised capital gains are tax-free. Capital gains beyond this “annual exempt amount” are subject to CGT. If you are already a higher or additional rate income taxpayer, then your capital gains are taxed at 20 percent (or 28 percent for gains from residential property). Any capital gains that fall within a taxpayer’s basic rate income tax band (once added to other taxable income) will be taxed at 10 percent (or 18 percent on residential property).

In addition, any realised capital *losses* can be used to reduce your taxable capital gains. If the claimed losses reduce your taxable gain to below the annual exempt amount, then any “unused” losses can be carried forward

indefinitely and used to reduce future taxable capital gains. The UK no longer accounts for inflation when calculating capital gains or losses.

Finally, business owners who meet certain eligibility criteria may be able to take advantage of business asset disposal relief (known as entrepreneurs’ relief until April 6, 2020) when they sell all or part of their business. This reduces the applicable CGT rate to 10 percent.

National Insurance

Despite the name, National Insurance has very little to do with “insurance” as the term is commonly understood. Rather, it is a tax on earnings from employment and self-employment. It does not apply to income from savings and investment, and it is not paid by people over the state pension age (currently 66 but set to rise in the future).

Employees pay National Insurance at a rate of 12 percent on weekly earnings between £183 and £962 (£792 to £4,167 per month), and at 2 percent above that. Employers pay National Insurance at a flat rate of 13.8 percent on weekly earnings in excess of £169 (£732 per month).

Strangely, while income tax is levied on an annual, cumulative, aggregate basis, National Insurance Contributions (NICs) are worked out per-employment and per-pay period. Hence the weekly and monthly earnings bands above. For ease of comparison, however, National Insurance is often talked about in annualised terms—as displayed in Table 4.2 on the following page.

TABLE 4.2
National Insurance Contribution Rates, 2020-21

Earnings (£)	Employee NICs (%)	Employer NICs (%)
0–8,785	0	0
8,785–9,500	0	
9,500–50,000	12	13.8
50,000+	2	

Source: Gov.uk, “Rates and allowances: National Insurance Contributions.”

For the self-employed, the system is slightly different. They pay NICs at 9 percent on profits between £9,500 and £50,000, and at 2 percent above that. In addition, people with annual self-employment profits above £6,475 pay Class 2 NICs at a rate of £3.05 per week. Nothing equivalent to employer NICs is levied on the self-employed. This means that, overall, National Insurance taxes employment much more heavily than self-employment.

A taxpayer’s NIC record is used to determine eligibility for certain benefits—by far the most important of which is the state pension. In general, however, the link between NICs and benefits is weak. National Insurance operates much more as a second income tax than it does as a contribution-based social insurance scheme.

The Structure of Marginal Tax Rates on Earnings

If you ask the average Briton what tax rate they pay, chances are that they will tell you they are a 20p, 40p, or 45p taxpayer. These numbers relate to the basic, higher, and additional rates of income tax. But as we have seen, the complexity of the UK’s personal income tax system means that few people are likely to face those precise marginal rates.

Even a full-time employee with no other source of income must factor in National Insurance as well as income tax. And that includes the NICs paid by the employer: the true burden—or economic incidence—of the tax is faced by workers.³¹ As with other payroll taxes, employer NICs are simply a cost associated with employment that serves to lower take-home pay.

Table 4.3 summarises the structure of marginal tax rates faced by British employees, taking account of the withdrawal of the personal allowance and both parts of National Insurance.

Predictably, reality is even more complicated than this table suggests, since there are numerous tax and benefit measures that can cause effective marginal tax rates to spike, seemingly at random, at particular levels of earnings.³² Nonetheless, the structure of marginal tax rates outlined in Table 4.3 should serve to convey the essential character of the UK’s approach to personal income taxes.

Recent Developments and Current Controversies

Over the last decade, the signature personal tax policy of the UK government has been to repeatedly raise the personal allowance by far more than the rate of inflation. The coalition government that took office in 2010 inherited a £6,475 personal allowance; as of April 2019, that

31 Stephen J. Entin, “Tax Incidence, Tax Burden, and Tax Shifting: Who Really Pays the Tax?” Institute for Research on the Economics of Taxation, Sept. 10, 2004, <https://files.taxfoundation.org/iret/BLTN-88.PDF>.

32 See Tom Clougherty, “Make Work Pay,” Centre for Policy Studies, Nov. 6, 2018, <https://www.cps.org.uk/research/make-work-pay>.

TABLE 4.3

Combined Income Tax and National Insurance Rates, 2020-21

Earnings (£)	Effective rate of income tax (%)	Effective rate of income tax plus employee NICs (%)	Effective rate of income tax plus employee and employer NICs (%)
0–8,785	0	0	0
8,785–9,500	0	0	12.1
9,500–12,500	0	12	22.7
12,500–50,000	20	32	40.2
50,000–100,000	40	42	49
100,000–125,000	60	62	66.6
125,000–150,000	40	42	49
150,000+	45	47	53.4

Source: Gov.uk; author calculations.

same allowance stood at £12,500. Between the 2010-11 and 2018-19 tax years, the personal allowance rose by 53 percent in real terms, taking more than five million low earners out of the income tax net.³³

All things being equal, a rise in the personal allowance will give a greater cash benefit to higher and additional rate taxpayers than to basic rate taxpayers. If you reduce by £1,000 the taxable income of someone paying a 40 percent marginal rate, they gain £400; for someone paying 20 percent, the gain is only £200.

For the most part, however, this did not occur in the UK, since the basic rate limit was reduced as the personal allowance was increased. Moreover, the £100,000 threshold for withdrawal of the personal allowance and the £150,000 threshold for the additional rate of income tax are fixed in nominal terms, responding neither to inflation nor to changes in the personal allowance.

Naturally, the political desire to prevent higher earners from benefiting “too much” from a rising personal allowance has had policy consequences of its own. The UK had already experienced a long period of “fiscal drag,” whereby income tax thresholds rose more slowly than incomes, with the result that an increasing share of taxpayers found themselves paying higher marginal rates of tax.³⁴ These measures compounded the trend.

Had the threshold for the 40p income tax rate moved in line with average earnings since 1988—the year of Nigel Lawson’s radical, tax-reforming budget—you would today have to earn more than £90,000 per year to pay it. Instead, the 40p tax rate currently kicks in at just £50,000. As a result, the share of British taxpayers facing the higher (and additional) rates has tripled over the past four decades, rising from 5 to 15 percent.³⁵

This development was a live issue during the Conservative leadership campaign of 2019, which ended with Boris Johnson becoming prime minister. At one stage he advocated raising the higher rate threshold to £80,000,

33 Ibid., 15.

34 See Ryan Bourne, “Taxing Problem: The UK’s incoherent tax system,” Institute of Economic Affairs, Dec. 1, 2014, 18–19, <https://iea.org.uk/publications/research/taxing-problem-the-uk's-incoherent-tax-system>.

35 Author calculations based on figures from the Office for National Statistics.

writing that “we should be raising thresholds of income tax—so that we help the huge numbers that have been captured in the higher rate by fiscal drag.”³⁶

That aspiration was subsequently abandoned, with Johnson’s campaign (and later his government) adopting a renewed focus on lower earners with a pledge to raise the primary threshold for NICs. The Conservative Party’s 2019 general election manifesto committed them to raising the point at which employee NICs kick in, with a long-term ambition to make the first £12,500 anyone earns in a year completely free of both income tax *and* National Insurance.³⁷

The Additional Rate of Income Tax

For more than two decades following the 1988 budget, the highest rate of income tax in the UK was 40 percent. In April 2010, however, the Labour government introduced a new “additional” rate of income tax, initially set at 50 percent on income over £150,000.³⁸

A year later, George Osborne—the coalition government’s Conservative chancellor—asked HMRC to review the additional rate ahead of the 2012 budget. Its findings were striking: “the underlying yield from the additional rate is much lower than originally forecast... [I]t is quite possible that it could be negative.”³⁹

In response, Osborne announced that the additional rate would be cut to 45 percent from April 2013, noting that once behavioural effects were factored in, the revenue loss from doing so

would only be about £100 million a year.

The additional rate remains at 45 percent today, but there is an ongoing debate about both the revenue it yields—some maintain that it pushes the top marginal tax rate above its revenue-maximising level—and its impact on the UK’s international competitiveness.

National Insurance and Self-Employment

As noted above, National Insurance taxes self-employment much more lightly than employment. The Institute for Fiscal Studies has calculated that this tax advantage amounts to £1,240 per person per year on average.⁴⁰

In 2017, then-chancellor Philip Hammond attempted to reduce the disparity, announcing that the standard rate of NICs on self-employment profits would be raised from 9 percent to 10 percent in 2018, and then to 11 percent in 2019. Under his plan, Class 2 NICs would have been abolished.

These proposals immediately sparked political controversy, with critics arguing that Hammond was violating a 2015 manifesto pledge not to raise “VAT, National Insurance contributions, or Income Tax.” A week after delivering his budget, Hammond was forced into a U-turn, writing in a national newspaper that there would be no changes to self-employed NICs after all.

Nevertheless, self-employment remains a contentious issue in personal taxation—not least because it has increased its share of total

36 Boris Johnson, “Economic innovation will turn the UK into a clean, green powerhouse,” *The Telegraph*, June 9, 2019, <https://www.telegraph.co.uk/politics/2019/06/09/economic-innovation-will-turn-uk-clean-green-powerhouse>.

37 The Conservative and Unionist Party, “Manifesto 2019,” Nov. 24, 2019, <https://vote.conservatives.com/our-plan>.

38 For a detailed history of the additional rate of income tax, see Antony Seely, “Income tax: the additional 50p rate,” House of Commons Library, Sept. 26, 2018, <https://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN00249>.

39 HMRC, “The Exchequer effect of the 50 per cent additional rate of income tax,” March 2012, 2, <https://webarchive.nationalarchives.gov.uk/20130127161217/http://www.hmrc.gov.uk/budget2012/excheq-income-tax-2042.pdf>.

40 Stuart Adam, Helen Miller, and Thomas Pope, “Tax, legal form and the gig economy,” Institute for Fiscal Studies, Feb. 2, 2017, <https://www.ifs.org.uk/publications/8872>.

employment steadily over the last two decades, rising from 11.9 percent in 2001 to 13 percent in 2008 and 14.9 percent in 2019.⁴¹

At the March 2020 Budget, the government implemented its manifesto promise to raise the primary threshold for NICs, increasing it from £8,630 to £9,500 (on an annualised basis) for both employees and the self-employed. The previously aligned threshold for *employer* NICs only increased in line with CPI inflation for 2020-21, to £8,785.

Capital Gains Tax

Few taxes have been subject to reform (for better and for worse) as frequently as CGT.

When the Labour Party won a landslide at the 1997 general election, they inherited a system in which CGT rates were aligned with those on earned income, and any gains (or losses) were indexed to inflation.

In his first budget, Gordon Brown replaced indexation with taper relief, according to which CGT rates fell the longer you owned an asset. Ten years later, his successor scrapped taper relief and set CGT at a flat-rate 18 percent, while establishing entrepreneurs' relief—which lowered the CGT rate to 10 percent on eligible gains.

The coalition government was initially expected to realign CGT rates with those for income tax. But as it turned out, they didn't go that far: from 2010-11 to 2015-16, they maintained the 18 percent rate for basic rate taxpayers, while levying a 28 percent rate on higher and additional rate taxpayers.

Following the 2015 general election, the Conservative government cut CGT rates on most gains—from 18 to 10 percent for basic rate taxpayers, and from 28 to 20 percent for higher and additional rate taxpayers. The previous rates were retained for taxable gains from residential property.

Despite this relentless policy churn, CGT can hardly be described as a settled part of the personal tax system. On the contrary: the last few years have seen frequent calls to tax capital gains at the standard income tax rates (potentially subject to a rate-of-return allowance).⁴²

Entrepreneur's relief has come in for particular criticism, with the Resolution Foundation calling it "the UK's worst tax break" and the Institute for Fiscal Studies advocating its abolition. At the March 2020 Budget, the government replaced entrepreneurs' relief with "business asset disposal relief." Under the new regime, only the first £1 million in qualifying lifetime gains is eligible for the reduced, 10 percent tax rate.

Revenue from Personal Income Taxes

According to the OECD, the UK's taxes on personal income raised more than 46 percent of all tax revenue in 2018. A little over 19 percent of total revenue came from NICs, with a 45:55 split between the employee and employer sides of the tax.⁴³ Around 1 percent of tax revenue came from CGT.

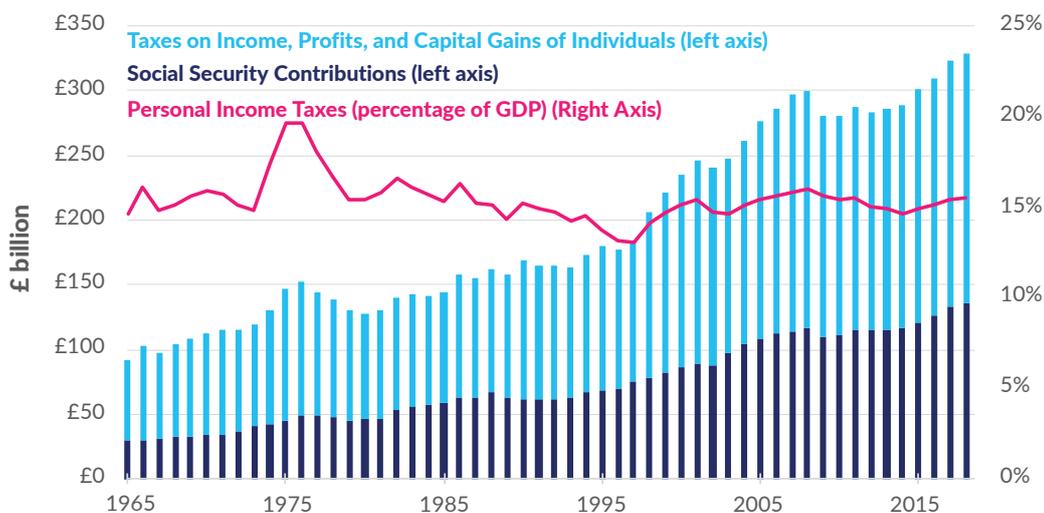
The rest—slightly more than a quarter of total tax revenue—came from income tax. Only a small fraction of income tax revenue (around 7 percent) comes from dividends, and even less (around 1 percent) from savings interest.

41 See Stephen Clarke and Nye Cominetti, "Setting the record straight," Resolution Foundation, Jan. 14, 2019, <https://www.resolutionfoundation.org/app/uploads/2019/01/Setting-the-record-straight-full-employment-report.pdf>.

42 See, for example, Shreya Nanda and Henry Parkes, "Just tax: Reforming the taxation of income from wealth and work," Institute for Public Policy Research, Sept. 9, 2019, <https://www.ippr.org/research/publications/just-tax>.

43 The 45:55 split is based on Office for Budget Responsibility, "Economic and fiscal outlook – supplementary fiscal tables: receipts and other," Mar. 13, 2019, <https://obr.uk/efo/economic-fiscal-outlook-march-2019>.

FIGURE 4.1
Revenue from Personal Income Taxes since 1965



Note: Sterling amounts are inflation-adjusted based on the Consumer Price Index with a 2018 base year.
 Source: "Revenue Statistics - OECD countries: Comparative tables."

The overwhelming majority of income tax revenue, then, comes from ordinary earnings (92 percent).⁴⁴

Figure 4.1 displays the revenue flowing from personal income taxes since 1965. In inflation-adjusted monetary terms, revenue from personal income taxes has grown strongly over time, rising from £92 billion in 1965 to £328 billion in 2018—a more than three-fold increase.

As a percentage of GDP, however, the revenue contribution of personal income taxes has been broadly stable, averaging around 15.4 percent from 1965 to 2018. The one noticeable spike in revenues comes after 1974, when revenues from income and capital gains taxes (but not social security contributions) were particularly high. Revenues then fell—both in monetary terms and as a percentage of GDP—for four successive years at the end of the 1970s.

How Heavily Does the UK Tax Labour?

The tax burden on labour is sometimes referred to as the “tax wedge.” It is a measure of the difference between an employee’s post-tax disposable income and their total cost to their employer. Research suggests that there is a negative relationship between the size of this tax wedge and employment.⁴⁵ As a result, good tax policy will usually seek to keep the tax burden on labour as light as realistically possible.

In the UK, an employee’s post-tax disposable income is determined by deducting income tax and NICs from their wages or salary. Their total cost to the employer is determined by their wages or salary *plus* any NICs paid by the employer. “Gross labour cost” is another way of describing this total.

44 Based on HMRC, “UK Income Tax Liabilities Statistics,” Table 2.6, June 28, 2019, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/812844/Income_Tax_Liabilities_Statistics_June_2019.pdf.

45 See Primož Dolenc and Suzana Laporšek, “Tax Wedge on Labour and Its Effect of Employment Growth in the European Union,” *Prague Economic Papers* 19:4 (December 2010), 345, https://researchgate.net/publication/227473547_Tax_Wedge_on_Labour_and_its_Effect_on_Employment_Growth_in_the_European_Union.

FIGURE 4.2

Tax Wedge for an Average-wage Worker, No Children, 2019



Note: Individual items may not sum to total because of rounding.
Source: OECD, "Taxing Wages 2020."

According to the OECD, the gross labour cost for an average worker (who is single, with no children) was approximately £44,645 in 2019.⁴⁶ However, that same worker's take-home pay was only around £30,850. Overall, 30.9 percent of the worker's gross labour cost is lost to taxes. Income tax accounts for 12.5 percent of gross labour cost, employee NICs for 8.5 percent, and employer NICs for 9.8 percent.

As it happens, this is one of the lower average tax burdens among the OECD countries. The highest tax wedge on a single worker with no children is found in Belgium, at 52.2 percent. The lowest is in Chile—just 7 percent. The OECD average tax wedge for such a worker is 36 percent (5.1 percentage points higher than in the UK). Figure 4.2 compares the UK's tax wedge with the OECD average.

All told, the UK ranks 27th out of 36 OECD countries on this measure, meaning that only nine countries had tax wedges smaller than the UK's. It is perhaps worth noting, however, that these more lightly taxed countries include Canada, the United States, Australia, and

New Zealand. Ireland's average tax wedge for a single, childless worker is slightly higher than the UK's, at 33.2 percent.

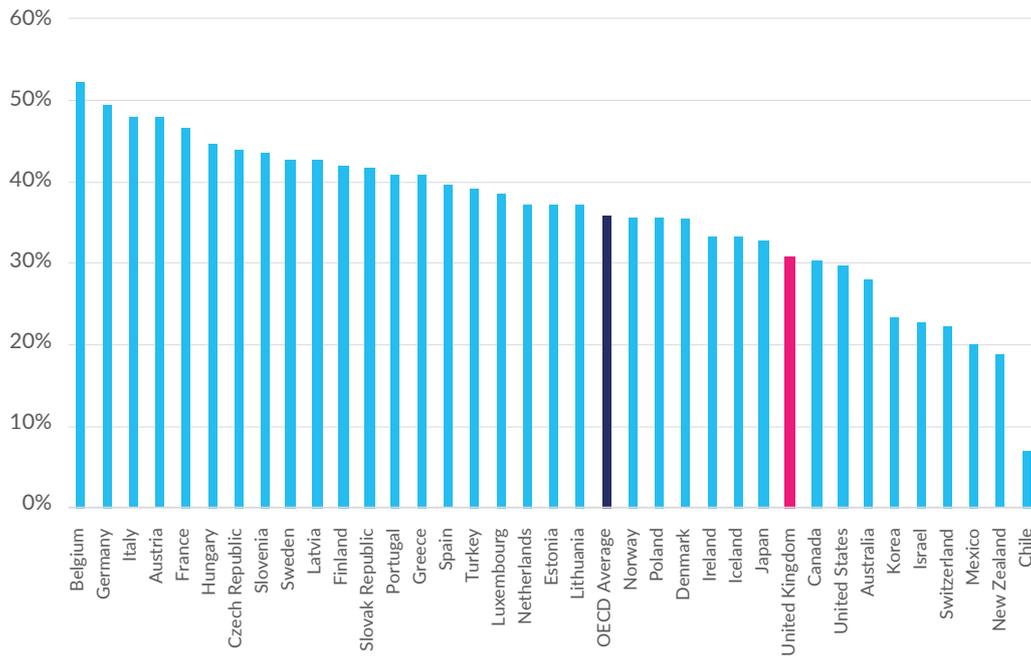
Of course, many OECD countries provide some form of tax relief for families. As a result, the average OECD tax wedge for families—defined for these purposes as a one-earner married couple with two children—is lower, at 26.4 percent in 2019, than it is for single workers.

The UK also taxes families more lightly than singles, but the difference is relatively small. A single-worker, two-child family faced a tax wedge of 26.3 percent in 2019, which is very close to the OECD average. This means that such a family's disposable income is only 5 percentage points higher than that of a single, childless worker. And while the UK has only the 27th highest tax wedge for singles, for families it comes in 22nd.

46 This figure is reported in U.S. dollars with equal purchasing power in OECD, "Taxing Wages 2020," Table 1.2, <https://www.oecd.org/tax/taxing-wages-20725124.htm>. It has been converted to pounds sterling using the OECD's 2019 purchasing power parity of \$1=£0.680.

FIGURE 4.3
The UK Tax Burden on Labour is Below the OECD Average

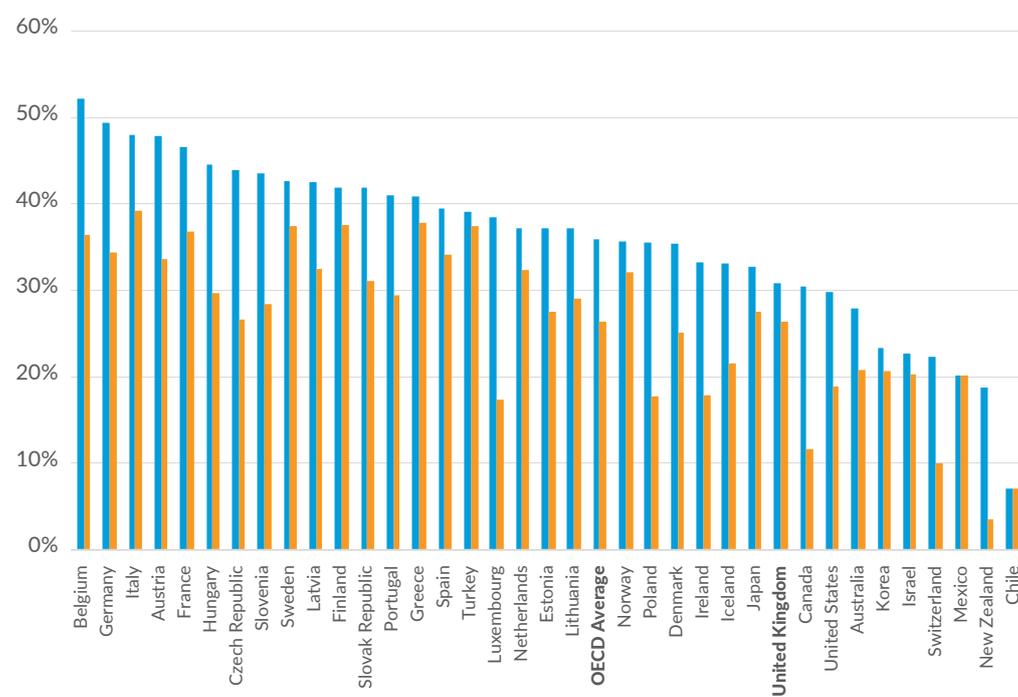
Tax Wedge of a Single Worker with no Children Earning a Nation's Average Wage, 2019



Source: OECD, "Taxing Wages 2020."

FIGURE 4.4
Single Workers in the UK Face a Higher Tax Burden on Their Work than Families with Children

Tax Wedges on Singles and Families at a Nation's Average Wage, 2019



Source: OECD, "Taxing Wages 2020."

The tax burden on average workers is obviously important—politically, economically, and as a basic matter of fairness. We all want ordinary Britons to keep as much of the product of their labour for themselves and their families as is practically possible. And while the UK could always do better on this front, comparisons with other OECD countries show that it isn't at present doing too badly.

Yet when we talk about the international competitiveness of a country's taxes, we must also consider the structure of the tax system as a whole, and in particular the marginal rates faced at the top of the income distribution.

This does not in any way reflect a concern *primarily* for the wealthy. On the contrary, this focus is merely an acknowledgment that business and investment decisions taken at the margin—the ones that will have an outsized effect on a country's economic growth rate—are likely to be very strongly influenced by such factors.

Comparing the UK's Personal Income Taxes Internationally

Personal income taxes are one of the five main variables assessed by the *International Tax Competitiveness Index*. Overall, the UK places 24th out of 36 OECD countries when it comes to the competitiveness of its personal income tax system.

A country's score—and, by extension, its ranking—for personal income taxes is determined by its performance in three sub-categories: the rate and progressivity of wage taxation; income tax complexity; and the extent to which corporate income is double-taxed at the individual level. Table 4.4 shows how the UK's personal income tax system compares with those of its main competitor economies: France, Germany, and the United States.

Clearly, none of the countries shown here does particularly well in the personal income taxes section of the *International Tax Competitiveness Index*. France comes dead last in the rankings, and the UK, U.S., and Germany also all have weaknesses compared to other developed world tax systems.

So what, in particular, stops the UK from doing better when it comes to the competitiveness of its personal income tax system?

As Table 4.4 suggests, income tax complexity—based on the number of hours it takes a business a year to comply with wage tax laws in each OECD country—is not a huge problem for the UK. It could do better: complying with wage tax laws takes 57 hours in Britain, compared with just 14 hours in OECD top-ranked Luxembourg.⁴⁷ But income tax compliance does not weigh too heavily on the UK's competitiveness.

TABLE 4.4

International Tax Competitiveness Index 2020: Income Tax Systems

	Individual Taxes Rank	Income Tax Rank	Complexity Rank	Capital Gains & Dividends Rank
United States	23	19	23	23
United Kingdom	24	26	15	29
Germany	25	9	32	22
France	36	33	26	33

Source: Tax Foundation, *International Tax Competitiveness Index 2020*.

47 These figures are taken from the PwC/World Bank "Doing Business" report. See PwC and the World Bank Group, "Paying Taxes 2020."

What does damage the UK's relative standing is its high top marginal tax rate, the inefficient structure of its wage taxation, and its overtaxation of dividend income.

At 47 percent (45 percent income tax plus 2 percent National Insurance), the UK's highest tax rate on wages is slightly above the OECD average. The flat (or mostly flat) tax systems of central and eastern Europe tend to do particularly well on this measure, but countries like New Zealand (top rate: 33 percent) and Switzerland (41.7 percent) also come out looking more attractive than the UK.

The structure of the UK's wage taxation also hurts its position on the *Index*. Looking at the OECD as a whole, the UK's income tax system is at the more progressive end of the spectrum.⁴⁸ That's often seen as a good thing on equity grounds, but there is a clear trade-off with economic efficiency and competitiveness.

For one thing, the more progressive a tax system is, the higher the top rate will need to be to raise a given amount of revenue. And because high marginal tax rates reduce work incentives, they tend to have a negative impact on economic growth. This means that raising an additional £1 of revenue from progressive wage taxation can be much more economically costly than raising the same amount of revenue from a flat tax—at any given level of overall taxation. Our research suggests that, in these terms, the UK actually has one of the *least economically efficient* systems of wage taxation in the OECD.⁴⁹

When it comes to wage taxation, then, the UK could undoubtedly boost its international competitiveness by making ordinary income taxes *flatter*, with lower marginal rates on higher earners. A flatter tax system would also be

much more economically efficient, allowing the government to reduce the deadweight losses associated with raising revenue from the UK's workforce.

Of course, as outlined above, the UK doesn't just tax labour income—it also taxes investment income in the form of dividends and capital gains. There are actually eight OECD countries that don't levy tax on long-term capital gains from listed shares, and a few more don't tax dividends at the personal level. But these taxes are, in general, widespread across developed economies.

The trouble with personal taxes on dividends and capital gains is that they very often constitute the double taxation of income that has already been taxed at the corporate level. This can increase the tax burden on capital, and therefore decrease investment, deter capital formation, and slow economic growth. Accordingly, the *International Tax Competitiveness Index* assesses the degree to which OECD tax systems double-tax corporate income, giving better scores to the countries that do it the least.

The UK's capital gains tax is fairly competitive. With a top rate of 20 percent (on business assets), the UK compares favourably with many OECD countries. Indeed, among countries that levy a capital gains tax at all, only Mexico (10 percent), Hungary, Greece, and the Czech Republic (15 percent), and Poland (19 percent) do better than the UK. Exempting the first £12,300 of capital gains from tax also helps to mitigate the impact of double taxation.

By contrast, the UK scores quite badly on the *International Tax Competitiveness Index* for its top rate of tax on dividends. At 38.1 percent, the

48 The *International Tax Competitiveness Index* bases its measure of progressivity on the income level at which the top rate begins compared to a country's average income. When the structure of tax rates on earnings is flatter, the point at which the top rate kicks in will be lower, and—accordingly—the country in question will receive a better score. The UK's top marginal tax rate on earnings kicks in at 3.7 times average earnings. Thus, on this measure, it ranks 21st out of 36 OECD countries.

49 The *International Tax Competitiveness Index* assesses the efficiency of a country's labour taxation by looking at the ratio of average tax wedges to marginal tax wedges. Our research suggests that raising £1 for public spending from the UK's workforce has a total economic cost of £1.39, compared to an OECD average of £1.23.

UK's top dividend tax rate is significantly higher than the OECD average (24 percent). Only four OECD countries—Canada, Korea, Denmark, and Ireland—levy a higher top rate.

In thinking about dividend taxes, it is helpful to consider the combined impact of corporation tax and income tax on business profits. If £100 of profit is subject to a 19 percent corporation tax, and then a 38.1 percent dividend tax (as prevails for the highest earners in the UK), only £50 of the original profit actually makes its way to the investor. This represents quite a heavy tax burden on capital, and in the long run will have a predictably deleterious effect on both competitiveness and economic growth.

Personal Income Tax Policies to Boost the UK's Tax Competitiveness

Compared with other developed economies, the UK imposes a relatively low tax burden on the average single worker. For an average one-earner household with children, the tax burden on labour is about average. But despite these somewhat encouraging findings, the UK's system of personal income taxation ranks in the bottom half among OECD countries when it comes to competitiveness. The *International Tax Competitiveness Index* places it 24th out of 36 countries' personal income tax systems. Plainly, then, there is room for improvement.

The UK's key weaknesses in this category are a top rate of income tax that is too high to be truly competitive, and the overtaxation of dividend income. Fixing these problems would make Britain's personal income taxes flatter and more pro-growth. We therefore suggest that the additional (45p) rate of income tax be abolished at the earliest opportunity, and that the tax rates applied to dividend income be significantly reduced, so as to fully reflect corporation tax

already paid. Effectively implementing these changes would improve the UK's personal income tax rank on the *International Tax Competitiveness Index* from 24th to 17th.

Of course, competitiveness isn't everything, and there are plenty of other problems with the UK's personal income tax system that a reforming government might want to address. Such reforms lie beyond the strict scope of this report, but we nevertheless recommend that policymakers seek to systematically rid Britain's tax code of the very high effective marginal tax rates that have been thoughtlessly introduced at various pinch points in the system—along with the complexity, perverse incentives, and unfairness they inevitably entail.

Recommendation 1: Abolish the Additional Rate of Income Tax

Our first recommendation for improving the competitiveness of the UK's personal income tax system is a very straightforward one: abolish the additional rate of income tax, so that the UK's combined rate of tax on ordinary income (income tax plus employee NICs) drops from 47 percent to 42 percent. For a year-one revenue cost of around £600 million, this reform would give Britain the 12th lowest top rate of tax in the OECD, allowing it to leapfrog countries such as Australia and the United States, and putting it pretty much on par with Switzerland.⁵⁰

Indeed, it is actually an open question whether abolishing the additional rate will cost the government any revenue at all. As part of the Institute for Fiscal Studies' *Mirrlees Review*, for example, researchers estimated that the total revenue-maximising marginal tax rate for the top 1 percent of earners was 56 percent.⁵¹ Once they had taken account of National Insurance and indirect taxes, that implied a revenue-

50 Revenue estimate derived from HMRC, "Direct effects of illustrative tax changes," May 1, 2020, <https://www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes>.

51 As summarised in James Mirrlees et al., "Tax by design," Institute for Fiscal Studies, Sept. 13, 2011, 109, <https://www.ifs.org.uk/publications/5353>.

maximising top *income tax rate* of around 40 percent—precisely what we are proposing here. (If anything, you might expect the revenue-maximising top income tax rate to be somewhat lower today, given that VAT and NIC rates are higher now than they were then.)

Abolishing the additional rate would help to make the UK a more attractive place to work, invest, and grow a business, especially from the perspective of internationally mobile corporations and individuals. It would also have a certain totemic significance: the top rate of income tax was 40 percent from 1988 to 2010 and was only increased as part of the response to the 2008-09 financial crisis. Abolishing the additional rate *now* would send a strong signal that, in the wake of Brexit and COVID-19, the UK was making a priority of its international tax competitiveness.

Recommendation 2: Reduce Tax Rates on Dividends

Taxing dividends is a form of double taxation, because the same income has already been taxed at the corporate level. Of course, the problem is not simply that the same income is taxed *twice* (that happens in all sorts of ways across the tax system) but rather that when you put both levels of tax together, you end up with a higher rate of tax on business income than you do on earned income. That tax bias discourages investment and, in doing so, diminishes a country's growth prospects.

As noted above, the UK currently has three tax bands for dividend income: a basic rate of 7.5 percent, a higher rate of 32.5 percent, and an additional rate of 38.1 percent. Table 4.5 shows how these rates combine with corporation tax (levied at 19 percent) to create a higher overall tax rate on business profits, once the £2,000 annual dividend allowance has been exhausted.

In an ideal world, the effective tax burdens in the right-most column of Table 4.5 would align with the standard rates of income tax, so that an additional pound of *business* income would not be taxed any more heavily than an equivalent extra pound of ordinary income.

There are a number of ways to achieve this objective. The most radical option would be to integrate the corporate and individual income taxes as countries like Estonia have effectively done. Estonians pay a flat income tax rate of 20 percent on their earnings. Their corporation tax, meanwhile, only applies to *distributed* profits (i.e., profits paid out to shareholders) and is also levied at a 20 percent rate. The upshot is that personal and business income are subject to the same (relatively low) tax rate.

However, while this option is an extremely appealing one in the long term, for now the UK has a different corporate tax base, and a progressive personal income tax structure with much higher marginal rates than those that apply in Estonia. For now, then, Estonian-style integration of income tax and corporation tax is probably not a viable reform for the UK.

TABLE 4.5

Effective Tax Burden on £100 of Business Profit, 2020

Profit	Corporation Tax @ 19%	Gross Dividend Income	Dividend Tax Rate	Dividend Tax Paid	Net Dividend Income	Effective Tax Burden
£100	£19	£81	7.5%	£6	£75	25%
£100	£19	£81	32.5%	£26	£55	45%
£100	£19	£81	38.1%	£31	£50	50%

Source: Author calculations.

An alternative approach has been adopted in Australia, which integrates its corporate and personal income taxes with a tax credit imputation. Essentially, when shareholders receive dividends, they pay ordinary income tax rates, but also get a tax credit to offset taxes already paid by the corporation. This ensures that Australians are only subject to standard income tax rates on their business income, even when the impact of the personal and corporate taxes is combined.

How might a full credit imputation system like this work in the UK? Let's stick with our example of £100 of profit. After corporation tax, £81 would be paid out to the shareholder. For tax purposes, this dividend would be "grossed up" to £100 and taxed at the shareholder's marginal rate (let's assume 40 percent). The shareholder would owe £40 of tax. However, this tax liability would be reduced by a £19 tax credit to reflect the tax already paid by the corporation, leaving the shareholder to pay £21 of income tax on his £81 dividend. Put the tax paid by the shareholder together with the tax paid by the corporation and you get £40 of tax paid on a £100 profit—an exact reflection of the shareholder's marginal tax rate.

We would support the introduction of a full credit imputation system in the UK. However, for the sake of simplicity, our recommendation here is for a slightly different means of achieving the same end. Instead of worrying about grossing up dividends and applying a tax credit to the resultant tax liability, we could simply stick with the existing British system of lower marginal tax rates on dividends, but ensure that those rates were *fully* adjusted to account for the prior impact of corporation tax. That would imply a basic dividend tax rate of 1 percent, a higher rate of 26 percent, and an additional rate of 32 percent.

Of course, we have already proposed the abolition of the additional rate of income tax. And that 1 percent tax on basic rate dividends seems barely worth levying. Easier to leave any dividend income that falls within the basic rate tax band untouched, and simply levy a 26 percent tax on the dividend income of higher rate taxpayers. A top dividend tax rate of 26 percent would move the UK much closer to the OECD average (24 percent), putting the UK in the middle of the pack for competitiveness on this measure, rather than near the bottom.

In normal times, we'd expect the year-one revenue cost of such a reform to be between £3.8 billion and £6 billion, depending on how much behavioural change the reform generated. The lower number would prevail if we use the same assumptions HMRC currently employs in its "ready reckoner" when it comes to changes to ordinary income tax rates—making it a reasonable number to rely on here.⁵²

Other Policies to Improve the UK's Personal Income Tax System

The UK's personal income tax system is subject to a litany of punitive effective marginal tax rates that appear at certain points in the income distribution for taxpayers with certain characteristics. A previous report by the Centre for Policy Studies—*Make Work Pay*—explored these issues in depth, so we will not dwell on them here.⁵³

However, it is clearly unfair that, for example, a father of three earning £55,000 faces an effective marginal tax rate of 67 percent thanks to the high income child benefit charge. Or that an extra penny of income could cost a married couple some £240 if they happen to be on the

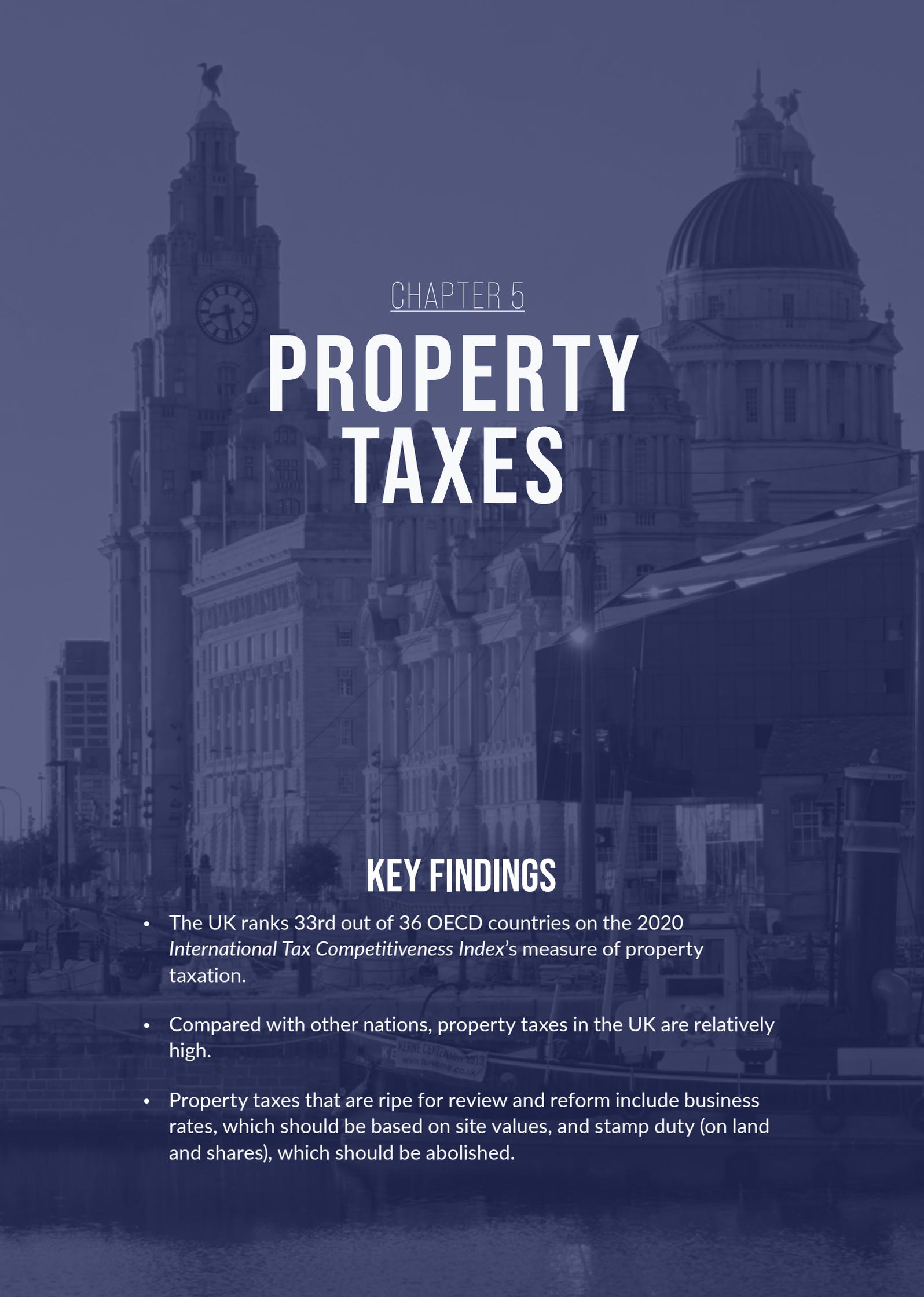
52 For the ready reckoner, see HMRC, "Direct effects of illustrative tax changes," May 1, 2020, <https://www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes>.

53 See Tom Clougherty, "Make Work Pay."

border between the basic and higher rates on income tax.

The withdrawal of the personal allowance similarly creates a weird spike in the tax structure, with the marginal income tax rate rising from 40p to 60p at £100,000 of income, before dropping again at £125,000. And complex rules around tapering the annual allowance for pension tax relief have caused all sorts of perverse incentives for high earners, especially within the National Health Service.

These problems are all the result of bad tax policymaking; of putting short-term political or revenue objectives ahead of a rational and coherent tax structure. They are not just sources of unnecessary complexity, but also of effort-sapping iniquity. Any comprehensive tax reform programme worthy of the name should seek to iron out these kinks in the tax code, while implementing the kind of competitiveness-boosting, pro-growth policies we have focused on in this report.



CHAPTER 5

PROPERTY TAXES

KEY FINDINGS

- The UK ranks 33rd out of 36 OECD countries on the 2020 *International Tax Competitiveness Index's* measure of property taxation.
- Compared with other nations, property taxes in the UK are relatively high.
- Property taxes that are ripe for review and reform include business rates, which should be based on site values, and stamp duty (on land and shares), which should be abolished.

Taxes on property raised £87.6 billion in 2018. That's equivalent to 12.3 percent of total taxation or 4.1 percent of GDP.⁵⁴

Both of these figures are high by international standards. Among OECD nations, only France equals our property tax take as a percentage of GDP. As a share of total taxation, the UK's property tax receipts exceed those of all our competitors—although the United States does come a close second.

The bottom line is that the UK relies heavily on property taxes to fund its public spending. As a matter of principle, this isn't *necessarily* a bad thing. OECD research suggests that well-structured property taxes are the least-worst way for governments to raise money.⁵⁵ Individual income taxes, corporate profit taxes, and—to a lesser extent—consumption taxes are all more harmful to economic growth.

Of course, the devil is very much in the detail. Recurrent taxes on residential property might have some pro-growth qualities, because they can encourage the usage of underdeveloped land and discourage overinvestment in housing versus other, more productive assets.⁵⁶ The downside is that such taxes tend to be quite unpopular with voters.

Meanwhile, other property taxes can be actively harmful to the economy—whether by taxing business inputs (like business rates), discouraging mutually beneficial transactions (like stamp duties), or weakening incentives to earn and save (like inheritance taxes). In each case, property taxes create economic distortions and reduce long-term productivity. Sound tax policy must seek to avoid these effects.

In that spirit, this chapter reviews the UK's system of property taxes, examining its main characteristics and comparing it with the property tax systems of other OECD countries. It concludes by outlining a series of policy proposals that would boost the UK's tax competitiveness and improve its long-term economic prospects.

An Overview of Property Taxes in the United Kingdom

There are six main taxes on property in the UK: business rates; council tax; inheritance tax; stamp duty land tax; stamp taxes on shares; and the bank levy. This section outlines the main characteristics of each tax, while considering important recent developments.

Business Rates

Business rates are an ongoing tax based on the rental value of non-domestic (and non-agricultural) properties, such as shops, offices, and factories. They are paid by the occupier of the property and are treated as a deductible business expense for corporation (or individual profits) tax purposes.

Rental values are meant to be assessed every three years by the Valuation Office Agency.⁵⁷ The most recent revaluation (for England and Wales) took effect on April 1, 2017, and was based on *rateable values* from two years earlier—April 1, 2015.

54 Based on figures from OECD.stat, "Revenue Statistics - OECD countries: Comparative tables," <https://stats.oecd.org/Index.aspx?DataSetCode=REV>.

55 See OECD, "Tax Policy Reform and Economic Growth," Nov. 3, 2010, <https://www.oecd.org/ctp/tax-policy/tax-policy-reform-and-economic-growth-9789264091085-en.htm>.

56 Ibid., 21.

57 Previously, rateable values were assessed every five years—at least in theory. The most recent revaluation was actually delayed from 2015 to 2017, primarily to avoid having business owners see their rates bill rise sharply in an election year.

The tax owed is calculated as a percentage of the rateable value. The standard multiplier is 50.4p (i.e., 50.4 percent of rateable value). Where the rateable value is below £51,000, the small business multiplier (49.1p) applies.

Crucially, rateable value includes not just the land and anything attached to it (such as buildings and associated infrastructure), but also a wide range of plant and machinery.⁵⁸ This can have perverse effects: to cite one well-known example, Tata Steel spent £185m upgrading a blast furnace at Port Talbot, only to see its business rates bill rise by £400,000 per year.⁵⁹ Business rates can, then, act as a significant disincentive to investment.

There are a number of reliefs available for rate-payers.⁶⁰ For example, where a business only uses one property, and that property has a rateable value of less than £15,000, small business rate relief applies. If the rateable value is £12,000 or less, no business rates are payable. For rateable values between £12,000 and £15,000, the relief is applied on a sliding scale—so that, for instance, you get 50 percent off your business rates bill if your rateable value is £13,500.

In the October 2018 budget, the government announced that it would introduce a business rates retail discount, which would apply in the 2019-20 and 2020-21 tax years. As announced, this gave eligible retail businesses with a rateable value of less than £51,000 one-third off their rates bill (subject to EU state aid limits).

In March 2020, this relief was significantly expanded in response to the emerging coronavirus pandemic, so that shops,

restaurants, cafes, bars, pubs, cinemas, music venues, and hospitality and leisure businesses could get 100 percent relief on their 2020-21 business rates bill, regardless of the rateable value of the occupied properties.

As of the March 2020 budget, business rates were forecast to raise £31.5 billion in 2020-21. Over the past two decades, they have reliably yielded annual revenues equivalent to around 1.5 percent of GDP and 4.5 percent of total taxation.

In its 2019 general election manifesto, the Conservative Party committed to a fundamental review of the system, pledging to “cut the burden of tax on business by reducing business rates.”⁶¹ The promised review of business rates was launched at the March 2020 budget, and is due to report soon.

Council Tax

Council tax is the UK’s main recurrent tax on residential property. It is an annual levy, generally paid by the occupier of a property in instalments over the course of the tax year.

Council tax is set and collected by local authorities and used to fund local services. However, the main characteristics and structure of the tax are largely controlled by the central government.

Residential properties are categorised into eight bands (A–H) based on their assessed market value. Local authorities get to set the overall level of council tax, which is usually expressed as the charge on a Band D property. But the bands

58 The details of business rates valuation are highly complex. The applicable regulations attempt to draw a distinction between: (a) “process” plant and machinery—things which can reasonably be described as “tools of the trade”—which is exempt from rateable value within certain limits; and (b) plant and machinery which is integral to the property or forms part of its infrastructure, which is included in rateable value and therefore subject to business rates. The following presentation gives useful background and helps to explain the current state of affairs: Tim Mould QC, “Valuation of plant and machinery,” Landmark Chambers, <https://www.landmarkchambers.co.uk/resources/bank/valuation-of-plant-and-machinery>.

59 See Jim Pickard and Michael Pooler, “Budget plan to exempt new machinery from rates bill,” *Financial Times*, Feb. 29, 2016, <https://www.ft.com/content/abadf956-dca6-11e5-8541-00fb33bdf038>.

60 The other business rates reliefs are: rural rate relief, charitable rate relief, exempted buildings and empty buildings relief, hardship relief, transitional relief, and local newspaper relief. Some “enterprise zones” also offer business rates relief.

61 Conservative and Unionist Party, “Manifesto 2019,” Nov. 24, 2019, 32, <https://vote.conservatives.com/our-plan>.

TABLE 5.1

Council Tax

Council Tax Band	Council Tax Rate Relative to Band D	Property Valuation as of April 1, 1991 (£)	Percentage of Total Dwellings in Band	Average Council Tax Rates in England (£)
A	6/9	0–40,000	24.2	1,211
B	7/9	40,000–52,000	19.6	1,413
C	8/9	52,001–68,000	21.8	1,615
D	9/9	68,001–88,000	15.5	1,817
E	11/9	88,001–120,000	9.6	2,221
F	13/9	120,001–160,000	5.1	2,625
G	15/9	160,001–320,000	3.5	3,028
H	18/9	320,001+	0.6	3,634

Source: This table is based on the one in Thomas Pope and Tom Waters, “A Survey of the UK Tax System,” Institute for Fiscal Studies, Nov. 23, 2016. Figures for percentage of dwellings in each band come from MHCLG, “Local Authority Council Tax base England 2019 (revised),” Nov. 13, 2019. The average Band D council tax rate in England is taken from MHCLG, “Council tax levels set by local authorities: England 2020-21,” Mar. 25, 2020.

themselves are fixed by Parliament, as are the ratios between charges for the different bands.

Table 5.1 outlines the structure of council tax and shows the average 2020-21 council tax rates for local authorities in England.

The tax rates above are subject to a variety of discounts, reliefs, and exemptions. For example, if you’re the only adult residing in a property, you get a 25 percent discount on the applicable council tax rate. Low-income residents can also apply to their local authority for a council tax reduction. Second homes may be subject to a council tax discount of up to 50 percent (depending on the local authority) and empty properties may be exempt, subject to normal council tax rates, or charged up to double, depending on the circumstances.

As of the March 2020 budget, council tax was forecast to raise £37.9 billion in 2020-21. Over the past two decades, it has consistently yielded revenue equivalent to around 1.5 percent of GDP and 4.7 percent of total taxation.

The extraordinary thing about council tax is that it is still based on property values from April 1991.⁶² To put it bluntly, Britain’s residential property tax base is nearly three decades out of date.

Land Registry data suggests that UK house prices have quadrupled over that period.⁶³ But this overall figure masks significant regional variation. As the Institute for Fiscal Studies recently pointed out, “The average price in London is now more than six times what it was in 1995, compared with barely three times in the North East.”

Even within individual towns and cities, absolute and relative house prices have changed dramatically over the last 30 years. This means that the council tax bands people find themselves in, and the bills they therefore have to pay, are becoming more and more arbitrary as time goes by.

A comprehensive council tax revaluation is long overdue, and often called for—but as yet there seems to be little appetite within government for the political controversy that would doubtless emerge.

62 For properties built more recently, an assumed April 1991 value is used.

63 See Land Registry, “UK House Price Index,” March 2020, <https://landregistry.data.gov.uk/app/ukhpi>.

An idea that occasionally looks more likely to come to fruition is making council tax more progressive, by adding one or more additional bands for higher value properties. Labour and the Liberal Democrats have both, at one time or another, proposed introducing two new tax bands for properties worth more than £2 million. And the current Conservative government supposedly considered (but decided against) something along those lines while preparing its most recent budget.

Inheritance Tax

Inheritance tax is levied on the value of a deceased person's estate. It is charged at a flat rate of 40 percent.

Any part of an estate covered by the “nil-rate band” is not subject to inheritance tax. In 2020-21, the nil-rate band is £325,000. This basic threshold has not increased since April 2009. However, an additional *residence* nil-rate band of £175,000 is available when a family home is being passed to children or grandchildren (provided that the estate as a whole is worth less than £2 million).

Transfers between spouses (and bequests to charities) are exempt from inheritance tax. In addition, when a surviving spouse subsequently dies, any part of the nil-rate band and residence nil-rate band that their deceased spouse did not use is added to their own ones for inheritance tax purposes.⁶⁴

There are complex inheritance tax rules around gifts made while the deceased was still alive.

In general, small gifts made out of a person's normal income are exempt from tax. So are gifts between spouses and wedding gifts (the latter subject to certain limits). A further £3,000 per year can be gifted without having any inheritance tax implications.

Beyond those categories, though, the value of gifts may be added to the deceased's estate for inheritance tax purposes if they were made within seven years of death. Subject to any applicable nil-rate bands, gifts made within three years of death are subject to inheritance tax at the full rate. Gifts made between three and seven years of death are subject to lower rates of tax, applied on a sliding scale.

Finally, there are a number of significant inheritance tax reliefs. There is 100 percent inheritance tax relief on businesses that are passed to heirs.⁶⁵ The same applies to shares in unlisted businesses. In each case, the deceased must have owned the business or assets for at least two years before they died. Some other business assets are eligible for 50 percent inheritance tax relief. Agricultural and woodland property may also be exempt from inheritance tax, provided certain conditions are met.⁶⁶

As of the March 2020 budget, inheritance tax was expected to raise £5.4 billion in 2020-21—less than 1 percent of total tax receipts. Figure 5.1 shows inheritance tax revenue, both in cash terms and as a percentage of GDP, from 1999-00 to 2018-19.

64 Technically, whatever share of the applicable nil-rate bands is not used by the first spouse is applied to the nil-rate bands that exist when the second spouse dies. Let's say that A died in 2000, when the nil-rate band was £234,000 (and before the residence nil-rate band was introduced). He used half of that (£117,000) on bequests to his children but left everything else to his wife. The wife, B, dies in 2020. In addition to her own £325,000 nil-rate band and £175,000 residence nil-rate band, her estate is subject to her husband's unused nil-rate bands—that's 50 percent of £325,000 (£162,500) and 100 percent of £175,000. In total, then, £837,500 of B's estate is exempt from inheritance tax (assuming that a family home is being left to children or grandchildren).

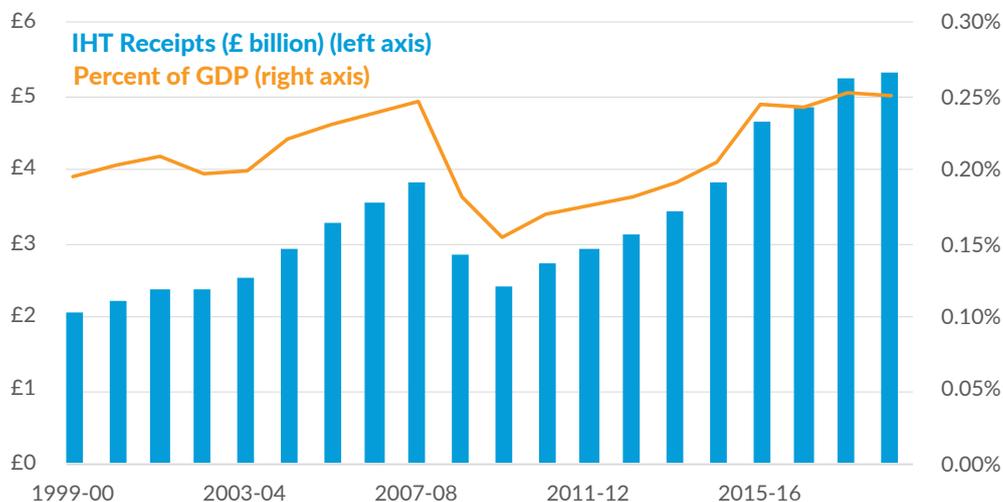
65 Unless the business “mainly deals with securities, stocks or shares, land or buildings, or in making or holding investments,” or falls into certain other categories. For more details, see HMRC, “Business Relief for Inheritance Tax,” <https://www.gov.uk/business-relief-inheritance-tax/what-qualifies-for-business-relief>.

66 See HMRC, “Agricultural Relief for Inheritance Tax,” <https://www.gov.uk/guidance/agricultural-relief-on-inheritance-tax>; and HMRC, “Woodland owners: tax planning,” <https://www.gov.uk/guidance/woodland-owners-tax-planning>.

FIGURE 5.1

Inheritance Receipts have more than Doubled in the Past Ten Years While Reaching Slightly more than 0.25% of GDP

Inheritance Tax Receipts, 1999-00 to 2018-19



Note: The 2018-19 data are forecast values.

Source: OBR, "Inheritance Tax," accessed Sep. 10, 2020, <https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/inheritance-tax/>.

For a tax that generates so little revenue, relatively speaking, and which ultimately imposes a charge on fewer than 4 percent of estates, inheritance tax certainly gets a lot of attention.⁶⁷

Britain's free-market groups are more-or-less united in their distaste for inheritance tax, with most favouring outright abolition.⁶⁸ But much of the recent policy discussion has been driven by left-leaning groups such as the Resolution Foundation and the Institute for Public Policy Research (IPPR), both of which have suggested replacing inheritance tax with a donee-based gift tax, levied on receipts above a lifetime allowance of £125,000.⁶⁹ Resolution would tax lifetime receipts between £125,000 and £500,000 at 20 percent, and any further receipts at 30 percent. The IPPR would simply

tax any receipts over the threshold as ordinary income.

The latest contribution to this debate has come from the All-Party Parliamentary Group on Inheritance and Intergenerational Fairness, chaired by Conservative MP John Stevenson. The group's January 2020 report on reforming inheritance tax called for sweeping changes to the system, abolishing most of the complex rules and reliefs outlined above in return for a much lower tax rate (10 percent) on estates over a generous allowance *and* lifetime gifts in excess of £30,000 per year (any tax, in this case, being paid by the donor).⁷⁰ The Office of Tax Simplification has also made a number of proposals to rationalise the existing inheritance tax system, issuing reports in both 2018 and 2019.⁷¹

67 See HMRC, "Inheritance Tax Statistics 2017-18," Jul. 30, 2020, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/832126/IHT_Commentary.pdf.

68 For example, see TaxPayers' Alliance, "Inheritance Tax," https://www.taxpayersalliance.com/inheritance_tax_briefing.

69 Adam Corlett, "Passing on: options for reforming inheritance taxation," Resolution Foundation, May 2, 2018, <https://www.resolutionfoundation.org/publications/passing-on-options-for-reforming-inheritance-taxation>; and Carys Roberts, Grace Blakeley, and Luke Murphy, "A Wealth of Difference: Reforming the Taxation of Wealth," Institute for Public Policy Research, Oct. 9, 2018, <https://www.ippr.org/research/publications/a-wealth-of-difference>.

70 APPG on Inheritance & Intergenerational Fairness, "Reforming Inheritance Tax," Jan. 2020, https://www.step.org/sites/default/files/media/files/2020-05/STEPReform_of_inheritance_tax_report_012020.pdf.

71 Office of Tax Simplification, "Inheritance Tax Review: First Report," Nov. 23, 2018, <https://www.gov.uk/government/publications/office-of-tax-simplification-inheritance-tax-review>; and Office of Tax Simplification, "Inheritance Tax Review: Second Report," July 5, 2019, <https://www.gov.uk/government/publications/ots-inheritance-tax-review-simplifying-the-design-of-the-tax>.

TABLE 5.2

Stamp Duty Land Tax Rates

Purchase price (£)	SDLT rate (%)	Rate with surcharge (%)
0–125,000	0	3
125,000–250,000	2	5
250,000–925,000	5	8
925,000–1,500,000	10	13
1,500,000+	12	15

Source: Gov.uk, “Stamp Duty Land Tax: Residential Property Rates.”

In short, some change to inheritance tax seems inevitable—but the direction that change will take remains, as yet, highly uncertain.

Stamp Duty Land Tax

Stamp Duty Land Tax (SDLT) is paid by the purchaser of real property. The tax owed is based on the purchase price, but there are different rates and bands depending on circumstances of the buyer and the nature of the property.

The standard rates of SDLT on residential property are shown in Table 5.2. Since 2016, people buying an additional residential property (such as buy-to-let or holiday homes) are subject to a 3 percent surcharge—combined rates are shown in the right-most column of Table 5.2.

The March 2020 budget introduced *another* surcharge, this time on non-UK resident buyers, of 2 percent. Given that most of these buyers will already own a property overseas, the total SDLT surcharge they face is likely

to be 5 percent—coming on top of standard marginal rates that are already rather high for a transaction tax.

It is important to note that the rates in Table 5.2 apply to each “slice” of a purchase that falls within a given band. For example, someone buying a house for £375,000 would pay no SDLT on the first £125,000, 2 percent SDLT on the next £125,000, and 5 percent SDLT on the final £125,000 of the purchase price. This may seem obvious, but—as will be discussed below—stamp duty hasn’t always worked that way.

For first-time buyers purchasing a property for £500,000 or less, different SDLT bands and rates have applied since 2017.⁷² In this case, the buyer pays no stamp duty on the first £300,000 of the purchase price, and then 5 percent on anything between £300,000 and £500,000. The moment the price rises above £500,000, however, the standard SDLT rates above apply to the *entire* purchase.

For those buying non-residential or mixed-use property, a third rate schedule applies:

TABLE 5.3

Stamp Duty Land Tax Rates, Non-Residential Property

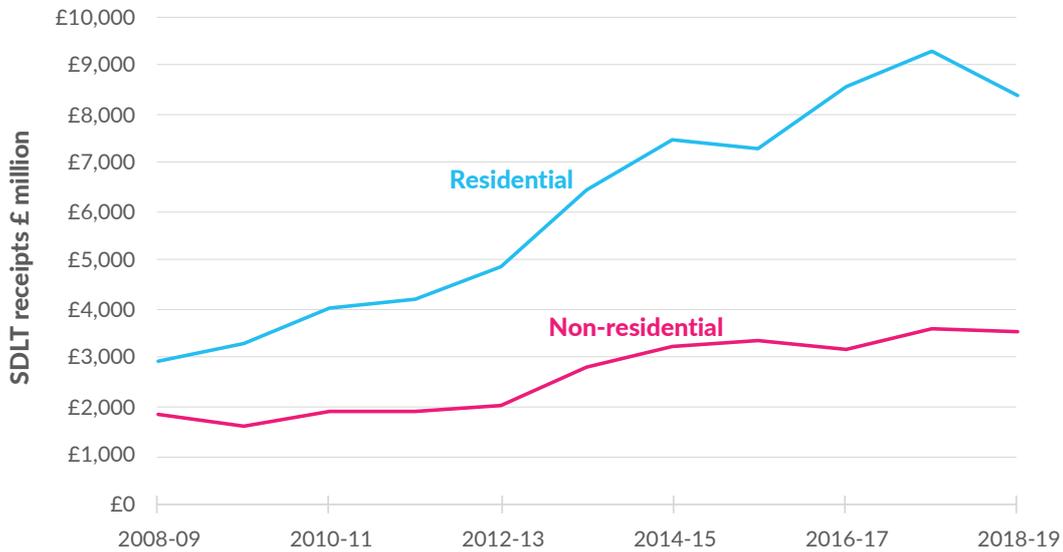
Purchase price (£)	SDLT rate (%)
0–150,000	0
150,000–250,000	2
250,000+	5

Source: Gov.uk, “Stamp Duty Land Tax: Rates for non-residential and mixed land and property.”

72 Special arrangements for first-time buyers had also been introduced as a temporary measure in the past.

FIGURE 5.2
Residential Stamp Duty Land Tax Receipts have more than Doubled in the Past Ten Years

Stamp Duty Land Tax Receipts, 2008-09 to 2018-19



Source: HMRC, "Annual Stamp Taxes Statistics, 2018-19—Commentary," Oct. 1, 2019, p. 5.

According to the most recent government statistics, SDLT raised nearly £12 billion in 2018-19.⁷³ Seventy-one percent of that revenue came from residential SDLT. The rest came from non-residential and mixed purchases. Figure 5.2 shows the path of SDLT revenues over the past decade.

Stamp Duty Land Tax is one of the few British taxes to have changed quite substantially under recent governments. When Tony Blair’s first ministry took office in 1997, it inherited an SDLT system that was relatively straightforward.

Property purchases of less than £60,000 were not taxed, while purchases above £60,000 were subject to a 1 percent charge.

By 2000, two additional SDLT rates had been introduced, at 3 percent on purchases between £250,000 and £500,000, and at 4 percent on purchases above that level. The coalition government, which came to power in 2010, added two further rates, at 5 and 7 percent, so that by 2012, the structure of SDLT (on residential property) looked like this:

TABLE 5.4
Stamp Duty Land Tax Rates on Residential Property, 2012

Purchase price (£)	SDLT rate (%)
0-125,000	0
125,000-250,000	1
250,000-500,000	3
500,000-1,000,000	4
1,000,000-2,000,000	5
2,000,000+	7

Source: HMRC, "Stamp Duty Land Tax rates: 6 April 2011 to 24 March 2012."

73 The March 2020 budget forecast property transaction tax revenues of £13.8 billion for 2020-21. This figure includes receipts from devolved administration taxes in Wales and Scotland, as well as from the Annual Tax on Enveloped Dwellings (ATED).

Crucially, these were *not* marginal rates. Instead, your property price determined what SDLT rate you paid, and you then paid that rate *on the entire purchase*. This meant, for example, that the SDLT due on a £499,999 purchase was £14,970, while the SDLT on a £500,000 purchase was £20,000—a tax difference of £5,030. Needless to say, this system led to significant distortions in the residential property market.

Change came in 2014, when this “slab” structure was ditched and the current schedule of bands and marginal rates was adopted. This long overdue reform certainly improved the underlying structure of SDLT—and, indeed, reduced tax bills for the vast majority of homebuyers.⁷⁴ But the high marginal rates it entailed for expensive properties do seem to have caused problems, discouraging high-value transactions and producing declining real-terms revenues over the past five years.⁷⁵

During his campaign to become leader of the Conservative Party, Boris Johnson floated the idea of SDLT reform, suggesting that he wanted to increase the threshold for residential properties from £125,000 to £500,000, and bring down the highest standard rate from 12 percent to 7 percent.⁷⁶

That objective was partially and temporarily met in July 2020 when, in an effort to boost the housing market, the threshold for SDLT on residential property rose from £125,000 to £500,000, effective until the end of March 2021.⁷⁷ This means that people buying primary residences currently pay no SDLT on the first £500,000 of the purchase price, a 5 percent

marginal rate up to £925,000, 10 percent up to £1.5 million, and then 12 percent beyond that.⁷⁸

Notwithstanding this time-limited “stimulus” measure, Stamp Duty Land Tax remains a prime candidate for more comprehensive reform in the years ahead.

Stamp Taxes on Shares

When people in the UK buy shares in public companies, they usually pay a tax or duty of 0.5 percent of the purchase price. Electronic transactions are subject to Stamp Duty Reserve Tax, while purchases made using a stock transfer form will be caught by stamp duty if the transaction value is more than £1,000.⁷⁹

As of the March 2020 budget, these taxes were expected to raise £3.6 billion in 2020-21—a bit less than half-a-percent of total forecast tax revenue.

As a rule, stamp taxes on shares are a little-discussed part of the UK tax system—so much so that when British policymakers rail against EU plans for a financial transaction tax, they seem to forget that, at least when it comes to shares, the UK already has one.

Nevertheless, financial stamp duties did make a cameo appearance in the 2019 general election campaign, with the opposition Labour Party outlining plans to extend Stamp Duty Reserve Tax to a much wider range of financial transactions—including foreign exchange, commodities, and interest rate derivatives.⁸⁰

74 Alex Morton, “Stamping Down: Why Cutting Residential Stamp Duty is Easier than You Think,” Centre for Policy Studies, Oct. 27, 2019, 11, <https://www.cps.org.uk/research/stamping-down>.

75 Ibid., 12-14.

76 See Lucian Cook, “The Case for Stamp Duty Reform,” Savills, Aug. 13, 2019, https://www.savills.co.uk/research_articles/229130/287763-0/the-case-for-stamp-duty-reform.

77 HM Treasury, “A Plan for Jobs,” July 8, 2020, <https://www.gov.uk/government/speeches/a-plan-for-jobs-speech>.

78 HMRC, “Stamp Duty Land Tax: Temporary Reduced Rates,” July 8, 2020, <https://www.gov.uk/guidance/stamp-duty-land-tax-temporary-reduced-rates>.

79 For more detail about the application of stamp taxes on shares, see HMRC, “Tax When You Buy Shares,” <https://www.gov.uk/tax-buy-shares>.

80 Labour outlined these plans in their policy costings document (“Funding Real Change,” November 2019, 35-36, <https://labour.org.uk/wp-content/uploads/2019/11/Funding-Real-Change-1.pdf>). The proposal was inspired by Keval Bharadia and Laurey Boughey, “Reinforcing Resilience: Making the UK a citadel of long-term finance,” Intelligence Capital, September 2019, <https://progressiveeconomyforum.com/wp-content/uploads/2019/09/Reinforcing-Resilience.pdf>.

They expected this broader tax to raise £8.8 billion in 2023-24.

The Bank Levy

The bank levy was introduced in 2011, in the wake of the financial crisis, ostensibly to charge banks for the implicit bailout guarantee they enjoy from government. It is a tax on the balance sheets of UK banks and building societies, and the UK operations of foreign banks.

The bank levy is charged at 0.14 percent on liabilities with a maturity of less than one year, and a 0.07 percent half-rate on longer term liabilities and equity. Ordinary deposits covered by the Financial Services Compensation Scheme are exempt from the levy, as are loans backed by UK gilts. The bank levy is not charged on banks' first £20 billion of chargeable liabilities or equity.

As of the March 2020 budget, the bank levy was expected to raise £1.9 billion in 2020-21.

Bank levy receipts peaked in 2015-16, at £3.2 billion. Since introducing the 8 percent corporation tax surcharge on bank profits in 2016, the government has been gradually reducing the bank levy rate, from a 2015 high of 0.21 percent. As a result, revenues have fallen, and are set to continue falling in the years ahead.

From January 1, 2021, the bank levy is set to be 0.1 percent on short-term liabilities, and 0.05 percent on long-term liabilities and equity. At the same time, the non-UK liabilities of UK banks will be excluded from the bank levy tax base.

Some critics of the bank levy remain concerned about the competitiveness of the UK's financial services tax regime in general. For example, PwC's "2019 Total Tax Contribution of the UK Banking Sector" report points out that the total tax rate for a model bank operating in London (47.1 percent) is higher than in either Frankfurt (44.7 percent) or New York City (33.5 percent).⁸¹ What's more, 43.3 percent of the tax borne by UK banks is not dependent on profitability.⁸² This includes the bank levy.

Some research suggests that the bank levy may not actually be an effective means of reducing risk in the financial sector—at least among those institutions that pose a realistic threat to the country's financial stability.⁸³ Nevertheless, the bank levy looks like an enduring—albeit minor—part of the UK tax system.

Revenue from Property Taxes

The March 2020 budget forecast that the property taxes outlined above would raise £94.2 billion in the 2020-21 tax year⁸⁴—just under 12 percent of total expected tax revenues. The anticipated breakdown of property tax revenues is shown in Figure 5.3.

Data from the OECD allows us to compare the UK's property tax revenues with those of other countries over time. Figure 5.4 shows property tax revenues as a percentage of GDP for the UK and some of its main competitor economies, along with the OECD average, from 1980 to 2018.

81 See PwC analysis, "2019 Total Tax Contribution of the UK Banking Sector," UK Finance, October 2019, <https://www.ukfinance.org.uk/policy-and-guidance/reports-publications/2019-total-tax-contribution-uk-banking-sector>. "Total Tax Rate" is the tax borne by a bank as a percentage of profits before business taxes.

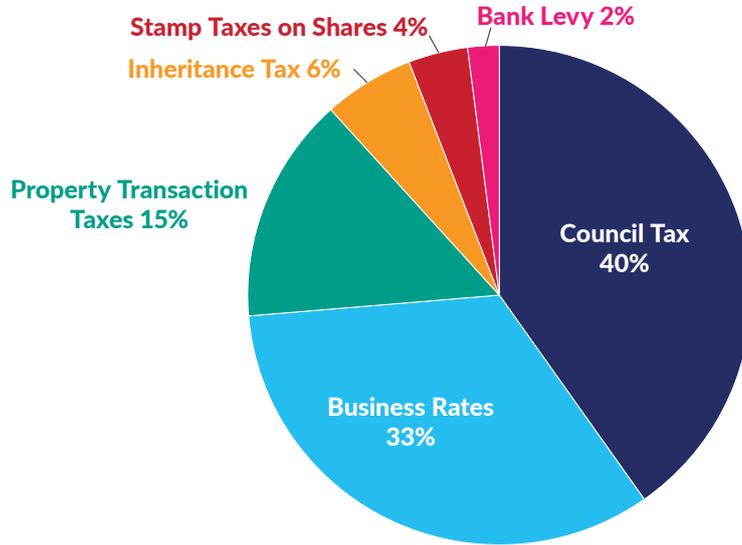
82 Ibid.

83 Leonardo Gambacorta et al., "The effects of tax on bank liability structure," Bank of International Settlements, February 2017, <https://www.bis.org/publ/work611.pdf>.

84 This includes receipts from ATED and the devolved administration property transaction taxes in Wales and Scotland.

FIGURE 5.3
Council Tax and Business Rates
Raise 70 Percent of Property Tax Revenues

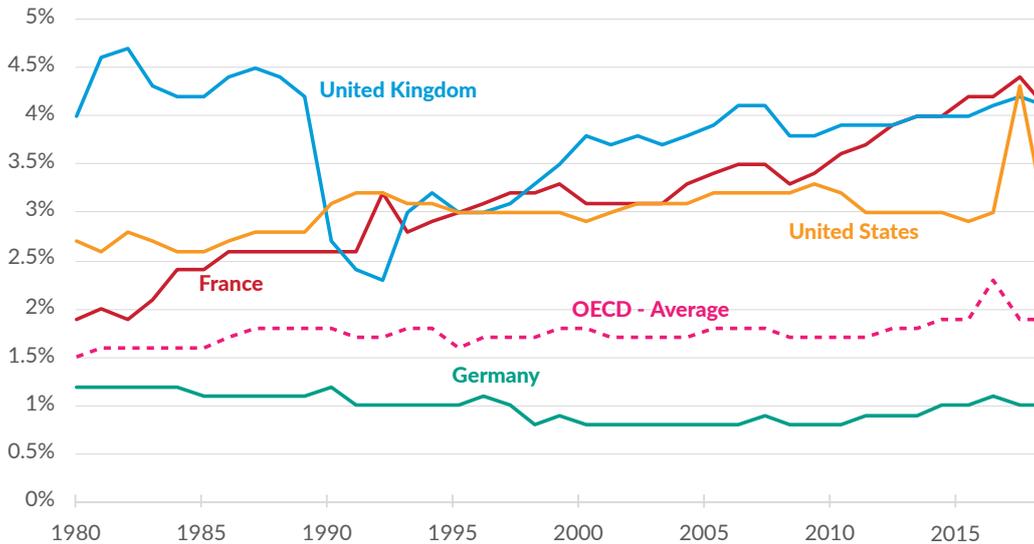
Breakdown of Forecast Property Tax Revenues in 2020-21



Source: HM Treasury, "Budget 2020," Table C.5: Current Receipts.

FIGURE 5.4
The UK Raises more from Property Taxes
than Most of its Main Competitors

Property Tax Revenue as a Percentage of GDP, 1980 to 2018



Source: OECD.stat, Revenue Statistics - OECD countries: Comparative tables.

The UK raises more from property taxes than most of its main competitors. Indeed, in many years (including the most recent one), the UK had the highest property tax revenues as a percentage of GDP in the OECD.

To put it simply, the UK raises a lot of money from taxes on property—more than almost every other country—and has consistently done so over many decades and through multiple economic cycles.

There was one precipitous drop in UK property tax revenue, between 1989 and 1992. This coincides with the abolition of domestic rates (a tax on the rental value of residential property) and their replacement with the community charge—a controversial per-person levy more commonly known as the “poll tax.”

Property tax revenues fell during this period because the community charge was not a tax on property. But once the community charge was itself hurriedly replaced by council tax, property tax revenue began to recover, climbing back towards (though never quite reaching) its previous levels.

Comparing the UK’s Property Taxes Internationally

Property taxes are one of the five main variables assessed by the *International Tax Competitiveness Index*. Overall, the UK ranks 33rd out of 36 OECD countries when it comes to the competitiveness of its property tax system—a strikingly poor result, and one that drags the UK tax system as a whole down the rankings. Table 5.5 highlights how the UK scores compared to some of its main competitor economies.

Clearly, the UK scores considerably worse than Germany, and somewhat worse than the United States and France. Examining a broader sample of countries would only amplify the UK’s relative underperformance: vastly more competitive property tax systems can be found in New Zealand (2nd in the rankings), Australia (3rd), and even high-tax Sweden (5th).

So where exactly does the UK fall down in our analysis?

Its rank for wealth and estate taxes (tied for 10th out of 36) isn’t a huge problem. The UK does lose points for levying inheritance tax. Such taxes tend to limit the resources available for investment and production, while diminishing the incentive to save and invest.⁸⁵ They create significant compliance costs for taxpayers while raising relatively little revenue.⁸⁶ Overall, though, the UK is solidly mid-table when it comes to wealth and inheritance taxes.

Britain’s capital and transaction taxes are rather more problematic (rank: 28th out of 36). By their very nature, these taxes distort economic decision-making by increasing the cost of capital, reducing the after-tax rate of return on investment, and discouraging mutually beneficial trade at the margin. A neutral, pro-growth tax system should therefore seek to avoid them.

Unfortunately, the UK departs from this principle by taxing both property sales (stamp duty land tax) and some financial transactions (stamp taxes on shares). These taxes result in significant economic distortions. The UK also relies relatively heavily on them for revenue. In 2018, the UK’s transaction taxes raised revenue equivalent to 0.8 percent of GDP (versus an OECD average of 0.5 percent) and 2.3 percent of total tax revenue (OECD average: 1.4 percent).

85 Jared Walczak, “State Inheritance and Estate Taxes: Rates, Economic Implications, and the Return of Interstate Competition,” Tax Foundation, July 17, 2017, https://taxfoundation.org/state-inheritance-estate-taxes-economic-implications/#_ftn84.

86 In Britain, inheritance tax raises less than 1 percent of tax revenue but accounts for more than 10 percent of the tax code. See TaxPayers’ Alliance, “Time to Scrap Inheritance Tax,” May 8, 2018, https://www.taxpayersalliance.com/time_to_scrap_inheritance_tax.

TABLE 5.5

International Tax Competitiveness Index 2020: Property Tax Systems

	Overall Rank	Real Property Taxes Rank	Wealth & Estate Taxes Rank	Capital & Transaction Taxes Rank
Germany	11	9	10	7
United States	28	33	10	16
France	29	28	10	28
United Kingdom	33	34	10	28

Source: Tax Foundation, *International Tax Competitiveness Index 2020*.

The UK's recurrent taxes on real property also significantly diminish the country's tax competitiveness. The *International Tax Competitiveness Index* ranks the UK 34th out of 36 in this sub-category—a disappointing result that is attributable both to the *structure* of the taxes imposed in the UK and the *burden* they place on taxpayers.

First, since Britain's business rates apply to buildings, structures, plant, and machinery—things economists call “produced inputs”—they can be quite economically damaging. Taxes structured in this way distort production processes and discourage capital formation. They represent a significant disincentive to business investment (a well-known weakness of the UK economy) and a serious barrier to capital-intensive industry.

Second, the economically-inefficient structure of business rates is compounded by the UK's heavy reliance on real property tax revenues. In fact, such taxes represent a heavier burden on taxpayers in the UK than they do in any other OECD country, with revenues equivalent to 2.6 percent of the country's private capital stock. That's nearly a third more than our nearest competitor, the United States (2 percent).

The UK's combination of a poorly-structured business property tax and a heavy reliance on immovable property tax revenues undoubtedly acts to slow investment, damaging productivity and growth. As such, it represents a significant drag on the country's tax competitiveness.

Property Tax Policies to Boost the UK's International Tax Competitiveness

There is clearly scope for the UK to boost its tax competitiveness through property tax reform. With an *International Tax Competitiveness Index* ranking of 33rd out of 36 in this category, there is plenty of room for improvement.

British policymakers should focus on reforms that eliminate the damaging economic distortions inherent in the existing system of property taxation. In particular, the government should overhaul business rates, by removing buildings, structures, plant, and machinery from the tax base altogether. It should also abolish stamp duty land tax and stamp taxes on shares.

These reforms—and their revenue implications—are outlined below. If enacted, they would improve the UK's ranking in the property tax section of the *International Tax Competitiveness Index* from 33rd to 25th, representing a significant improvement in the pro-growth credentials of Britain's tax system.

In addition to our core proposals, the government should also consider a programme of revaluation and reform for council tax—which could, potentially, be a helpful revenue-raising measure—as well as a major simplification of inheritance tax.

Recommendation 1: Base Business Rates on Site Values

The government should begin its reform of UK property taxes by following the lead of Australia, New Zealand, and Estonia—the countries that rank highest on the *International Tax Competitiveness Index* in this category—and removing buildings, structures, plant, and machinery from the business rates tax base. Rather than taking into account any “improvements” to the property, business rates should be based solely on the value of the underlying site given its legally permitted use.

To illustrate, imagine a sophisticated manufacturing plant. At the moment, its valuation for business rates purposes would reflect the rental value of any office and factory buildings on the site, as well as any plant and machinery that could be considered part of the “infrastructure” of the property (like solar panels or a blast furnace). What we’re proposing here is that all of this be *excluded* from the valuation in the future, and that rateable value should reflect only the value of an empty site in the same location and with the same permitted use (the market value of a site obviously depends on what you are allowed to do with it).

Such a system of valuation may sound odd to British ears, since it differs so much from what we are used to. But it is already practised in a number of national jurisdictions—and many sub-national ones—around the world. And while switching to a site-value basis would obviously require some complex administrative changes, ongoing advances in data collection and analysis would make the transition much easier now than it might have been in the past. A technology-driven approach, utilising artificial intelligence, could easily supplement and eventually replace widespread on-site inspections. Once only site

values matter for valuation purposes, there would in any case be less to inspect.

What’s more, shifting to a site-valuation basis for business rates may already be on the cards politically. In February, *The Times* reported that the government’s business rates review—subsequently announced at the March 2020 budget—would “examine proposals for a tax on land rather than the buildings based on its ‘permitted planning use.’”⁸⁷ In our view, developing a robust blueprint for the introduction of precisely that sort of reform would be the ideal outcome of the business rates review.

Basing business rates on underlying site values would have a series of important benefits. For one thing, since it would reduce the tax burden on businesses investing in their properties, this reform would serve to boost business investment, all else being equal. One outstanding study of business rates—which reached a similar conclusion to our own—suggested that “removing business rates from physical structures...could boost business investment by at least 1% (around £2 billion a year), and productivity and GDP by 0.4% (around £8 billion) in the long run.”⁸⁸ The authors noted that much higher figures “would also be plausible.”

The same study’s modelling underlines the way basing business rates on site values could further several other government objectives as well. In particular, the regional and sectoral impact of the reform could give a big boost to the levelling-up agenda. Across England, the biggest reduction in tax bills would occur in the north and the midlands, with high streets in deprived areas and manufacturing businesses throughout the country coming out as the biggest winners. Even when combining a site-

87 Steven Swinford and Oliver Wright, “Rishi Sunak budget: Tories ‘to save high street’ with land tax to replace business rate,” *The Times*, Feb. 22, 2020, <https://www.thetimes.co.uk/article/rishi-sunak-budget-tories-to-save-high-street-with-land-tax-to-replace-business-rate-7kv6x2zrz>.

88 Adam Corlett, Andrew Dixon, Dominic Humphrey, and Max von Thun, “Replacing business rates: taxing land, not investment,” Liberal Democrats, September 2018, 15, <https://www.libdems.org.uk/autumn-18-replacing-business-rates>.

value basis with a 10 percentage-point higher tax rate, the authors' modelling suggested an average 22 percent tax reduction for manufacturing premises.⁸⁹

A further benefit of putting business rates on a site value basis is that tax bills would fall significantly on energy, communications, and transport infrastructure. This has obvious implications for the government's ambitious capital investment programme as well as for the green agenda—in both cases, the private sector will be encouraged to invest more in Britain's next generation of infrastructure, without fear of facing higher business rates bills as a result.

The obvious question is, how much would this reform cost? The equally obvious answer is, well, it depends.

On the one hand, shifting business rates to a site-value basis need not cost anything at all. You could theoretically make a revenue-neutral switch to site-value basis without significantly compromising the pro-growth aspects of the reform (as outlined above). After all, if you're only taxing land—which, crucially, is not a *produced* input—the economic distortions are minimal. If anything, such a tax would simply encourage the most efficient possible use of any given site.

It is also important to realize that, despite appearances to the contrary, the burden of business rates at present largely falls on *landowners* rather than occupying businesses (sometimes these are one and the same, of course). This means that the ultimate

beneficiaries of lower business rates might not be who you would immediately expect.⁹⁰

We do not, therefore, *assume* any revenue loss from our core recommendation here: to base business rates on underlying site values. Nevertheless, if the government did want to cut the overall level of business rates and was prepared to make room in the budget to do so, there are good reasons to favour such an approach.

First, almost 40 percent of the small- and medium-sized enterprises in England that have a premises own it.⁹¹ For these businesses, the question of incidence is moot. Second, the UK is an international outlier in how much it raises from business rates. This suggests a cut might be reasonable.⁹² Third—and perhaps most important—it is politically much easier to reform taxes if you cut them at the same time. Doing so increases the number of winners from reform and minimizes the number of losers.

With all this in mind, the simplest *tax-cutting* option might be strip everything except permitted-use site value out of the business rates base while leaving the rest of the tax, including the existing multipliers, as it is. In normal times, that would imply a revenue cost of £6.7 billion in England for 2020-21.⁹³

Obviously, if business rates revenues remain depressed because of coronavirus (and the business support measures it has led to) the cost of reform could be lower. More positively, if this reform resulted in the growth effects we anticipate—that is, more investment and higher

89 Ibid., 42.

90 Perhaps that needs a little explanation. Essentially, since the supply of land for various commercial purposes is more-or-less fixed, the market-clearing price is determined by demand—that is, by what tenants are prepared to pay. And from the perspective of an occupying business, it doesn't make much difference whether its money is going to the Treasury or to its landlord. What matters is the overall cost of the premises (rent plus business rates). As a result, the main effect of simply raising or lowering business rates is to change landowner revenues (in aggregate and over the medium term) by a corresponding amount. In other words, the economic *incidence* of business rates falls on them, rather than their tenants.

91 Ibid., 19.

92 OECD data suggests that in 2018, the UK raised 1.5 percent of GDP from "other than households recurrent taxes on immovable property." That's less than Israel, which raised 1.9 percent of GDP, but significantly more than any other OECD country for which data is available.

93 This is based on the estimate from Corlett, Dixon, Humphrey, and von Thun that land accounts for around 75 percent commercial property value in England.

productivity—then the initial revenue cost would be reduced or even eliminated in the medium term, as tax receipts rise relative to the baseline elsewhere in the system. Our £6.7 billion should therefore be regarded as an upper-end estimate.

Since business rates are devolved to Wales, Scotland, and Northern Ireland, the UK government can only reform the system for England. Naturally, though, we would recommend that the devolved administrations followed suit. Furthermore, since business rates revenue is an important source of *local* government funding, any reform of the business rate base must be accompanied by the revision of council funding formulas so that local authorities are not left short of money to pay for important services.

Finally, are there other changes that could helpfully be made alongside the shift to a site-value basis for business rates? Certainly. If we're changing the valuation methodology anyway, this might be a good moment to switch to more frequent—perhaps even annual—revaluations. From a business perspective, this would make inevitable changes in the rates bill smaller and more manageable. From the government's point of view, it would help to ensure that “planning gains” are quickly reflected in higher revenues, as well as limiting the political fallout of large and overdue rates adjustments.

In addition, if one of the goals of reform is to encourage the most efficient permitted use of commercial sites, we might in the long run want to revisit rules around vacant properties—in principle they should be taxed just like occupied ones. And once we have a fairer and more economically efficient tax base in place, we might want to reconsider and rationalise the various reliefs, exemptions, and so on that currently exist. There is plainly much room for simplification.

Making business rates a tax paid by property owners rather than tenants would also be a good move in the long run. It would boost transparency (since that's where the incidence of the tax largely falls anyway), reduce the administrative burden on government (fewer sites to value and fewer taxpayers to collect from), and just make life easier for the majority of smaller businesses which don't own their premises. But such a change would also have to be phased in carefully to avoid suddenly leaving commercial landlords struggling to make ends meet.

Ultimately, though, the short-term goal of reform should be the more modest one we have focused on here: to change the business rates tax base so that it excludes buildings, structures, plant, and machinery, and includes only the value of the underlying site at its permitted use. Doing this would give a considerable boost to the UK's tax competitiveness and boost its economic growth prospects.

Recommendation 2: Abolish Stamp Duty Land Tax

Stamp duty land tax is probably the worst tax on the UK statute books. In the interests of growth, competitiveness, and—indeed—straightforward fairness, it should be abolished at the earliest opportunity.

All taxes have deadweight costs, of course. And most of them—to a greater or lesser degree—encourage some behavioural response that policymakers would rather avoid, all things being equal. What sets stamp duty land tax apart is just how negative its impact is.

An authoritative study from the Australian Treasury, for example, found that stamp duty caused a welfare loss of 72 cents for each \$1 raised, *over and above* the \$1 loss to those

actually paying the tax.⁹⁴ This meant that stamp duty was more than four times as economically damaging as income tax, and five times more harmful than VAT. Another study found that a 2 percentage-point increase in stamp duty caused productivity and welfare losses equivalent to 80 percent of any revenue gains to government.⁹⁵ To put it bluntly, these are extraordinary numbers; they demand action.

So why is stamp duty so harmful? Let's start with the buyers and sellers of a property. From the buyers' perspective, stamp duty makes purchasing a property more expensive. That's true in the short term—having to stump up the cash for stamp duty obviously makes it harder to afford the home you want. But it may also be true over the longer run—stamp duty means buyers will have less money available for a deposit, which may mean a larger mortgage at a higher interest rate. Bigger, costlier mortgages significantly increase lifetime expenses, and also mean greater exposure to risk should the housing market hit a downturn. Finally, having to pay stamp duty can mean less money for repairs, renovations, and so on.

All of this makes buying a property far less attractive than it would be in the absence of stamp duty land tax.

Now let's consider the sellers' perspective. For one thing, while buyers are the ones who actually *pay* stamp duty bills, the economic incidence of the tax is actually split between both parties. It raises costs for the buyer, of course, but it also reduces what sellers are able to charge (because buyers have less money available to spend).

One study suggested that in the UK, the underlying burden of stamp duty is split roughly

60:40, with the buyer bearing the lion's share of the cost, but the seller losing out significantly as well.⁹⁶ This means that as well as making buying a property less attractive, stamp duty can undermine the economics of selling one—especially when you consider that many sellers will be trying to buy another property at the same time. Stamp duty reduces what a seller will get for their current property and reduces what they'll be able to spend on their next one.

Put these two perspectives together, and the obvious consequence is that stamp duty land tax means you get fewer property transactions than would otherwise be the case—a good example of the old adage that the more you tax something, the less you get of it.

Unfortunately, fewer property transactions isn't just bad news for Britain's estate agents. It also has significant negative implications for society as a whole.

When you prevent otherwise mutually beneficial housing transactions from taking place, you also ensure that the country's housing stock isn't allocated in the most efficient, welfare-maximising way. You get more young families crowding into properties that are too small for them, and more empty-nesters hanging on to properties that are much bigger than they really want. Crucially, you also make it harder for people to move where the best job opportunities are—with all the economic disadvantages that entails.

To make matters worse, all these effects are amplified by a restrictive planning system. When it's easy to build new homes—of the sort and in the location that people want—allocating existing ones isn't quite so important. If, on the other hand, the supply of housing is tightly

94 Liangyue Cao et al., "Understanding the economy-wide efficiency and incidence of major Australian taxes," Apr. 7, 2015, <https://treasury.gov.au/publication/understanding-the-economy-wide-efficiency-and-incidence-of-major-australian-taxes>.

95 Christian A.L. Hilber and Teemu Lyytikäinen, "Transfer Taxes and Household Mobility: Distortion on the Housing or Labor Market?" *Journal of Urban Economics* 101 (September 2017): 57-73.

96 Timothy Besley, Neil Meads, and Paolo Surico, "The incidence of transaction taxes: evidence from a stamp duty holiday," *Journal of Public Economics* 199 (November 2014): 61-70.

constrained, then efficient allocation—making sure each property ends up in the hands of the people who value it the most—is absolutely vital.⁹⁷ Sadly, Britain falls very firmly into that second category. Yet it taxes property transactions in a way that makes efficient allocation all but impossible.

Most economists—and a fair few policymakers—would agree with this analysis. Indeed, the Institute for Fiscal Studies’ *Mirrlees Review* (for many the first and last word on tax reform) didn’t exactly mince words when it looked at stamp duty, concluding that “there is no sound case for maintaining stamp duty and we believe that it should be abolished.”⁹⁸

The problem, predictably, is that stamp duty land tax raises quite a lot of money for the government, yielding £11.85 billion in England (and another £80 million in Northern Ireland) according to the latest annual figures.⁹⁹ Losing that revenue would be tough to swallow at the best of times, and perhaps even less appealing when the public finances are stretched (as they clearly are right now).

But would abolishing stamp duty land tax really cost that much? In fact, there are good reasons to believe that it would not, because the flip side of stamp duty land tax reducing property transactions is that getting rid of it would, all things being equal, cause transactions to increase. That would lead to welfare gains for the reasons outlined above, but it might also deliver significant fiscal benefits.

For starters, every property transaction supports a bundle of different tax revenues. It isn’t just stamp duty land tax. Property transactions mean extra business for estate agents, lawyers, surveyors, removals firms, and

so on—all of whom contribute to the Exchequer via corporation tax, VAT, and PAYE. So while the government would clearly lose stamp duty land tax revenue if they abolished it, they might also gain other, offsetting tax revenues if property transactions increased.

This effect could be fairly significant. Based on previous research from the Centre for Policy Studies, abolishing stamp duty land tax could increase transactions by as much as 46 percent. If we combine that with figures from Ludgrove Property,¹⁰⁰ which suggest that the average property transaction in England yields £5,837 in non-stamp duty tax revenue, then we can estimate that the disappearance of stamp duty would be partially offset by a £3 billion increase in other property transaction-related tax revenues.

Perhaps we can go further. The evidence suggests that any increase in housing transactions is very likely to result in an increase in new build homes. This is a clear and direct relationship that comes through strongly from several decades of data. Indeed, Centre for Policy Studies research suggests that you get one additional new build property for every 8.5 extra housing transactions that occur.¹⁰¹ This too has positive fiscal implications.

First, more new build housing means that the government raises more money from planning gain levies like Section 106 agreements and the Community Infrastructure Levy. If abolishing stamp duty increases transactions by 46 percent, and that 1:8.5 relationship between new builds and transactions holds, you might expect around £2.4 billion of additional revenue from these sources.

97 This point is made by Ben Southwood in “Beyond the call of duty: Why we should abolish stamp duty land tax,” Adam Smith Institute, Oct. 30, 2017, <https://www.adamsmith.org/research/beyond-the-call-of-duty>.

98 James Mirrlees et al., “Tax by design,” Institute for Fiscal Studies, Sept. 13, 2011, 404, <https://www.ifs.org.uk/publications/5353>.

99 HMRC, “UK Stamp Tax Statistics, 2018-19,” Oct. 1, 2019, <https://www.gov.uk/government/statistics/uk-stamp-tax-statistics>.

100 Ludgrove Property, “Stamp Duty: The £9.8bn Opportunity,” Oct. 8, 2019, <https://www.ludgroveproperty.com/post/stamp-duty-the-9-8bn-opportunity>.

101 Morton, “Stamping Down: Why Cutting Residential Stamp Duty is Easier than You Think.”

Second, in order to meet its housing targets, the government currently supports development by subsidising the construction of “affordable homes.” If abolishing stamp duty results in more new builds, then some of this spending would be rendered unnecessary—perhaps saving another £1.3 billion.

Putting that all together, it’s possible that the immediate effects of abolishing stamp duty on transaction volumes and new build construction might offset more than half of the anticipated revenue loss—so that abolition costs a little over £5 billion, rather than nearly £12 billion. And this is without considering any of the longer run growth and income effects that one might expect from abolishing a levy as distortionary as stamp duty land tax.

At such a reduced price, abolishing stamp duty could easily be considered a bargain—a tax reform that would boost growth, be politically popular, and not prove ruinously expensive. The government has little excuse for inaction.

Before moving on, it’s worth noting a couple of things. First, while much of this proposal is framed in terms of *housing*, our call for stamp duty abolition applies to commercial property as well. Stamp duty doesn’t magically become a less economically harmful tax just because a business, rather than an individual, is paying it. Second, the numbers above relate specifically to stamp duty land tax in England and Northern Ireland (which is under the control of the government at Westminster), but the same analysis could easily be applied to Wales and Scotland. Accordingly, we recommend that the devolved administrations abolish their property transaction taxes as well.

Recommendation 3: Abolish Stamp Taxes on Shares

Stamp taxes on shares should also be abolished. The same principles that apply to stamp duty land tax apply here too. Transaction taxes are bad taxes. They discourage mutually beneficial trade and distort the allocation of capital in the economy. Ultimately, this diminishes growth and hurts living standards.

As transaction taxes go, stamp taxes on shares are particularly perverse, since they raise so little revenue relative to the economic costs they impose. For the sake of less than half-a-percent of total tax revenue, stamp taxes depress share prices—hurting people’s savings—and raise the cost of equity finance, which hits business investment. They also distort financial markets, creating a bias towards foreign companies over British ones, for private equity over publicly-listed shares, and to derivatives and spread-betting over traditional stock purchases.

Indeed, economics consultancy Oxera has found that abolishing stamp taxes on shares in the UK would increase share prices by 7.2 percent, reduce the cost of equity by 7-8.5 percent, and cut the cost of capital by 5.4-6.5 percent—all leading to a significant increase in fixed business investment by FTSE 350 firms (and thereby helping to address a well-known weakness in the UK economy).¹⁰²

Such effects would boost the value of ordinary investors’ savings and help to increase the size of pension funds at retirement. They would also increase the size of the economy in the long run—Oxera suggests that a permanent increase of between 0.24 and 0.78 percent could be expected.

Overall, the cost of such a reform is likely to be trivial. You would obviously lose the £3.6 billion

102 Oxera, “Stamp duty: its impact and the benefits of its abolition,” May 2007, <https://www.oxera.com/publications/stamp-duty-its-impact-and-the-benefits-of-its-abolition>.

that stamp taxes on shares were expected to raise in 2020-21. On the other hand, you might in the short term see higher income, capital gains, and consumption tax returns as people cash in on the increased value of their share portfolios. More to the point, a larger economy means stronger tax revenues over the long term. Abolishing stamp taxes on shares would be revenue-neutral if long-run GDP increased by 0.41 percent relative to the baseline. If the economic effect were larger, then reform would more than pay for itself.

Needless to say, getting rid of stamp taxes on shares would also make the UK tax system more competitive internationally—particularly compared to its EU neighbours. One of the great ironies of the UK levying stamp taxes on shares is that when the EU proposed a 0.1 percent tax on stock and bond trades, David Cameron vetoed it on competitiveness grounds, saying that “unless the rest of the world all agreed” to impose an equivalent tax, it couldn’t happen.¹⁰³ Yet the UK was already taxing many stock transactions at 0.5 percent—and continues to do so to this day.

Cameron’s instinct, though, was the right one. Most OECD countries do not tax share transactions, and few of those that do levy a rate as high as 0.5 percent. If other countries don’t do it, then the UK—with its large and economically vital financial services industry—certainly shouldn’t either. Stamp taxes on shares should be abolished at the earliest opportunity.

Other Policies to Improve the UK’s Property Taxes

Reforming business rates and abolishing stamp duties would make the UK tax code significantly more competitive internationally. But these reforms would not, by themselves, leave us with a “perfect” system of property taxation,

or anything like it. Further reforms should still be pursued in the years ahead. In particular, Britain’s two most unpopular taxes—council tax and inheritance tax—should each receive long-overdue overhauls. In what follows, we will briefly sketch out the direction such reform should take.

First, **council tax**. If the main objective here was political appeal, one might want to scrap the tax altogether, replacing it with something more obviously palatable, like a local sales or income tax. Yet a local sales tax would be administratively complex and is sure to place an unwelcome burden on the businesses that would be responsible for operating it. Replacing a tax on residential property with an additional tax on earnings, on the other hand, would certainly not be a pro-growth move. Income taxes deter work, whereas residential property taxes, for all their unpopularity, are actually fairly benign from an economic perspective.

Reform, then, is the way forward. But how to proceed? The bedrock of any change to council tax must surely be a revaluation of residential property, so that an important tax base is no longer linked to property prices that are nearly 30 years out of date. And once that revaluation is out of the way, subsequent revisions should take place as regularly and reliably as possible. None of this is to deny the political challenges inherent in revaluation—and clearly, a generous package of transitional relief for anyone who loses out would be necessary. Nevertheless, a tax base that bears some resemblance to reality is the *sine qua non* of a sensible tax system.

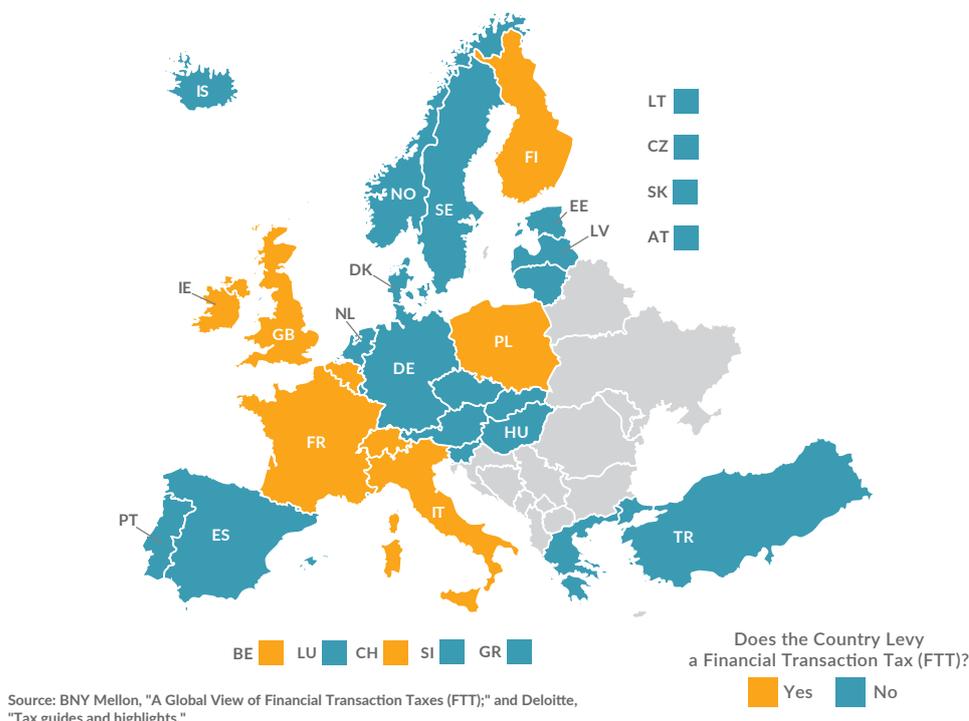
With revaluation complete, a few options present themselves. You could simply leave the rest of council tax as it is, maintaining the existing band system in its current form, but basing it on the new, up-to-date values. Or you could go for incremental change, adding one

¹⁰³ Reuters, “David Cameron: I will veto financial transaction tax,” *The Telegraph*, Jan. 8, 2012, <https://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9000702/David-Cameron-I-will-veto-financial-transaction-tax.html>.

FIGURE 5.4

Financial Transaction Taxes in Europe

European OECD Countries that Levy a Tax on Certain Financial Transactions



or several new bands for the most and least expensive properties.

The Institute for Fiscal Studies recently examined a third option, which is undoubtedly the most appealing from a tax design point of view—if also the most challenging from a political standpoint. That is to replace the band system with a “continuous and proportional council tax” that would be levied at a set percentage of assessed value on all properties in a given local authority.¹⁰⁴

Assuming that local government funding were fully adjusted to reflect different property values in different parts of the country, IFS modelling suggests that a proportionate tax along these lines would cut average bills by more than 20 percent in the north and midlands, and by 0.5 to 0.9 percent of household income for those in the bottom half of the income distribution. The flip side of that, of course, is higher bills in London and the south-east, and

for better-off families. Abolishing stamp duty land tax may placate some of the latter group, but we shouldn’t be in any doubt that tax reform can be a tricky business.

What about **inheritance tax**? Fundamentally, it is not a great way for governments to raise money. It is deeply unpopular, cumbersome and expensive to operate, and generates only a small fraction of overall revenues. Taxing transfers to the next generation discourages work, saving, and investment, and inhibits capital accumulation. None of that is good for economic growth or for a country’s tax competitiveness.

Broadly speaking, there are three possible routes forward. As noted above, the one that has garnered the most attention recently is the idea of replacing inheritance tax with some form of receipts tax, which would involve treating gifts and inheritances as a sort of income and taxing them accordingly over the course of a person’s lifetime.

104 Stuart Adam et al., “Revaluation and reform: bringing council tax in England into the 21st Century,” Institute for Fiscal Studies, Mar. 18, 2020, <https://www.ifs.org.uk/publications/14761>.

Such proposals do, admittedly, have a certain logic to them. As the *Mirrlees Review* put it, if the goal of taxing wealth transfers is greater equality of opportunity, then it is the recipient's gains—and not the size of the deceased's estate—that matters.

Yet such a shift is, in our view, more likely to amplify complaints about “inheritance tax” than it is to quell them. People will heartily resent having to keep track of gifts and declare them to the taxman—all the more so if gifts in kind (like help with accommodation, tuition, or childcare costs) are brought into the tax net, as they would surely have to be to prevent widespread avoidance. There is something unseemly about the state inserting itself into transfers between family members and trying to take a cut and, as such, a receipts tax is unlikely ever to be seen as fair. Nor does it effectively deal with the economic downsides any tax on wealth transfers is likely to have.

A better option is to abolish inheritance tax altogether. This could be accompanied by a change to capital gains tax rules so that rather than forgiving historical capital gains at death—as currently occurs—heirs would acquire the deceased's original cost basis along with any inherited assets. If those assets were subsequently sold, the heirs would have to pay capital gains tax—where applicable—on the entire historic gain, rather than just any part of it that had happened on their watch.

Abolishing inheritance tax in this way would have several advantages. First, increased capital gains tax receipts would help to offset any lost revenue from scrapping inheritance tax. Second, ending the practice of wiping out capital gains tax liability at death would eliminate one of the most significant economic distortions that tax causes—the “lock-in effect” that occurs because people understand it is more tax-efficient to hold on to an asset until death than it is to

realize a lifetime capital gain. Third, existing capital gains tax rules on primary residence and business property relief would mean that heirs who continued to live in a family home or run a family business would not face any tax liability at all.

Should this approach be considered too radical then, in the shorter term, changes to inheritance tax should focus on simplification. Today, many estates can exempt £1 million from inheritance tax, but getting to that number requires the combination of four different allowances, two of which (worth up to £175,000 apiece) only apply to primary residences. It would do wonders for the rationality of the tax system if the government simply said that the first £1 million of every estate were exempt from inheritance tax and left it at that.

A higher, more comprehensive threshold could also help to address the problem that while fewer than 5 percent of estates are ultimately subject to inheritance tax, more than 10 times as many have to fill out and submit all the paperwork.¹⁰⁵ Restricting the inheritance tax net to only the highest-value estates would mean that the vast majority of families who have lost a loved one could simply self-certify that no inheritance tax was owed.

Ultimately, while public sentiment isn't always the best guide to an efficient tax system, when it comes to council tax and inheritance tax, the British people have got it absolutely right. In their current form, these are poorly designed and thoroughly outdated taxes. Fixing them may not be top priorities when it comes to making the UK tax code more competitive internationally, but they should still form part of a comprehensive tax reform agenda in the years ahead.

105 Office of Tax Simplification, “Inheritance Tax Review: Second Report,” 4.

An aerial view of a city street, likely in London, showing a mix of historic and modern buildings, a street with cars and pedestrians, and a large church spire in the background. The entire image is overlaid with a semi-transparent teal color.

CHAPTER 6

CONSUMPTION TAXES

KEY FINDINGS

- The UK ranks 22nd out of 36 OECD countries on the 2020 *International Tax Competitiveness Index's* measure of consumption taxation.
- The UK has a very narrow base for its VAT which leads to distortions and complexity.
- Expanding the VAT base to the OECD average would yield significant revenue to support pro-growth reforms.

In 2018-19, taxes on consumption were responsible for more than a quarter of total tax receipts in the UK, bringing in around £195 billion of revenue.¹⁰⁶

By far the most important tax on consumption is Value-Added Tax (VAT), which by itself raised £133 billion—some 18 percent of total receipts. Other taxes on consumption raised a further £62 billion in 2018-19, representing around 8.5 percent of tax receipts. Fuel duty was the most significant of these other consumption taxes, with 2018-19 revenue of £28 billion.¹⁰⁷

In general, consumption taxes are seen as less harmful to economic growth than corporate or individual income taxes. For a given level of revenue, well-structured consumption taxes typically do less damage to work incentives than income taxes. Moreover, whereas income taxes of both types tend to create a bias against saving and investment, consumption taxes are neutral in this regard.

Another attraction of consumption taxes is revenue stability: consumption tends to be less volatile than the incomes of individuals or businesses, and therefore provides a reliable source of government revenue over the long term.¹⁰⁸

These factors combine to make well-designed consumption taxes a good way to raise revenue while minimising economic distortions. Shifting the burden of taxation away from earnings and

profits and towards consumption can therefore be an important element of pro-growth tax reform—provided, of course, that it is done in the right way.

One downside of consumption taxes is that they are often seen as regressive, weighing more heavily on poorer individuals and households (who are likely to consume a larger share of their income) than richer ones.

This problem can be overplayed, however. For one thing, it doesn't really matter from a distributional point of view that a *particular* tax is regressive; it's the impact of the tax and benefit system *as a whole* that counts.¹⁰⁹

For another, over the course of a person's lifetime, their expenditure should naturally be equal to their income.¹¹⁰ This means that a tax which looks regressive in a single year can actually be proportional (or even, in certain circumstances, progressive) when examined over the longer term.

This chapter reviews the UK's system of consumption taxation—with a particular focus on VAT—and compares it with those of other OECD countries. It also outlines one potential approach to VAT reform that would improve Britain's consumption taxes and help to make its tax system as a whole more supportive of economic growth.

106 The consumption taxes included in this figure are VAT, fuel duty, excise duties on tobacco, alcohol, and gambling, Air Passenger Duty, and Insurance Premium Tax.

107 Betting and gaming duty receipts are taken from HMRC, "National Statistics: UK Betting and Gaming Statistics," Apr. 30, 2020, <https://www.gov.uk/government/statistics/uk-betting-and-gaming-statistics>. Revenue figures for the other consumption taxes covered here are taken from Table C.5 of the March 2020 Budget from HMRC, "Budget 2020: Documents," Mar. 12, 2020, <https://www.gov.uk/government/publications/budget-2020-documents>.

108 See Hannah Simon and Michelle Harding, "What drives consumption tax revenues?" OECD Taxation Working Papers No. 47, Apr. 2, 2020, https://www.oecd-ilibrary.org/taxation/what-drives-consumption-tax-revenues_94ed8187-en;jsessionid=hJ-O_HG-AIHB7reRp0JBUUx.ip-10-240-5-12.

109 For more on the supposed regressivity of VAT and its implications, see Alastair Thomas, "Reassessing the regressivity of the VAT," OECD Taxation Working Papers No. 49, Aug. 10, 2020, https://www.oecd-ilibrary.org/taxation/reassessing-the-regressivity-of-the-vat_b76ced82-en.

110 Bequests, inheritances, and unpaid debts are obvious exceptions to this rule.

Value-Added Tax (VAT)

Value-Added Tax is levied at a standard rate of 20 percent on a wide range of goods and services. It was introduced in 1973 and is currently the third-largest source of revenue for the government, after income tax and National Insurance.

Although it ultimately functions as a tax on final sales to consumers, VAT differs from a retail sales tax in that it is collected in stages through the production process.

VAT-registered businesses pay VAT on their purchases (inputs) and collect VAT on their sales (outputs). When remitting VAT to the taxman, however, businesses deduct the VAT they have paid from the VAT they have collected, either handing over the difference or claiming a VAT refund.

Businesses with a turnover below £85,000 are not required to register for VAT. Those who do register but have a turnover below £150,000 have the option of using the Flat Rate Scheme, according to which they pay a flat rate of tax on their turnover, with the rates set for different sectors based on estimates of average net VAT liabilities.

The VAT system has a number of advantages. It is a tax on value added rather than simply on sales, so businesses can recoup the costs of their input VAT against their VAT liability. This means that while VAT is collected every time a transaction occurs, there is “input neutrality.” Tax is not being charged in full at each stage of the production process, so there is no “cascading effect” from charging a full sales tax on products which have already been subject to full tax further up the supply chain.

From a compliance perspective, moreover, the fact that each stage of the production process involves the assessment and collection of VAT means there is a paper trail for HMRC to follow. Academic economists such as Dina Pomeranz see this as one of the key advantages of a VAT system over other taxation options such as a retail sales tax.¹¹¹

Firms have to keep records of both their input and output VAT, which means that accounts can be cross-referenced to check that one firm’s information is consistent with the information held by another firm.¹¹² This deters avoidance and evasion, and means that the authorities have a greater quantity of information on which to base their enforcement activities.

The practical upshot is that VAT can be levied at a much higher rate than a traditional sales tax without resulting in widespread evasion and can therefore bring in a correspondingly larger amount of revenue.

From an economic standpoint, the big advantage of VAT is that it can be relatively non-distortionary compared to other forms of taxation. However, such neutrality requires the tax base to be as broad as possible. A broader tax base means fewer exemptions or reduced rates which are, *ipso facto*, distortionary by advantaging some products over others.

In addition, the greater the proportion of goods and services given a VAT discount, the higher the headline rate needs to be to raise a given amount of revenue. A high rate means there are greater incentives for avoidance and evasion. It also amplifies the distortionary impact of VAT exemptions, by widening the effective price differential between goods and services that are subject to VAT and those that are not.

111 Dina Pomeranz, “No Taxation without Information: Deterrence and Self-Enforcement in the Value Added Tax,” *American Economic Review* 105:8 (August 2015), <https://eml.berkeley.edu/~saez/course/pomeranzAER15.pdf>.

112 It is worth noting, however, that the *Mirrlees Review* pointed to practical difficulties with such cross-referencing. See Stuart Adam et al., “Dimensions of Tax Design,” Institute for Fiscal Studies, Sept. 13, 2010, 295, <https://www.ifs.org.uk/publications/7184>.

The use of exemptions and reduced rates for VAT is relatively widespread in the UK. Confusingly, there is also a distinction between items which are simply exempt from VAT (sales of which are not included in taxable turnover for VAT purposes) and those that are “zero rated”—which means they are technically subject to VAT, but at a rate of 0 percent.

Zero rating is usually applied to goods deemed to be essentials as a policy instrument for reducing the cost of living for low-income households, whereas exemptions apply in cases where quantifying true “value added” would be difficult, such as in financial services or the public sector, or where some public benefit (e.g., education or health care) is being supplied.

It is worth noting that there is an important practical difference between zero rating and exemption. Zero rating means the seller can still reclaim their input VAT. On the other hand, sellers cannot reclaim input VAT against VAT-exempt output. That distinction causes a lot of complexity (accountants having to allocate input VAT between different outputs) as well as significant economic distortions (since the same inputs may effectively be more expensive for some sellers than others). Maurice Lauré, the so-called “father of VAT,” is said to have described exemptions as “the cancer of the VAT system.”¹¹³

In the UK, most foods, books, transport, and clothing are zero rated. Some food and drink is standard rated because it is not deemed “essential,” such as bottled water, confectionary, alcohol, “eat-in” food supplied in a restaurant or café, and hot takeaway food. A reduced rate of 5 percent is applied to a smaller pool of items, including domestic fuel supplies and children’s car seats.

The fact that a plethora of consumer goods are zero rated raises some bizarre anomalies and, as a result, can distort markets. In some cases, the way different products are treated for VAT purposes has no obvious explanation or is seemingly based on the drawing of arbitrary lines between outwardly similar products.

If we look at how different chocolate baked goods are treated, we can see how some of these peculiarities arise. Cakes and biscuits are normally zero rated, but a chocolate-covered biscuit is subject to standard rate VAT at 20 percent. Chocolate *chip* cookies are zero rated. So is “millionaire’s shortcake”—a shortbread base topped with a layer of caramel and a layer of chocolate. But a shortbread with just chocolate on it is standard rated.¹¹⁴ Likewise, a gingerbread man with chocolate eyes is zero rated, but if he has chocolate trousers he is subject to VAT at 20 percent.¹¹⁵

Zero rating of food alone is estimated by HMRC to cost the Exchequer nearly £19 billion a year. Zero rating for the construction and sale of new dwellings, meanwhile, is worth £15 billion. Applying the reduced rate of 5 percent to domestic fuel and power leads to nearly £5 billion in forgone revenue. The total value of all the zero and reduced rates included in HMRC’s tax relief statistics is just over £55 billion.¹¹⁶

The reasoning behind VAT exemptions is also not clear in many cases. Services such as health and education may be exempt because they are deemed to be in the public interest. But given the inherent distortion to consumer behaviour, it is far from clear that exempting such services from VAT is preferable to alternative redistributive measures, which could easily be funded from the revenue being forgone.

113 Stuart Adam et al., “Dimensions of tax design,” 176.

114 HMRC, “Guidance: Food products (VAT Notice 701/14),” July 9, 2020, <https://www.gov.uk/guidance/food-products-and-vat-notice-70114>.

115 Office of Tax Simplification, “Value added tax: routes to simplification,” November 2017, 39–40, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/657213/Value_added_tax_routes_to_simplification_web.pdf.

116 HMRC, “Non-structural tax reliefs: Estimated cost of non-structural tax reliefs (October 2019),” May 20, 2020, <https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs>.

TABLE 6.1

The Estimated Revenue Cost of Non-structural VAT Reliefs, 2019-20 (£m)

Zero rated (0%)	Food	18,900
	Construction and sale of new residential buildings	15,200
	Domestic passenger transport	5,550
	Drugs and supplies on prescription	3,200
	Water and sewerage services	2,500
	Children's clothing	2,000
	Books	1,500
	Vehicles for the disabled	850
	UK portion of international passenger transport	300
	Cycle helmets	25
	Reduced rate (5%)	Domestic fuel and power
Installation of energy-saving materials		80
Women's sanitary products		35
Smoking cessation products		25
Children's car seats		25
Contraceptive products		15
Small traders' exemption from compulsory VAT registration (annual turnover below £85,000)		2,150
TOTAL		57,155

Source: HMRC, "Non-structural tax reliefs: Estimated costs and unavailable costs of non-structural tax reliefs," May 20, 2020, <https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs>.

Financial services are also exempt, meaning financial institutions cannot reclaim VAT paid on the goods and services they use, but also that the VAT system captures none of the value they add through their services. A whole chapter of the *Mirrlees Review's* concluding publication was devoted to the anomaly of financial services and VAT.¹¹⁷

HMRC estimate that the exemption for finance and insurance is worth £12.6 billion, and that the total value of *structural* VAT reliefs across all sectors is £49 billion (this includes more than £19 billion in VAT refunds to public sector bodies).¹¹⁸

The justifications for the expensive zero and reduced rates have traditionally been on the grounds of redistribution and social welfare. Policymakers are aware that, compared to direct

taxes such as income tax, VAT is *prima facie* a relatively regressive tax because it is blind to circumstances; I pay the same price in a shop whether I am rich or poor.

Lower income households also use a higher proportion of their income for consumption than those on higher incomes, who save and invest a larger proportion of their income on average. The bottom income quintile of individuals pays nearly 10 percent of their gross income in VAT compared to less than 5 percent for the top quintile.

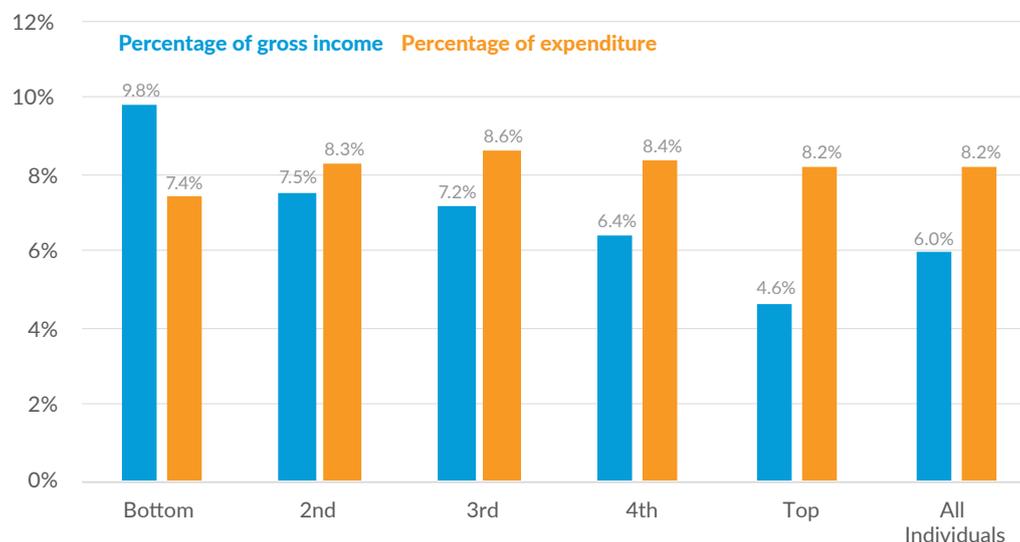
117 See James Mirrlees et al., "Tax by design," Institute for Fiscal Studies, Sept. 13, 2011, Chapter 8, <https://www.ifs.org.uk/publications/5353>.

118 HMRC, "Estimated cost of structural tax reliefs (October 2019)," Oct. 10, 2019, <https://www.gov.uk/government/statistics/minor-tax-expenditures-and-structural-reliefs>.

FIGURE 6.1

Individuals in Bottom Income Quintile Pay Nearly 10 Percent of their Gross Income in VAT compared to less than 5 Percent for the Top Quintile

Percentage of gross income and expenditure paid in VAT by income quintile, 2018-19



Source: Office for National Statistics, "Effects of taxes and benefits on household income, 2018-19," Table 8, June 23, 2020, <https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/datasets/theeffectsoftaxesandbenefitsonhouseholdincomefinancialyearending2014>.

With this in mind, it is easy to see why policymakers have opted to reduce the VAT on essential goods to bring down the cost of living for poorer households. In practice, however, it has long been recognised that this is a highly inefficient way of supporting the living standards of lower-income households. While VAT relief may be worth more to lower-income households as a proportion of their income, in cash terms the majority of the forgone revenue benefits middle- or higher-income households.

Furthermore, it might be assumed that—since zero rates are meant to be reserved for “essentials”—poorer households would pay a lower proportion of their actual expenditure in VAT than better-off households, who we might expect to be spending more on luxuries. In reality, zero rates are so broad that there is very little difference, with 7.4% of the bottom income quintile’s expenditure going to VAT compared to 8.2% for the top quintile.¹¹⁹ In short, it is an incredibly expensive use of resources which is both poorly targeted and highly distortionary.

However, while it is easy to point out the practical merits of a comprehensive VAT base, recent political history is not encouraging when it comes to the prospect of reform.

Attempts to iron out various anomalies in the VAT system were included in the 2012 Budget and were the main reason this became known as the “Omnishambles Budget.” A peculiarity within the VAT rules for hot takeaway food meant the sale of pasties and pies was zero rated because they were deemed to be only “incidentally” warm after baking (the rule exists largely to ensure freshly baked bread is not treated as hot food and thus liable for VAT). The 2012 Budget sought to apply VAT to all hot food except freshly baked bread, but this was dubbed the “pasty tax” in the media and the government was forced to reverse the policy.

Another planned measure—to remove an anomaly that meant mobile caravans were subject to VAT but static caravans were

¹¹⁹ Office for National Statistics, “Effects of taxes and benefits on household income, 2018-19,” Table 8, June 23, 2020, <https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/datasets/theeffectsoftaxesandbenefitsonhouseholdincomefinancialyearending2014>.

not—was also watered down, with the reduced rate of 5 percent being applied in the end.

More recently, debates around the UK's increased flexibility over domestic policy after leaving the European Union have included calls for yet more zero rates to be applied. Women's sanitary products are required under EU rules to have at least the reduced rate of VAT applied, dubbed a "tampon tax" by campaigners, and the government has committed to zero rating them after the Brexit transition period ends. Domestic fuel and power are subject to reduced rate VAT, which was a live political issue in the 1990s, and some have called for zero rating to be applied again when the UK regains the right to do so.

At the March 2020 budget, the government introduced zero rating of e-books to remove the so-called "reading tax." The move was planned for December 2020 but was fast-tracked in response to rising demand for electronic publications due to the coronavirus pandemic. It is estimated to cost around £200 million per year.¹²⁰

More recently still, the government temporarily cut VAT from the standard 20 percent rate to the reduced 5 percent rate for hospitality (food and nonalcoholic drinks in cafés, pubs, and restaurants), hotel and holiday accommodation, and certain attractions such as cinemas, theatres, and amusement parks. This tax break, which is expected to cost a little over £4 billion, will apply until January 12, 2021.¹²¹

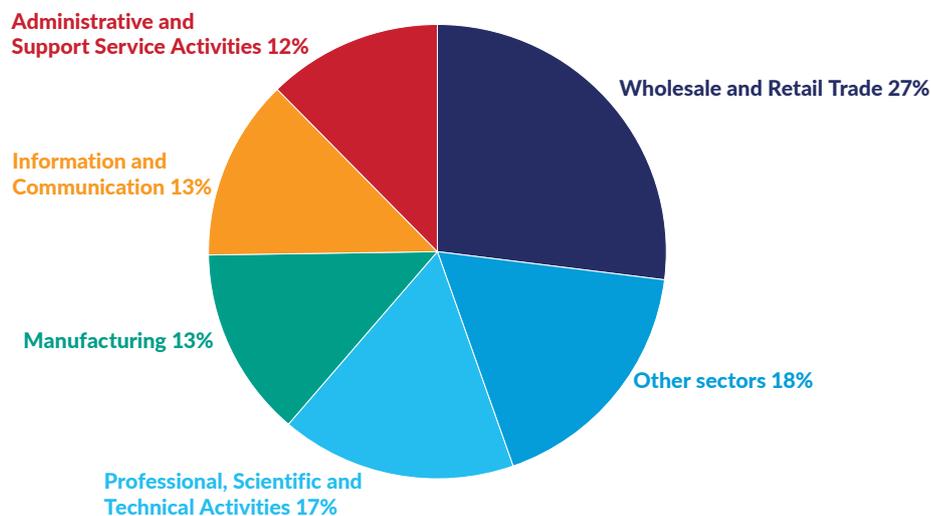
VAT Revenue

VAT receipts in 2018-19 were £132 billion, consisting of £99 billion of domestic ("home") VAT and £33 billion of import VAT. Within home VAT receipts, by far the biggest contributing sector is wholesale and retail trade, which had £28 billion of liabilities in 2018-19. Four other sectors had declared VAT liabilities above £10 billion (see Figure 6.2), and together these top five sectors account for 82 percent of total home VAT.

FIGURE 6.2

Among All VAT Receipts Biggest Contributing Sector is Wholesale and Retail Trade

Net Home VAT-Declared Liabilities by Trade Subsector, 2018-19



Source: HMRC, "Annual UK VAT Statistics 2018-19," Table 4b, Nov. 28, 2019, <https://www.gov.uk/government/statistics/value-added-tax-vat-annual-statistics>.

120 Gov.uk, "Budget 2020: Documents," Mar. 12, 2020, <https://www.gov.uk/government/publications/budget-2020-documents>.

121 Rob Janering, "Temporary VAT rate reduction to 5% for the hospitality and tourism industry," Crowe, July 8, 2020, <https://www.crowe.com/uk/croweuk/insights/temporary-vat-rate-reduction>.

Revenue as a percentage of GDP has risen gradually since 1980 from just under 5 percent of GDP to 7 percent in 2018. As a proportion of overall tax revenue, VAT receipts have risen from just under 15 percent to 21 percent. As we would expect, there is a dip in receipts in 2008-09 due to the temporary cut in the standard rate from 17.5 percent to 15 percent as part of the government's stimulus package, and a subsequent rise above the pre-crisis average when the rate was increased to 20 percent under the Coalition to raise revenue for deficit reduction.

Comparisons with other countries on VAT alone are difficult because some countries do not operate a VAT system and use other taxes on goods and services instead, such as retail sales taxes. The OECD dataset on VAT revenue in different countries, therefore, gives a figure of 0 for several countries, such as the U.S. If we look at the OECD data for taxes on goods and services more widely, we can see that the UK's slight increase in revenues as a proportion of GDP since 1980 is broadly in line with the story across the OECD.

Other Consumption Taxes

A number of other smaller taxes on consumption exist in the UK. In most cases, these are designed to in some way compensate for the public costs of negative externalities, though some duties exist for little reason other than to raise revenue.¹²² Some of these sources of revenue have been in gradual decline, partly due to politics (fuel duty) and partly due to social and economic developments (tobacco). Others have been used as tools to subtly raise additional revenue without increasing direct taxes.

By far the largest revenue raiser is duty on hydrocarbon fuels, which raised £27.6 billion in 2019-20.¹²³ Around £10 billion of this comes from duty on petrol and £17 billion from duty on diesel. Duty is set in pounds and pence terms per litre, rather than as a percentage rate.

Fuel duty revenue will gradually drop as the use of hybrid and electric vehicles increases and the government progresses towards its stated target of ending the sale of petrol and diesel cars by 2035. But fuel duty has also proved an easy political lever for popular headlines at fiscal events. This is perhaps partly because, unlike other taxes, most excise duties take the form of a cash-terms levy and thus need to be updated at each budget to maintain their value.

As a percentage of GDP, fuel duty receipts dropped from 2.2 percent in 1999-2000 to 1.3 percent in 2017-18—a 40 percent decline.¹²⁴ Fuel duty was reduced by the Coalition by 1p per litre in 2011 and has been frozen in every budget since then. This means that not only was the planned “escalator” inherited from Labour scrapped but there has also been no indexation: note that a duty “freeze” is in reality a tax cut. According to the Institute for Fiscal Studies, fuel duty policy decisions since 2010 have cost more than £11 billion relative to the plans inherited by the Coalition, and £5.5 billion relative to uprating in line with inflation (CPI).¹²⁵

Duty is levied on tobacco, with different levies applied to different products. Tobacco duties raised £8.8 billion in 2019-20.¹²⁶ The vast majority of revenue (81 percent) comes from duty on cigarettes, for which a levy per 1,000 cigarettes is applied plus 16.5 percent of the retail price.¹²⁷ Revenue from hand rolling

122 Excise duties on alcohol, tobacco, and energy have until now been subject to an EU directive specifying minimum tax rates and certain calculation methods. Once the Brexit transition period comes to an end, these rules will (absent further agreement) cease to apply in the UK. British policymakers may see this as an opportunity for reassessment and reform.

123 HMRC, “National statistics: Hydrocarbon Oils Bulletin,” Mar. 20, 2020, <https://www.gov.uk/government/statistics/hydrocarbon-oils-bulletin>.

124 Office for Budget Responsibility, “Tax by tax, spend by spend: Fuel duties,” <https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/fuel-duties>.

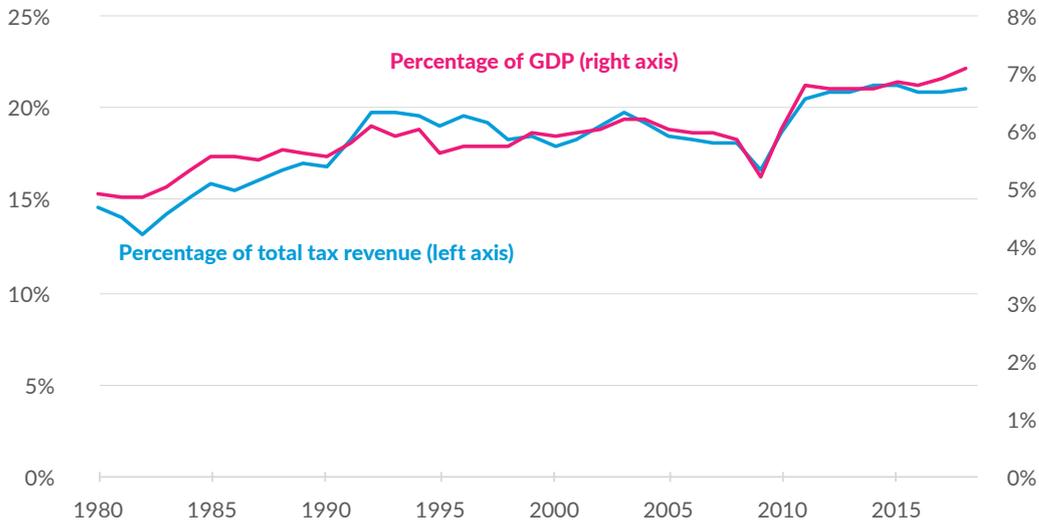
125 Stuart Adam and Rebekah Stroud, “A road map for motoring taxation,” Institute for Fiscal Studies, Oct. 4, 2019, <https://www.ifs.org.uk/publications/14407>.

126 HMRC, “National statistics: Tobacco statistics tables April 2020,” Aug. 21, 2020, <https://www.gov.uk/government/statistics/tobacco-bulletin>.

127 HMRC, “Guidance: Tobacco products duty rates,” Mar. 11, 2020, <https://www.gov.uk/government/publications/rates-and-allowances-excise-duty-tobacco-duty/excise-duty-tobacco-duty-rates>.

FIGURE 6.3
From 1980 to 2018 VAT Receipts as a Proportion of Overall Tax Revenue Rose from Just Under 15 Percent to 21 Percent

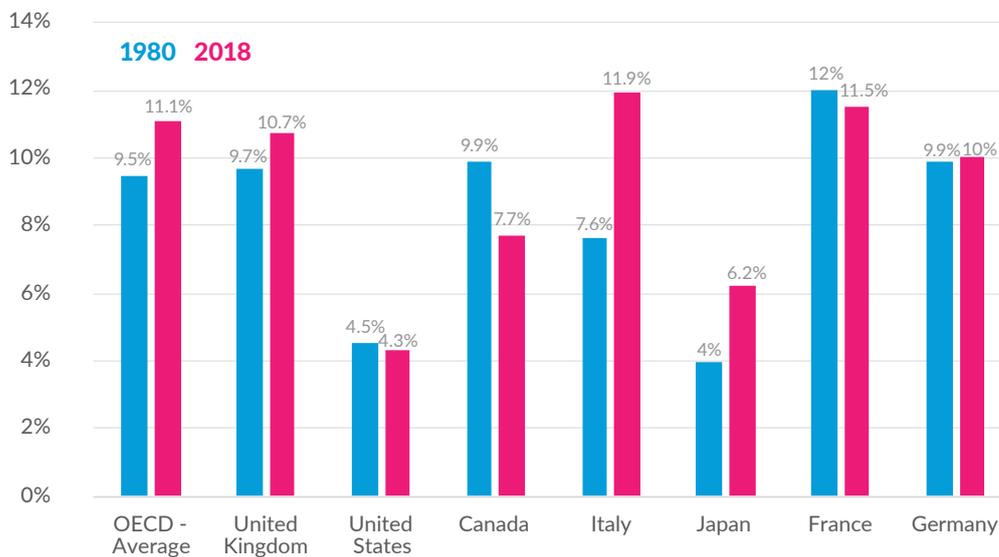
UK VAT Revenue 1980-2018, as Percentage of Total Tax Revenue and of GDP



Source: OECD, "Revenue Statistics - OECD countries: Comparative tables," <https://stats.oecd.org/Index.aspx?DataSetCode=REV>.

FIGURE 6.4
From 1980 to 2018, UK Consumption Tax Revenues Increased Slightly as a Share of GDP

Taxes on Goods and Services as a Percentage of GDP in Different Countries, 1980-2018



Source: OECD, "Revenue Statistics - OECD countries: Comparative tables," <https://stats.oecd.org/Index.aspx?DataSetCode=REV>.

tobacco has been increasing in recent years due to the price differential with traditional cigarettes. The government has responded by significantly increasing duty on hand rolling tobacco, over and above the above-inflation increases in duty on cigarettes. In the March 2020 budget, the Chancellor increased duty

on cigarettes by inflation (RPI) plus 2 percent and increased duty for hand rolling tobacco by inflation plus 6 percent.

Tobacco duty receipts have been decreasing for decades as smoking rates have declined substantially. In the early 1990s, roughly 3

percent of all tax revenue was from tobacco duties, but this had dropped to just 1.3 percent by 2019-20.¹²⁸

Alcoholic drinks are subject to different duties depending on the category of beverage. Overall revenue from these duties is around £12 billion in 2019-20, consisting of £4.4 billion on wine, £3.8 billion on spirits, and £3.8 billion on beer and cider.¹²⁹ The different duties are calculated in different ways—for example, wine duty is based on a rate per hectolitre of wine, whereas spirits duty is levied per litre of pure alcohol in the product. Government has often found it tempting to freeze or cut duties, particularly beer duties, for political reasons (“a penny off a pint”).

Most forms of gambling are subject to duties, including general betting, gaming in casinos, bingo, and lottery tickets. These duties collectively raised £3 billion for the Exchequer in 2019-20.¹³⁰

Air Passenger Duty (APD) is charged on passenger travel by plane. It is levied on each passenger, with revenue totalling £3.6 billion in 2018-19.¹³¹ Different rates are charged on different “bands” of destination, with Band A applying to destination countries whose capital city is within 2,000 miles of London and Band B for further distances. Recently, governments have tended to focus their attention on longer-haul flying, with standard APD Band A rates remaining unchanged since 2012 at £26 but Band B being increased each year, going from £130 to £176.¹³² Receipts have roughly doubled over the last decade.

Finally, Insurance Premium Tax (IPT) is a levy on general insurance premiums that functions as a partial substitute for VAT. In recent years governments have found it a useful way of raising extra revenue while losing minimal political capital. Since 2010 the standard rate of IPT has risen from 5 percent to 12 percent, and the higher rate has risen from 17.5 percent to 20 percent.¹³³ Receipts have more than doubled in the last five years alone, rising from £3 billion in 2014-15 to £6.2 billion in 2018-19.¹³⁴

Comparing the UK's Consumption Taxes Internationally

Consumption taxes are one of the five main categories of taxation assessed by the *International Tax Competitiveness Index*. Overall, the UK ranks 22nd out of 36 OECD countries when it comes to the competitiveness of its consumption tax system.

In this category, the *Index* focuses primarily on VAT (or retail sales taxes if no VAT is levied). It judges a consumption tax system to be competitive if the tax rate is relatively low, the tax base is relatively broad, and compliance is not too time-consuming. A consumption tax system with these characteristics will be one that raises revenue efficiently, without distorting markets or diminishing economic growth.

Table 6.2 shows how the UK scores compared to some of its main competitor economies.

128 Calculated as a percentage of national accounts taxes, based on HMRC, “National Statistics, Tobacco statistics tables, April 2020,” and at Office for Budget Responsibility, “Public finances databank – June 2020,” Receipts (Ebn), Jun. 23, 2020, <https://obr.uk/data/>.

129 HMRC, “National Statistics: UK alcohol duty statistics tables (July 2020),” Aug. 28, 2020, <https://www.gov.uk/government/statistics/alcohol-bulletin>.

130 HMRC, “National Statistics: UK Betting and Gaming Statistics.”

131 HMRC, “National Statistics: Air Passenger Duty Statistics Tables, March 2020,” Table 1, Apr. 30, 2020, <https://www.gov.uk/government/statistics/air-passenger-duty-bulletin>.

132 Ibid., Table 3.

133 HMRC, “Guidance: Insurance Premium Tax rates,” Aug. 4, 2017, <https://www.gov.uk/government/publications/rates-and-allowances-insurance-premium-tax/insurance-premium-tax-rates>.

134 HMRC, “National Statistics: Insurance Premium Tax (IPT) tables (December 2019),” July 31, 2020, <https://www.gov.uk/government/statistics/insurance-premium-tax-ipt-bulletin>.

TABLE 6.2

International Tax Competitiveness Index 2020: Consumption Tax Systems

	Consumption Taxes Rank	Rate Rank	Base Rank	Complexity Rank
United States	5	1	25	12
Germany	12	12	12	19
France	21	14	33	11
United Kingdom	22	14	36	7

Source: Tax Foundation, *International Tax Competitiveness Index 2020*.

Clearly, the UK does not fare too badly on complexity. It ranks 7th out of 36 OECD countries on that sub-variable, with an average VAT compliance time of 25 hours, compared with an OECD average of 53 hours. Nor does the UK's standard VAT rate particularly harm its competitiveness. At 20 percent, the UK's standard VAT rate is very close to the OECD average (a little over 19 percent).

What does let the UK down, however, is its consumption tax base. The *Index* assesses countries' performance on this measure in two ways. First, it looks at the threshold for VAT registration. The UK's £85,000 threshold is high by international standards—in fact, it is the highest threshold in the OECD, and stands at more than twice the OECD average (roughly £32,900).

Second, the *Index* looks at the ratio of actual VAT revenue to potential VAT revenue—that is, to the revenues that would be raised if the standard rate (20 percent) applied to *all* consumption. (The difference between actual and potential VAT revenues is due to policy choices to exempt certain goods and services from VAT or tax them at a reduced rate, as well as gaps in VAT compliance.)

The UK fares poorly on this measure too: at just 45 percent of potential revenue, its VAT base ranks as one of the narrowest in the OECD. New Zealand, which comes out on top for this measure, manages almost 100 percent;

Switzerland and Japan manage 69 and 72 percent, respectively.

Overall, the UK is judged to have the least competitive consumption tax base in the OECD, ranking 36th out of 36 developed economies. A narrow base means a higher headline tax rate to raise a given amount of revenue, leads to administrative complexity, and distorts economic decision-making. Given that well-designed consumption taxes are less harmful to economic growth than taxes on earnings, investment, or profits, a narrow VAT tax base invariably makes the tax code *as a whole* less growth-friendly—since the substantial forgone revenue must be made up elsewhere in the system.

What about the UK's other consumption taxes? While they do not figure in the *Index* directly, it's worth noting here that the UK's excise duties are relatively high by international standards. Its taxes on petrol are the 6th highest in Europe. Its taxes on spirits are the 4th highest in Europe. Its beer and wine taxes are the 3rd highest. And its taxes on cigarettes are second only to those of the Republic of Ireland.

Consumption Tax Policies to Boost the UK's Tax Competitiveness

VAT is far and away the most important part of Britain's consumption tax system. By itself, it accounts for nearly a fifth of total tax revenues. Only the main taxes on personal income— income tax and National Insurance—raise more money for the Exchequer. Corporation tax, the next biggest revenue-spinner, yields less than half the receipts VAT does.

What's more, a well-designed VAT can be a relatively growth-friendly tax. It weighs less heavily on the economy than corporate or personal income taxes and is certainly less damaging than Britain's *existing* property tax system. Properly implemented, VAT is neutral towards spending, saving, and investment decisions. Crucially, the abundant revenue VAT produces allows other, more economically damaging taxes to be lower. As such, getting VAT right is an important part of a pro-growth tax reform agenda.

Unfortunately, our analysis suggests that the UK does not get VAT right. A well-designed VAT would have a broad base and a low rate. Yet Britain has the 7th narrowest VAT base in the OECD and a standard rate that is slightly above average. Its consumption tax system is therefore compromised in two significant ways: first, it is economically distortionary; second, it is not as effective a money-raiser for the government as it otherwise would be.

As noted above, the politics of VAT are difficult. Attempts at piecemeal reform in the past have been unpopular failures. But perhaps a more comprehensive programme—embedded in a wider, pro-growth tax agenda—could prove more successful. While fully recognising the challenges involved, that is the approach we recommend here.

Recommendation: Broaden the VAT Base

Our primary concern in this report is to make the UK's tax system more supportive of economic growth. A broader VAT base would do that by making the tax system more neutral towards economic decision-making, and by enabling a broader shift in the tax burden from production (in all its forms) to consumption.

It is worth noting at the outset, however, that from a simple revenue perspective, the theoretical gains from a broader VAT base are quite spectacular.

Had the UK's VAT base been as broad as New Zealand's in 2018-19, for example, VAT receipts would have more than doubled to a little over £290 billion. The extra revenue (just shy of £160 billion) could have single-handedly funded the NHS or, alternatively, have allowed the government to abolish corporation tax, council tax, business rates, capital gains tax, inheritance tax, and stamp duties—and still left a decent chunk of change to spare.¹³⁵

Making the UK's VAT base as broad as Switzerland's, meanwhile, would have generated £70 billion or so of additional revenue in 2018-19—that's more than what was spent on defence *and* transport in the same year, and about what was raised by business rates, council tax, and inheritance tax combined.

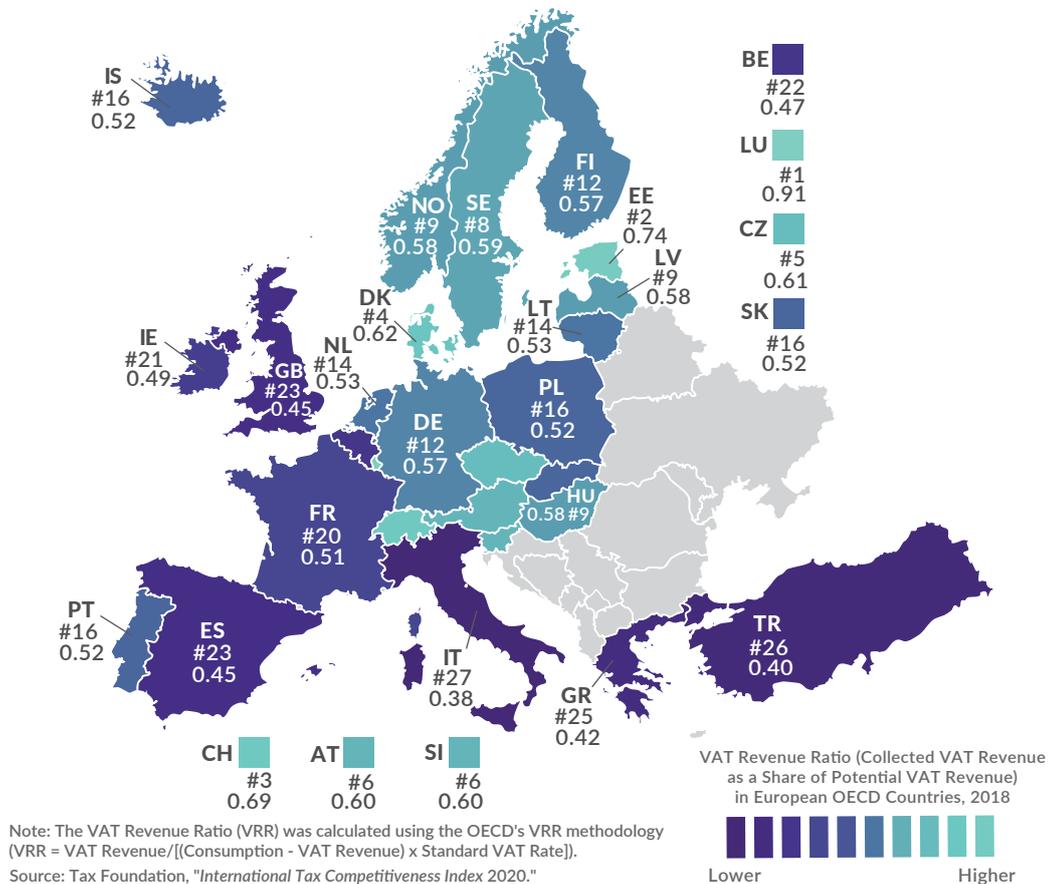
In short, these are very big numbers we are talking about. That alone should help to make it clear that narrowing the VAT base is an extraordinarily inefficient way for governments to meet distributional policy goals. If the regressivity of VAT is deemed to be a problem, it can be addressed far more cheaply through targeted assistance to poorer households than it can by carving out so-called "essentials" from the tax base.

¹³⁵ Note that this is simply an indicative list. The taxes named are not *necessarily* the best ones to cut or abolish in pursuit of a pro-growth agenda.

FIGURE 6.5

VAT Bases in Europe

VAT Revenue Ratio (Collected VAT Revenue as a Share of Potential VAT Revenue) in European OECD Countries, 2018



The challenge, of course, is getting from here to there. It would undoubtedly be over-optimistic to think that Britain could adopt a VAT system like New Zealand's—or even Switzerland's—overnight. A slightly more modest approach is more realistic. Our suggestion, then, is that the UK aims to simply make its VAT base as broad as the OECD average. That would be equivalent to taxing 56 percent of total consumption at the standard rate of VAT, as opposed to just 45 percent.¹³⁶

It would be up to the government to determine precisely how that base broadening should be achieved. They needn't aim for absolutely purity. In the interests of administrative

simplicity, for example, the current threshold for VAT registration could be maintained—although given that it is already the highest such threshold in the OECD, the government probably should decline to raise it any further.

And while broad categories of goods and services like food, transport, and domestic fuel *would* almost certainly have to be taxed at the standard rate going forward, there is plenty of scope to avoid politically toxic tax increases on, say, prescription medicines, or women's sanitary products. The taxation of residential property, meanwhile, is clearly something that should be looked at separately from any effort to broaden the VAT base.

136 It is worth noting here that HMRC estimates a £10 billion "VAT gap" for 2018-19—that is, a shortfall in actual VAT receipts versus the VAT receipts you would expect based on "net VAT total theoretical liability." Closing this VAT gap would be another way to improve the UK's VAT base on the metric used by the *International Tax Competitiveness Index*. See HMRC, "Preliminary estimate of the VAT gap for 2018-19," Mar. 11, 2020, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/870830/est-vat-gap-2019.pdf.

Looking at pre-coronavirus tax receipts forecasts, you might expect broadening Britain's VAT base to the OECD average level to yield more than £35 billion of extra revenue in 2021-22. If one were looking at VAT reform in isolation, you could simply use that increased revenue to cut the standard VAT rate—dropping it to 16 percent would be roughly revenue-neutral, overall. Alternatively, you could fund the most affordable version of the reforms outlined elsewhere in this report, while cutting the standard VAT rate back to 17.5 percent—its pre-financial crisis level.

However, neither of these options addresses the distributional impact of a broader VAT base. And while we don't think it is necessary to maintain a *particular* degree of progressivity in the tax system, we also don't want poorer households to lose out from our proposed reforms. How, then, can we square the circle?

The Institute for Fiscal Studies' *Mirrlees Review* came up with two options.¹³⁷ One would have devoted the vast majority of the increased revenue from VAT base broadening to a package of generous benefit increases and income tax cuts, as well as a few tweaks to tax allowances. Their modelling suggested that it was possible (at least in the aggregate) to fully compensate every household for the impact of a broader VAT base, without damaging work incentives, and with extra revenue left over to share.

The Institute for Fiscal Studies' second option simply devoted some 55 percent of the revenue from VAT base broadening to “a 15% increase in all the main means-tested benefits and tax credits.” This left the poorest third of households better off, but meant higher taxes for the rest, while weakening work incentives (increasing effective marginal tax rates *and* participation tax rates), especially for low earners.

While we don't endorse either of the exact approaches outlined in the *Mirrlees Review*, they do at least show what is possible with a bit of creative thinking.

Our own preference—and our central recommendation here—is to put about two-fifths of the revenue from VAT base broadening towards funding our other pro-growth tax reforms, while using the remainder to turn VAT itself into a mildly progressive tax. This could be accomplished by making every adult in the UK eligible for a flat-rate VAT “prebate” worth up to £400 a year, effectively exempting a small amount of each household's spending from VAT (and functioning rather like a personal allowance for consumption tax).¹³⁸

Detailed modelling would clearly need to be undertaken before such a policy were implemented, but our initial estimates suggest this approach would fully compensate (and in many cases benefit) lower-income households, while partially offsetting the impact of a broader VAT base among better-off groups.

Overall, the impact of this reform would be to significantly reduce the economic distortions inherent in the UK's complex and incomplete VAT base, while raising revenue for pro-growth tax reform elsewhere in the system *without* burdening less well-off taxpayers.

What's more, our proposed reform would make VAT a much more efficient revenue raiser in the future and might help to neutralise the perception that VAT is a necessarily regressive tax. This last point could enable further reform—and a greater shift towards taxing consumption instead of work, investment, and production—in the years ahead.

137 See James Mirrlees et al., “Tax by Design,” Chapter 9.

138 This is obviously a simplified model for a progressive VAT. Policymakers would need to consider whether it would be better to operate any such prebate on a household basis, taking account of family characteristics. They might also be tempting to taper the prebate for better-off households—though it must be noted that this would raise effective marginal tax rates and could diminish work incentives.

CHAPTER 7

CORPORATE TAXES

KEY FINDINGS

- The UK ranks 17th out of 36 OECD countries on the 2020 *International Tax Competitiveness Index's* measure of corporate taxation.
- Despite a low headline rate, the structure of the UK's corporation tax increases the costs of new investments and creates a bias towards debt financing.
- Capital allowances should be made more generous to improve incentives for investment, and limits on loss carry-forwards should be abolished.

In 2018, the UK raised 8.6 percent of its total revenues from taxes on corporations.¹³⁹

Because investment can easily move across borders, corporation tax is an important element for businesses determining whether and to what extent they invest and hire in the UK.¹⁴⁰

Over the last two decades, the UK has changed both its corporate tax rate and its corporate tax base. Combined, the changes have lowered the tax burden on some business investments and activities while increasing the burden on others.

When a business is deciding to invest it must consider multiple factors. These include its shareholders' required rate of return on an investment, and the costs of making an investment—including tax costs.¹⁴¹

Tax policy impacts business investment decisions on whether to invest, what to invest in, and how to finance that investment.¹⁴² If the costs of investing are too high relative to the expected payoff, a business will choose not to make the investment. Tax policy not only impacts whether businesses invest, but also what they invest in. If the tax code makes the cost of investing in a factory higher than investing in research and development for a new patent, over time the economy will shift to reflect those biases. Additionally, if investment costs are lower when a business borrows rather than raises equity, a business may carry a larger debt load than otherwise.

In general, the design of the UK corporation tax system has several biases that can shift investment decisions in critical ways.

Competitiveness of the UK Corporation Tax

The *International Tax Competitiveness Index* measures the relative competitiveness of corporate tax systems using 12 variables across three categories.¹⁴³ The UK ranks 17th overall out of the 36 OECD countries on corporate taxation, but this is mainly driven by its relatively low statutory corporate tax rate, which is tied for 4th lowest among OECD countries.

On measures of cost recovery, which include loss treatment, capital cost allowances, inventory valuation, and whether the country provides an allowance for corporate equity,¹⁴⁴ the UK ranks 35th, and on the corporate complexity and incentives category of the *Index*, the UK ranks at the middle of the pack at 18th.

Statutory Corporate Tax Rate

For the past several decades, countries around the world have been reducing their statutory corporate income tax rates significantly. While the worldwide average corporate rate was 40.4 percent in 1980, that average had fallen to 24.2 percent in 2019.¹⁴⁵ The policy choices behind this trend partially reflect the recognition that high corporate tax rates can negatively impact business investment, which is a driver of long-run economic growth.¹⁴⁶

Since 2000, the UK corporation tax rate has been cut from 30 percent to the current level of 19 percent. This is below the OECD average of 23.6 percent and the lowest corporate rate among the G7 countries by nearly 7 percentage

139 OECD, "Global Revenue Statistics Database," https://stats.oecd.org/Index.aspx?DataSetCode=RS_GBL.

140 G. Peter Wilson, R. Glen Hubbard, and Joel Slemrod, "The Role of Taxes in Location and Sourcing Decisions," in Alberto Giovannini, R. Glen Hubbard, and Joel Slemrod (eds.), *Studies in International Taxation* (Chicago: University of Chicago Press), 1993, <https://www.nber.org/chapters/c7998.pdf>.

141 Michael P. Devereux and Rachel Griffith, "The Taxation of Discrete Investment Choices," The Institute for Fiscal Studies, Working Paper W98/16, February 1999, <https://www.ifs.org.uk/wps/wp9816.pdf>.

142 Ibid.

143 Tax Foundation, *International Tax Competitiveness Index 2020*.

144 Allowances for corporate equity are sometimes also referred to as "notional interest deductions."

145 Elke Asen, "Corporate Tax Rates Around the World, 2019," Tax Foundation, Dec. 10, 2019, <https://taxfoundation.org/corporate-tax-rates-around-the-world-2019/>.

146 Organisation for Economic Co-operation and Development (OECD), "Tax and Economic Growth," Economics Department Working Paper No. 620, July 11, 2008.

points.¹⁴⁷ Over the last 20 years, the UK rate has stayed below the combined corporate rates of Germany, France, and the United States.

Effective Corporate Tax Rates

Corporate taxes impact the profitability of investments both through the statutory rate and relevant deductions and credits. When a business invests in a new project it must compare the rate of return on that project to other alternatives and explore whether to fund the project with debt or equity (assuming it has a choice between the two). The cost of capital, influenced by tax policies, can thus impact investment decisions. The cost of capital is simply the rate of return necessary for a business to at least break even on an investment.

The effective marginal tax rate (EMTR) is essentially the tax wedge on an investment.¹⁴⁸ The EMTR can show how the tax rate and the tax base interact. A high corporate tax rate and

limited cost deductions lead to a high EMTR, and a low corporate tax rate and generous cost deductions lead to a lower EMTR. There are also other combinations, as in the UK, where the corporation tax rate is relatively low, but limited cost deductions drive up the EMTR.

An additional measure of the tax system is the effective average tax rate (EATR). Compared to the effective marginal tax rate, the EATR measures the tax burden not on the next investment but on average across all profits. In other words, it is a measurement of the share of corporate profits a business pays in taxes.

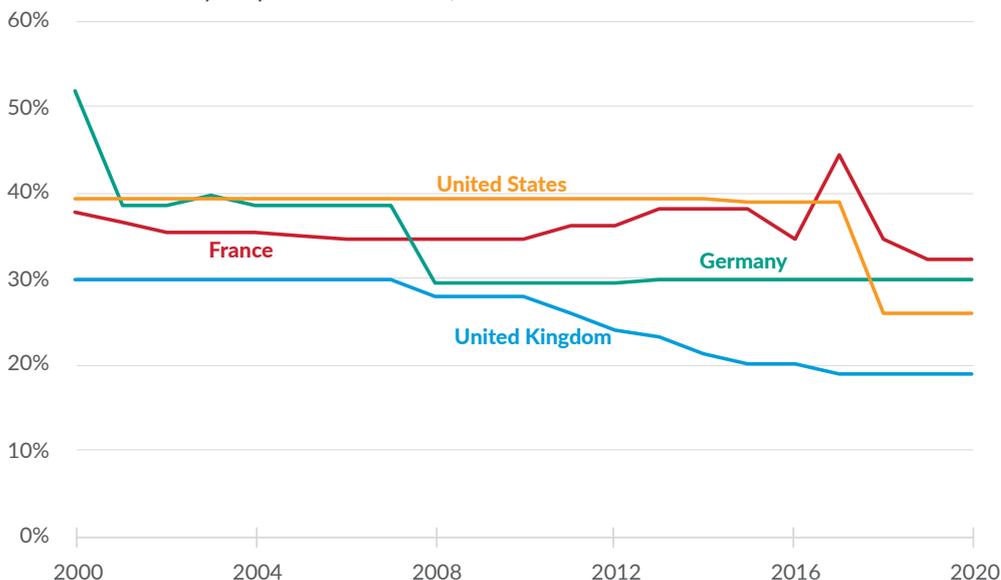
Over the last decade, the UK has lowered its corporate tax rate while broadening its tax base. While this has brought down both the EMTR and EATR, the change has not been proportional.

Since 1998, the statutory rate has fallen by 38.7 percent (from 31 percent to 19 percent). Over that same time, the EATR and EMTR fell by 32.0

FIGURE 7.1

The UK Corporation Tax Rate Has Fallen Significantly in the Past 20 Years

Combined Statutory Corporation Tax Rates, 2000-2020



Source: OECD, "Table II.1. Statutory corporate income tax rate," updated April 2020, https://stats.oecd.org/index.aspx?DataSetCode=Table_II1.

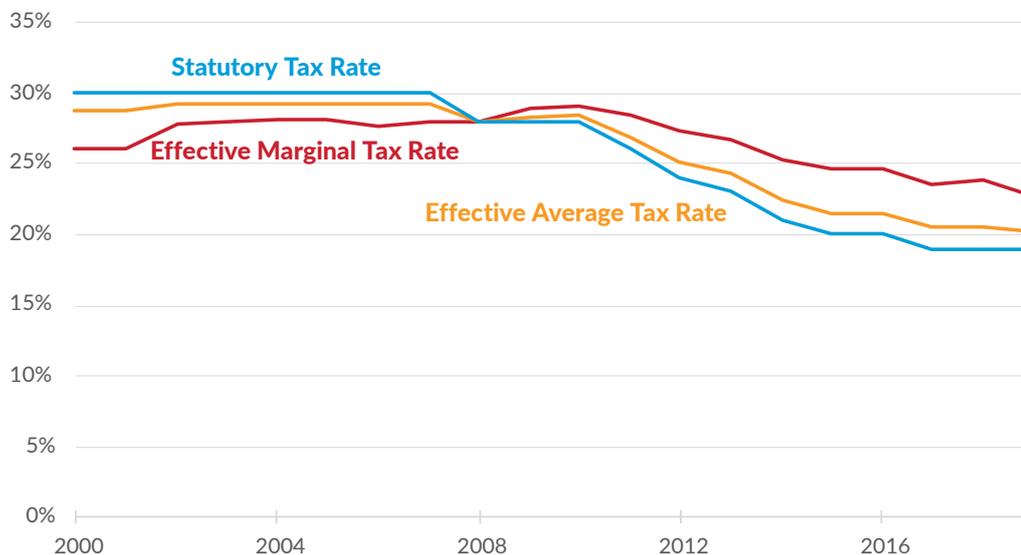
147 Ibid.

148 Devereux and Griffith, "The Taxation of Discrete Investment Choices."

FIGURE 7.2

Effective Tax Rate Measures Have not Fallen as much as the Statutory Tax Rate

Comparison of UK Statutory Corporate Tax Rate, Average, and Marginal Effective Tax Rates, 2000-2019



Source: Spengel et al., "Effective Tax Levels Using the Devereux/Griffith Methodology."

and 16.9 percent, respectively.¹⁴⁹ The trade-offs that were made in the process of corporation tax reforms over that time frame lowered the burden more on new investments in financial assets and intangible assets than in buildings and machinery.¹⁵⁰

As will be discussed below, changes in capital cost allowances, treatment of losses, and other tax base shifts have contributed to these trends.

Cost Recovery

The UK tax base ranks poorly in the *International Tax Competitiveness Index* due to limited capital cost allowances, poor treatment of inventory costs, and limits on loss carrybacks and carryforwards.¹⁵¹

These policies affect the competitiveness of a tax system because they can increase the cost of investing in the UK whether for a domestic business or for a multinational enterprise. Improving the tax base through changes to cost recovery policies could therefore make investing in the UK more profitable.

Capital Cost Allowances

The tax treatment of investments relies on both the statutory corporate tax rate and deductions against corporation tax.¹⁵² In general terms, most countries tax businesses on their net income, which is their revenues minus their costs. When it comes to the profits from a new investment, in a new manufacturing facility or a new office building, the costs associated with those investments cannot usually be deducted immediately.

149 Authors' calculations using data from Christoph Spengel, Frank Schmidt, Jost Heckemeyer, and Katharina Nicolay, "Effective Tax Levels Using the Devereux/Griffith Methodology," European Commission, November 2019, https://ec.europa.eu/taxation_customs/sites/taxation/files/final_report_2019_effective_tax_levels_revised_en.pdf.

150 Ibid.

151 Tax Foundation, *International Tax Competitiveness Index* 2020.

152 Devereux and Griffith, "The Taxation of Discrete Investment Choices."

TABLE 7.1

Depreciation Schedules by Asset Category

Asset Category	Type of Depreciation	Allowance Rate	Useful Life (Deemed or Eligible)
Industrial Buildings	Straight Line	3 percent	33 1/3 years
Machinery	Declining Balance	18 percent	25 years
Patents	Declining Balance	25 percent	Until fully depreciated

Source: Spengel et al., "Effective Tax Levels Using the Devereux/Griffith Methodology."

Instead, countries including the UK use depreciation schedules to define how quickly a business can deduct the costs of its investments. Longer depreciation schedules mean that it takes a longer time before a business can recoup the investment costs. The deductions defined by depreciation schedules are called capital cost allowances.

In the UK, capital cost allowances are least favourable for investments in industrial buildings. From 2011 to 2018, costs associated with industrial buildings could not be deducted at all.¹⁵³ Current policy allows a company that builds a new industrial building to deduct costs associated with that structure over 33 1/3 years at an annual rate of 3 percent of the initial cost (straight-line method). Machinery with a useful life of 25 years or less can be written off at an annual rate of 18 percent of the remaining deductible cost (declining balance method). A business that purchases a patent or other eligible intellectual property can deduct the cost of that patent at an annual rate of 25 percent of the remaining deductible costs.¹⁵⁴

The UK has several other asset classes and definitions that also impact investment decisions. For instance, if a company is planning to build a new manufacturing facility with an industrial building and machinery, it will have to calculate cost allowances for more than just two assets. Costs of the integral features of the

building (e.g., elevators, climate control, etc.) are deductible at a different rate than either the building or the machinery.¹⁵⁵

The Net Present Value of Capital Cost Allowances

By requiring businesses to deduct their investment costs over a long time period rather than when the expenses are incurred, depreciation schedules increase the cost of capital. Both inflation and a required normal return on investment lead to an erosion of the deductible costs of an investment.

A weighted average across asset categories shows that, in net present value terms, the UK allows 61.7 percent of investment costs to be deducted for machinery, industrial buildings, and acquired patents.¹⁵⁶ The UK provides the most generous allowances for purchasing patents: 83 percent of those costs can be deducted in net present value terms. Industrial buildings, on the other hand, receive the worst treatment—only 39 percent of costs can be deducted. Compared to France, the United States, and Germany, the UK system provides a weighted average of 61.7 percent of cost deductions for investment expenses, just ahead of Germany (61.5 percent), but below France (74.2 percent) and the United States (67.7 percent).

153 Spengel et al., "Effective Tax Levels Using the Devereux/Griffith Methodology."

154 Ibid.

155 Gov.UK. "Claim Capital Allowances," accessed Aug. 10, 2020, <https://www.gov.uk/capital-allowances>.

156 See note on Table 7.2 for information on the weighted average.

TABLE 7.2

Comparison of Net Present Value of Capital Cost Allowances

Country	Machinery	Industrial Buildings	Patents	Weighted Average
France	88%	55%	87%	74%
United States	100%	35%	63%	68%
United Kingdom	76%	39%	83%	62%
Germany	74%	39%	87%	62%

Note: Calculations assume a fixed inflation rate of 2.5 percent and fixed interest rate of 5 percent to calculate the present discounted values. The average is weighted by the capital stock's respective share in an economy (machinery: 44 percent; industrial buildings: 41 percent; and intangibles: 15 percent).
 Source: Elke Asen, "Capital Cost Recovery across the OECD," Tax Foundation, Apr. 8, 2020, <https://taxfoundation.org/publications/capital-cost-recovery-across-the-oecd/>. Calculations were updated to reflect the 3 percent structures and buildings allowance introduced as part of the UK's 2020 Finance Bill.

The best way to provide businesses with the ability to deduct the full costs of their investments is through full expensing. Full expensing can allow a restaurant owner who buys a new refrigerator or new dishwashing equipment to deduct the full cost of that investment in the same year the purchase is made.

Businesses respond to changes in capital cost allowances because the allowances can change the profitability of investments. A recent study found that in 2004, when the UK changed the requirements for an investment incentive targeted at smaller companies, newly eligible businesses increased their investment rate by 2.1-2.5 percentage points relative to similar firms that were not eligible.¹⁵⁷

Annual Investment Allowance

The UK has a limited policy that provides full expensing for some investments. The Annual Investment Allowance (AIA) has been part of the UK corporation tax system for a bit more than a decade. The provision allows a share of investments in plants and machinery to be written off in the same year the cost is incurred. The amount of the AIA has varied over time, but it was temporarily increased for 2019 and 2020

from £200,000 to £1 million. After 2020, the AIA would revert to its previous level.¹⁵⁸

Though the AIA does work to reduce the tax costs of investments, full expensing for all investments would not be limited by an arbitrary amount like the AIA. A business that is making a significant expansion may have investment costs that go beyond the AIA threshold or are in assets other than plant and machinery. Those extra costs would be subject to depreciation schedules as with other investments.

Inventory

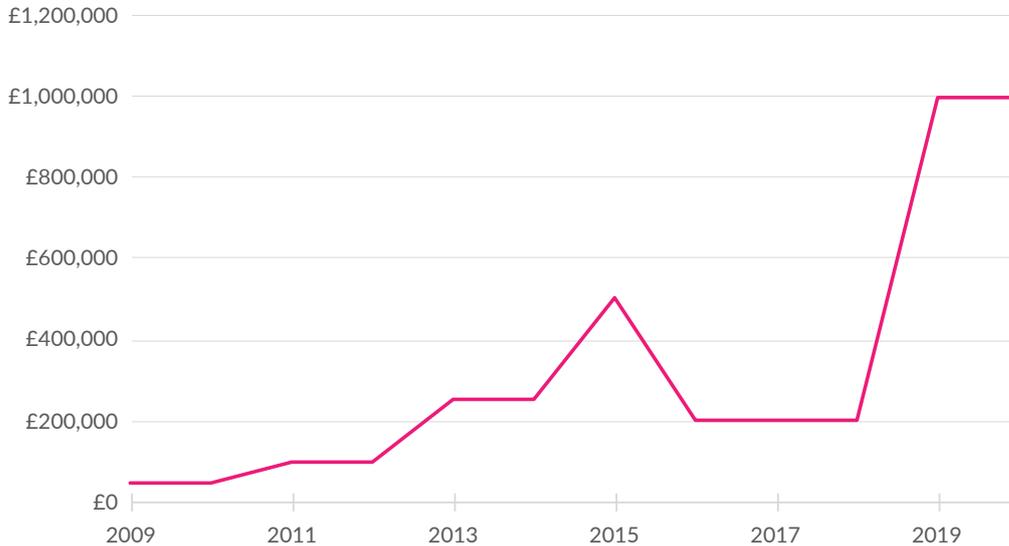
Each business needs to assess the value of its inventory to calculate its corporate income tax liability. There are different types of valuation methods, and, if prices have changed over the year, each method leads to a different amount of tax-deductible inventory costs.

The UK allows businesses to deduct the cost of inventory based on the first-in-first-out (FIFO) method. If a garage is constantly buying and selling tires throughout the tax year, FIFO requires the business to deduct the cost of its tire inventory based on the price of the tax year's first-acquired tire. If the global price

157 Giorgia Maffini, Jing Xing, and Michael P. Devereux, "The Impact of Investment Incentives: Evidence from UK Corporation Tax Returns," *American Economic Journal: Economic Policy* 11:3 (August 2019), <https://www.aeaweb.org/articles?id=10.1257/pol.20170254>.

158 HM Revenue & Customs, "Temporary increase in the Annual Investment Allowance," Oct. 29, 2018, <https://www.gov.uk/government/publications/temporary-increase-in-the-annual-investment-allowance/temporary-increase-in-the-annual-investment-allowance>.

FIGURE 7.3

Annual Investment Allowance has Grown Substantially in Recent Years*Annual Investment Allowance, 2009-2020*

Note: The Annual Investment Allowance amount shown is as of January 1 of each year; some mid-year reductions are not reflected.
 Source: EY, "Worldwide Corporate Tax Guide," EY, 2020, https://www.ey.com/en_gl/tax-guides/worldwide-corporate-tax-guide-2020, and HM Revenue & Customs, "Temporary increase in the Annual Investment Allowance," Gov.UK, Oct. 29, 2018, <https://www.gov.uk/government/publications/temporary-increase-in-the-annual-investment-allowance>.

of rubber increases and the most recently purchased inventory is significantly more costly than inventory purchased earlier, the deductible cost is still calculated using the older inventory.

In the context of product-specific and general inflation, FIFO leads to profits being overstated relative to the true cost of the inventory being sold.¹⁵⁹ Other countries use a method for valuing inventory called last-in-first-out (LIFO). LIFO allows a business to deduct the cost of inventory based on the most recently acquired inventory.

The garage facing price inflation of tires would be able to deduct the cost of inventory at the most recent price of its purchases when calculating its taxable profits.

Some countries require businesses to calculate a weighted average of the cost of their inventory. For the garage, the deductible cost of a tire would be the weighted average of the different costs of tires in inventory.

Among the 36 OECD countries, 14 use LIFO, 16 use weighted average, and only six (including the UK) use FIFO.¹⁶⁰

TABLE 7.3

Valuation Method for Inventories

Country	Inventory Valuation Method
France	Weighted Average
Germany	LIFO
UK	FIFO
USA	LIFO

Source: Spengel et al., "Effective Tax Levels Using the Devereux/Griffith Methodology."

159 Devereux and Griffith, "The Taxation of Discrete Investment Choices."

160 PwC, "Worldwide Tax Summaries: Corporate - Income Determination," <https://taxsummaries.pwc.com/united-kingdom/corporate/income-determination>; and EY, "Worldwide Corporate Tax Guide 2020," https://www.ey.com/en_gl/tax-guides/worldwide-corporate-tax-guide-2020.

Treatment of Losses

Many businesses run losses at different points in time, and this can be particularly true for new businesses. Tax systems usually allow businesses to offset some share of current income with losses from prior years. Loss carrybacks (offsetting prior years' taxes) and carryforwards (offsetting future years' taxes) help to ensure that businesses are taxed on their average profitability over time.¹⁶¹ Limiting loss carrybacks and carryforwards artificially increases tax liability in profitable years relative to a system that allows unlimited loss offsets.¹⁶²

In the UK, both trading losses and capital losses are subject to limitations. Trading losses (losses associated with normal buying and selling of goods and services) can offset taxable income in one previous year or be carried forward without time limit. However, the annual deduction for carryforward losses is limited to £5 million plus 50 percent of the current year's taxable income;

loss carrybacks are only time-limited to one year. Annual capital loss (losses associated with buying and selling a business or other capital asset) deductions for carryforward losses are limited to 50 percent of current year gains (no carryback allowed).¹⁶³

Limiting carryforward losses changes the taxable income of a firm over time. A company that usually makes £100 million in profits, but has a £400 million loss in one year, will have to deduct those losses over several years as shown in Table 7.4. Instead of being worth £400 million as a deduction, the restriction lowers the net present value of the deductions to roughly £372 million.¹⁶⁴

Of the 20 OECD countries that allow losses to be carried forward indefinitely, just nine limit the amount of losses that can be deducted each year.¹⁶⁵ Just four OECD member countries (the UK, Belgium, South Korea, and the Netherlands) are expected to broaden their tax bases via

TABLE 7.4

Example of Limitation on Trading Loss Offsets

Year	Taxable Profit (Loss)	Loss Adjustment (nominal)	Profit after Loss Adjustment	Tax Liability after Loss Adjustment	NPV of Loss Adjustment (in Year 3 real terms)
1	£100.00		£100.00	£19.00	£0
2	£100.00	£100.00	£0	£0	£115.56
3	-£400.00		£0	£0	£0
4	£100.00	£55.00	£45.00	£8.55	£55.00
5	£100.00	£55.00	£45.00	£8.55	£51.16
6	£100.00	£55.00	£45.00	£8.55	£47.59
7	£100.00	£55.00	£45.00	£8.55	£44.27
8	£100.00	£55.00	£45.00	£8.55	£41.18
9	£100.00	£25.00	£75.00	£14.25	£17.41
10	£100.00		£100.00	£19.00	£0
Total	£500.00	£400.00	£500.00	£95.00	£372.19

Note: The net present value calculation uses a discount rate of 7.5 percent.
Source: Authors' calculations

161 Huaqun Li, "A Quick Overview of the Asymmetric Taxation of Business Gains and Losses," Tax Foundation, May 31, 2017, <https://taxfoundation.org/taxation-business-gains-losses-nol/>.

162 Michael P. Devereux and Clemens Fuest, "Is the Corporation Tax an Effective Automatic Stabilizer?" *National Tax Journal* 62:3 (September 2009), <https://www.ntanet.org/NTJ/62/3/ntj-v62n03p429-37-corporation-tax-effective-automatic.html>.

163 HM Revenue & Customs, "Corporate capital loss restriction for Corporation Tax," July 11, 2019, <https://www.gov.uk/government/publications/corporate-capital-loss-restriction-for-corporation-tax/corporate-capital-loss-restriction-for-corporation-tax>.

164 This assumes a discount rate of 7.5 percent.

165 Tax Foundation, *International Tax Competitiveness Index* 2020.

further restrictions on loss carryforwards in the coming years.¹⁶⁶

A tax policy that is neutral toward losses would allow businesses to deduct their losses without limits, and any carried forward amount could be augmented by an interest rate to compensate for the time value of money.

Interest Expense

Financing business investment through new debt creates deductible interest costs. Deductible interest lowers the effective tax rate on an investment, which creates a tax bias against equity financing.

As part of the 2017 Finance Bill, the UK limited interest deductibility for businesses that deduct more than £2 million in interest costs in a year.¹⁶⁷ Businesses are limited to the lower of 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA) or the company's worldwide net interest expense. An alternative calculation (the group ratio method) requires a business to work out a company's worldwide net interest expense to unrelated parties and its share of the company's worldwide EBITDA.

In recent years, many countries have recognized how businesses can use intra-company financing to minimize their tax bills. A strategy that can be employed by a multinational entity relies on an offshore entity (in a low-tax jurisdiction) lending to a domestic firm. Interest expense is then deducted by the domestic firm and the offshore entity earns interest income at the lower tax rate.

Interest expense limits can lead to less intra-company borrowing by limiting the tax benefits of such a strategy.¹⁶⁸ Among OECD countries with interest expense limitations, the UK approach of limiting deductions to 30 percent of EBITDA is the most common.¹⁶⁹

Biases and Distortions in UK Corporation Tax Policy

The *International Tax Competitiveness Index* accounts for tax incentives and complexity that arise from the design of corporation tax systems. Countries rank better when they have fewer targeted incentives and the amount of time to comply with corporation taxes is lower. The UK ranks 18th out of the 36 OECD countries on this measure.¹⁷⁰

The UK's patent box and research and development tax credit are specific subsidies to certain business activities. Such targeted tax policies violate the principle of neutrality.

Certain features of the tax system, including targeted taxes and reliefs, contribute to biases and complexity. Temporary measures can also create distortions in taxpayer behaviour. However, as discussed above, the design of capital allowances, inventory, and financing of new investments also reveals biases.

Targeted Provisions

Many countries introduce targeted taxes and reliefs using various rationales. However, a simple, neutral approach to taxation can create a better tax environment overall by reducing complexity.

166 OECD, "Tax Policy Reforms 2019," OECD, Sept. 5, 2019, https://www.oecd-ilibrary.org/taxation/tax-policy-reforms-2019_da56c295-en.

167 HM Revenue & Customs, "Restriction on Corporation Tax relief for interest deductions," July 1, 2020, <https://www.gov.uk/guidance/corporate-interest-restriction-on-deductions-for-groups#if-youll-deduct-less-than-2-million>.

168 For a review of several studies of interest deduction limits, see Elke Asen, "The Economics Behind Thin-Cap Rules," Tax Foundation, June 27, 2019, <https://taxfoundation.org/thin-cap-rules-economics/>.

169 Tax Foundation, *International Tax Competitiveness Index* 2020.

170 Ibid.

The UK system has both targeted taxes and reliefs. Major tax reliefs include a lower tax rate (10 percent) for income earned from patents, tax subsidies for research and development, and a film production tax credit. Oil and gas companies operating in the UK Continental Shelf enjoy both a special relief and tax regime. Banks are subject to a special tax regime, and the shipping industry calculates its income based on a set formula rather than using standard net income calculations.¹⁷¹ The recently adopted Digital Services Tax is designed to tax revenues from certain online business models.¹⁷²

Targeted tax policies can lead to outcomes that only benefit (or tax) a small share of taxpayers. For instance, in 2016-17, just 1,170 businesses claimed relief under the patent box. Financial and insurance companies made up just 1 percent of those firms and claimed 37 percent of the relief.¹⁷³ The Digital Services Tax only applies to social media platforms, search engines, or online marketplaces with more than £500 million in global revenues and £25 million in UK revenues.¹⁷⁴ These narrow provisions create inequalities in the corporation tax that can drive taxpayer behavior to either avoid or become eligible for a provision depending on whether it is beneficial.

Provisions like the research and development (R&D) credit are common among OECD

countries, but studies of their effectiveness vary in their findings.¹⁷⁵ A 2016 study of the UK R&D credit focusing on the 2006-2011 time period showed significant impacts on R&D spending as well as patenting by firms using the R&D credit, while a separate analysis focused on a 2008 reform found that for each pound of forgone tax revenue, the R&D credit results in £1 of R&D spending.¹⁷⁶ Another study that focused on UK small business use of R&D credits found little impact of credit use on innovations.¹⁷⁷

In 2015, HM Revenue & Customs performed an evaluation of the R&D tax credit.¹⁷⁸ The evaluation found that R&D credits spur more research spending than the amount of the credit by lowering the cost of investing in research and development. The evaluation also showed that tax credit claims are concentrated in London, the South East, and the East of England. A broad measure of UK tax incentives for R&D more than tripled in volume from 2007 to 2017.¹⁷⁹

Identifying Biases in Corporation Tax Policy

One way to identify the biases in the structure of corporation tax is to look at measures of effective tax rates.¹⁸⁰ These measures show long-running biases against investments in structures, and bias toward debt finance and high tech products.

171 HM Revenue & Customs, "Find out how to pay tonnage tax if you're a shipping company," Apr. 25, 2019, <https://www.gov.uk/guidance/tonnage-tax-for-shipping-companies>.

172 Daniel Bunn, "A Distortionary and Complex Digital Tax Proposal from the UK," Tax Foundation, Nov. 28, 2018, <https://taxfoundation.org/distortionary-complex-digital-tax-proposal-uk/>.

173 HM Revenue & Customs, "Patent Box reliefs statistics: Patent box Statistics Tables October 2019, Table 3: Patent Box data by industry sector, 2016-17," Oct. 10, 2019, <https://www.gov.uk/government/statistics/patent-box-reliefs-statistics>.

174 HM Revenue & Customs, "Introduction of the new Digital Services Tax," July 11, 2019, <https://www.gov.uk/government/publications/introduction-of-the-new-digital-services-tax/introduction-of-the-new-digital-services-tax>.

175 A summary of the tax literature can be found at OECD, "R&D tax incentives: rationale, design, evaluation," November 2010, <http://www.oecd.org/sti/ind/46352862.pdf>.

176 Antoine Dechezleprêtre, et al., "Do Tax Incentives for Research Increase Firm Innovation? An RD Design for R&D," National Bureau of Economic Research, Working Paper 22405, July 2016, <https://www.nber.org/papers/w22405.pdf>; and Irem Gucer and Li Liu, "Effectiveness of Fiscal Incentives for R&D: Quasi-experimental evidence," *American Economic Journal: Economic Policy* 11:1 (February 2019), <https://www.aeaweb.org/articles?id=10.1257/pol.20170403>.

177 Marc Cowling, "You can lead a firm to R&D but can you make it innovate? UK evidence from SMEs," *Small Business Economics* 46:4 (April 2016), <https://link.springer.com/article/10.1007/s11187-016-9704-2>.

178 Rigmor Kringelholt Fowkes, João Sousa, and Neil Duncan, "Evaluation of Research and Development Tax Credit," HM Revenue & Customs, HMRC Working Paper 17, March 2015, <https://www.gov.uk/government/publications/evaluation-of-research-and-development-tax-credit>.

179 OECD, "R&D tax expenditure and direct government funding of BERD," <https://stats.oecd.org/Index.aspx?DataSetCode=RDTAX>.

180 Unless otherwise noted marginal tax rates in this section are from Spengel et al., "Effective Tax Levels Using the Devereux/Griffith Methodology."

TABLE 7.5

Examples of Targeted Taxes, Special Regimes, and Reliefs

Provision	Description	Type of Provision	Amount of Revenue (Projected for Tax Year 2019-20, £millions)	Amount of Relief (Projected for Tax Year 2019-20, £millions)
Bank Levy	Tax based on equity and liability of banks. A zero percent rate applies to the first £20 billion in taxable base. A 0.08 percent rate applies to long-term balance sheet items, and a 0.16 percent rate applies to other amounts.	Tax	2,332	
Oil and Gas Extraction	Oil and gas operations in the UK Continental Shelf can be separated from other operations for special tax and relief provisions. Effectively, all capital costs can be deducted in the year of the expense (full expensing). Special expensing provisions also apply to decommission of oil and gas infrastructure. Ring-fenced profits are taxed at 30 percent.	Special Regime (Both Tax and Relief)	1,059	810
Tonnage Tax	Shipping companies can calculate a notional profit based on net tonnage of ships and days in use. Various rates of tax apply.	Special Regime (Both Tax and Relief)	2.9 (a)	160
Digital Services Tax	Gross revenue tax on digital services at 2 percent. Includes a safe harbour calculation for low-margin businesses.	Tax	5	
Patent Box	Reduced corporation tax rate (10 percent) for profits from patents.	Relief		1,160
R&D Incentives (Large Businesses)	Above-the-line tax credit.	Relief		2,330
R&D Incentives (Small and Medium Businesses)	Super-deduction available to smaller businesses. Loss-making businesses can surrender loss deductions for a payable credit.	Relief		2,450
Film Production Tax Credit	Tax credit for film production expenditure in the UK. Loss-making businesses can surrender loss deductions for a payable credit.	Relief		565

Note:

(a.) Tonnage Tax revenues are for tax year 2017-18 and were provided to the authors by HM Revenue & Customs after a Freedom of Information Act request.

Sources: HM Revenue & Customs, "Non-structural tax reliefs: Estimated cost of non-structural tax reliefs," Gov.UK, May 20, 2020; <https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs>; Office for Budget Responsibility, "Bank Levy," <https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/bank-levy/>; Office for Budget Responsibility, "Oil and gas revenues," <https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/oil-and-gas-revenues/>; and HM Revenue & Customs, "Introduction of the new Digital Services Tax."

The EMTR on a given investment can differ significantly depending on what a business is investing in.¹⁸¹ This is mostly driven by the differences in capital cost allowances for various assets. For the UK in 2019, the EMTR for investing in a building was 40.8 percent while for an investment in a patent it was just 14.7 percent. Strikingly, Figure 7.4 shows the impact of the limited capital cost allowances for industrial buildings. Though the statutory corporate rate fell significantly over 1998-2019 as mentioned previously, the EMTR on buildings rose and has remained elevated.

There are small differences among the EMTR on financial assets, intangibles, and machinery due to the differences in capital allowances. However, the variance among the other categories is not quite as dramatic as the overall variance because the EMTR on buildings is so significant. While firms may still be able to overcome the high effective tax rate and construct buildings, investors looking for a high after-tax return on their investment will be less likely to contribute equity to firms that require new industrial space.

181. The Effective Marginal Tax Rate (EMTR) is explained above under the heading "Effective Tax Rates."

Over the two decades from 1998 through 2018, new industrial construction in the UK was weakest among various categories for construction activity. While annual new private construction levels for commercial, housing, and infrastructure all more than doubled over that time period, industrial construction grew by just 13 percent.¹⁸²

Another bias in the UK tax system arises from the differential treatment of debt and equity-financed investment. Interest payments are tax-deductible, but there is no similar deduction related to equity financing. This creates a gap between the tax costs of financing an investment with debt rather than new equity.

In 2019, the marginal tax rate on debt-financed investments was 21.5 percentage points lower than the marginal tax rate on equity-financed investments. This gap is critical because it can impact the capital structure used by businesses.¹⁸³ Industries and businesses where debt finance is less available are therefore penalized relative to others that have more opportunities to borrow to finance projects.

To offset this debt bias, several OECD countries including Belgium, Italy, Poland, Portugal, and Turkey provide an Allowance for Corporate Equity (ACE), which reflects a deduction for the notional interest costs of financing an investment with equity.¹⁸⁴ An ACE that equals the interest costs from financing an investment with debt eliminates the gap between the tax costs of debt and equity. Another approach to limit the debt bias is through limiting debt deductions as the UK has done with interest expense limitations.

Comparing the different asset types and financing mechanisms reveals where the current corporation tax system creates a significant tax wedge for some investment/financing combinations, while other combinations face a zero or smaller EMTR.

Additional bias is created by incentives for patents and research and development. According to a 2018 study, a UK business utilising both the patent box and research and development credit could potentially reduce its effective average tax rate from 15.7 percent to 6.02 percent.¹⁸⁵

TABLE 7.6

Effective Marginal Tax Rates on Investment for Various Combinations of Assets and Funding Sources

	Industrial buildings	Intangibles	Machinery	Financial assets	Inventory	Weighted Average (by asset type)
Equity	44.6	22.3	23.0	24.6	24.6	29.0
Debt	32.1	-4.1	-2.9	0.0	0.0	7.5
Weighted average (by financing mechanism)	40.8	14.7	15.6	17.5	17.5	22.7

Note: Red is used to denote an effective marginal tax rate that is above the overall weighted average while blue denotes rates below the overall weighted average. The weighted averages in the cited study weight the assets equally at 20 percent each and weights financing through equity at 65 percent (includes 10 percent from new equity and 55 percent from retained earnings) and 35 percent for financing through debt.

Source: Spengel et al., "Effective Tax Levels Using the Devereux/Griffith Methodology."

182 Office for National Statistics, "Construction statistics annual tables: Construction Statistics Great Britain: 2018, Table 2.4b, Value of construction output by type of work," Oct. 18, 2019, <https://www.ons.gov.uk/businessindustryandtrade/constructionindustry/datasets/constructionstatisticsannualtables>.

183 Michael Overesch and Dennis Voeller, "The Impact of Personal and Corporate Taxation on Capital Structure Choices," *FinanzArchiv/Public Finance Analysis* 66:3 (September 2010), https://www.jstor.org/stable/20839193?seq=1#metadata_info_tab_contents.

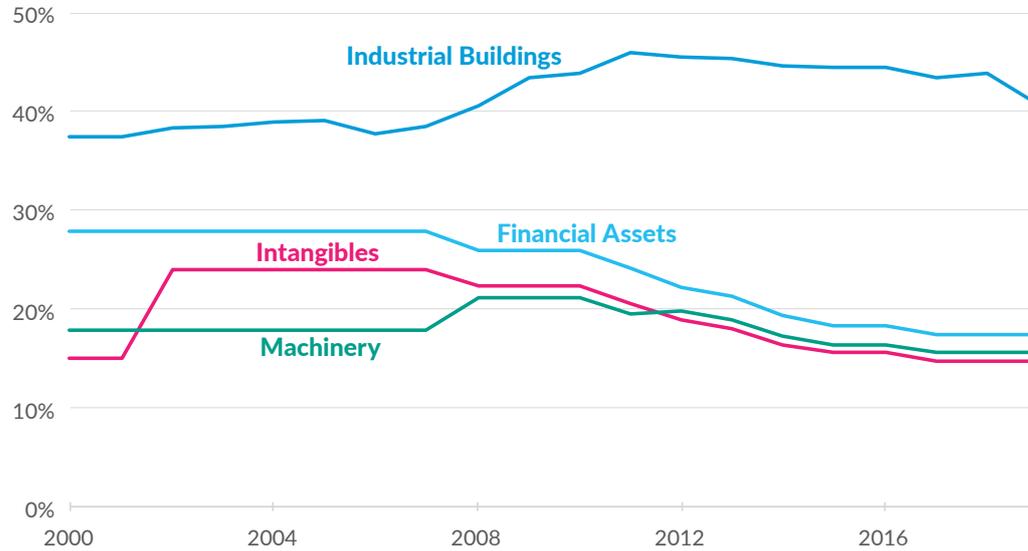
184 Spengel et al., "Effective Tax Levels Using the Devereux/Griffith Methodology."

185 Frank Schmidt, et al., "Digital Tax Index 2018: Locational Tax Attractiveness for Digital Business Models," PwC, December 2018, http://ftp.zew.de/pub/zew-docs/gutachten/Digital_Tax_Index_2018.pdf.

FIGURE 7.4

Industrial Buildings Face Significantly Higher Effective Marginal Tax Rates Compared to Other Investments

Effective Marginal Tax Rates on Investment by Asset Type, 2000-2019

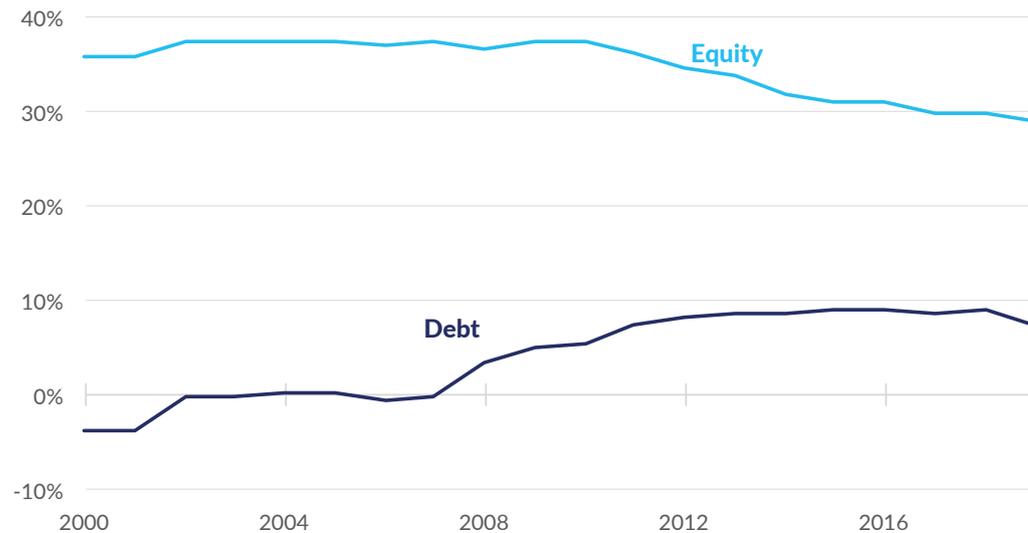


Source: Spengel et al., "Effective Tax Levels Using the Devereux/Griffith Methodology."

FIGURE 7.5

Equity-Financed Investments Face Significantly Higher Effective Marginal Tax Rates than Investments Financed with Debt

Effective Marginal Tax Rates on Investment by Funding Source, 2000-2019



Source: Spengel et al., "Effective Tax Levels Using the Devereux/Griffith Methodology."

Temporary Tax Policy

Businesses need time to plan their investments, and a stable tax policy can be beneficial to that planning process. A temporary policy that lowers the costs of investing can speed up business investments but may not impact the level of investment in an economy over the longer term.¹⁸⁶ Temporary changes can also reduce the economic impact of those policy changes relative to a permanent policy.

While policymakers may want to use a temporary policy tool to stimulate business investment over the short term, businesses must recognise the tax costs of their investments both during the temporary policy and after that policy expires.

A key example of this temporary policy in the UK is the swings in the AIA and the current temporary elevated level. The policy may lower the tax costs of investments for firms by providing eligible firms with larger deductions for plant and machinery costs than they could claim otherwise. However, instead of developing new investment plans, firms may be taking advantage of the AIA with existing investment plans.

If a company already had plans to replace old machinery with new equipment prior to the AIA expansion, the expansion creates a windfall, increasing the after-tax profitability of that investment. However, in such a situation, the AIA expansion is not incentivising new investment.

Instead of designing temporary policies to address economic weakness, a well-designed corporation tax can work as an automatic stabilizer. In weak years when businesses are running losses, a well-designed corporation tax can allow companies to deduct those

losses and carry them forward to offset future profits. During a time of increased investment, corporation tax should not stand in the way, allowing businesses to deduct the full costs of their investments. And when businesses are running profits in excess of their carried forward losses, investment costs, and other costs including labour costs, corporation tax should apply equally. In this way, corporation tax will tax the average profitability of companies without distorting investment and hiring decisions along the way.

Over the long term, corporation tax can work to offset the impacts of economic cycles, but such an achievement requires stable policies and full allowances for recognising losses, investment costs, and other costs.¹⁸⁷

Recommendations

Though its corporation tax rate is quite competitive among developed countries, the UK has a corporate tax base that is ripe for reform. The UK should work to eliminate biases against investment, reinforce countercyclical policies, and evaluate targeted tax reliefs that can introduce a variety of distortions in behaviour and economic activity.

In the face of a serious economic crisis, policymakers should recognise the importance of long-term reforms that will improve international competitiveness and the local climate for investing. The road to economic recovery will be a long one, but the journey will be less arduous if the tax system does not stand in the way of business investment and hiring.

The recommendations in this chapter cover three areas that are ripe for reform. First is the treatment of capital investment. As discussed previously, corporation tax in the UK is biased against capital investment, particularly in

¹⁸⁶ Christopher House and Matthew D. Shapiro, "Temporary Investment Tax Incentives: Theory with Evidence from Bonus Depreciation," NBER Working Paper 12514, September 2006, <https://www.nber.org/papers/w12514.pdf>.

¹⁸⁷ Devereux and Fuest, "Is the Corporation Tax an Effective Automatic Stabilizer?"

buildings and structures. Investment activity is likely to be depressed in the short term by the uncertain economic climate, but as the uncertainty dissipates, policy should be ready to support new investment opportunities.

The second area of recommendations is on building a countercyclical corporation tax. Current policy means that businesses that are incurring significant losses will not be able to fully deduct those against future profits. Removing loss limitations will not only serve a purpose for the economic crisis, it is also good long-term policy as it allows businesses to be taxed on their average profitability over time.

The third area is on reviewing targeted business tax reliefs. Targeted reliefs can both distort investment decisions and be costly from a revenue perspective. While any one relief may seem justified in support of an industry or business activity, the more reliefs and special regimes there are, the more complex a tax system becomes. Complexity brings costs both for tax administration and for business compliance, diverting valuable resources. The UK should review the existing corporation tax system to identify reliefs and specialized regimes that lead to increased complexity with a goal of designing a more neutral and less complex corporation tax system.

Improving Tax Treatment of Capital Investment.

Capital investment is the foundation for long-term growth, higher wages, and better jobs. The UK tax code is biased against new investment and particularly against equity-financed investments. A more neutral tax code would

allow corporations to fully deduct the cost of their investments in the first year.

The UK could provide immediate cost recovery for all investments, allowing businesses to deduct expenses for new investments immediately rather than relying on lengthy depreciation schedules to recoup only a fraction of their costs in real terms. This option is likely to be costly from a revenue perspective, especially in the short run. Long-run benefits from new investments would partially offset that up-front revenue cost, though.¹⁸⁸ The first-year revenue loss could measure up to £30 billion with the longer-run annual shortfall of £20 billion, without taking account of positive economic growth effects.¹⁸⁹

Two main options are offered here that could move the UK closer to this goal to different extents.

The first option would make the Annual Investment Allowance unlimited, removing the current £1 million cap. The first-year revenue loss would be in the region of £10 billion, with a longer-run annual shortfall of around £1.5 billion (again, without taking account of any growth effects).¹⁹⁰ Alongside this, the government could adopt a neutral cost recovery approach to the structures and buildings allowance.¹⁹¹ Neutral cost recovery for structures and buildings would ensure that depreciation allowances for buildings reflect economic costs,¹⁹² by adjusting annual allowances for inflation and a rate of return that could be tied either to corporate or government long-term bond rates. The up-front cost of applying neutral cost recovery to the

188 For estimates of the revenue cost, see Sam Dumitriu and Pedro Serodio, "Abolishing the Factory Tax: How to Boost Investment and Level Up Britain," Adam Smith Institute, Feb. 19, 2020, <https://www.adamsmith.org/s/Abolishing-the-Factory-Tax-Sam-Dumitriu-Dr-Pedro-Serodio-Final.pdf>, and Centre for Policy Studies, "A Budget for No Deal," Mar. 19, 2019, <https://www.cps.org.uk/files/reports/original/190307171809-ABudgetforNoDeal.pdf>. Dumitriu and Serodio estimate a long-run revenue cost of £9.4 billion without factoring in additional revenues from increased investment, wages, and output. Centre for Policy Studies estimated a £9 billion revenue cost in the first year of both an unlimited AIA and a 17 percent corporation tax rate.

189 Centre for Policy Studies modelling.

190 Ibid.

191 This would work similarly to an Allowance for Corporate Equity.

192 Stephen J. Entin, "Boosting Growth as the UK Leaves the European Union," Centre for Policy Studies, Mar. 6, 2020, <https://www.cps.org.uk/files/reports/original/200306123709-boostinggrowthukeu.pdf>.

structures and buildings allowance would be negligible, amounting to perhaps £25 million in the first year.¹⁹³

Even in the context of a 33 1/3-year depreciation schedule, a neutral cost recovery element could eliminate the bias against investments in structures due to the time value of money. A business would go from deducting just 39 percent of its costs (in net present value) for buildings and structures to 100 percent of those costs. Under current policy a business that builds a £10 million building would be able to deduct £300,000 per year for 33 1/3 years to recoup the cost of the building. However, the time value of money means that in real terms, the business is only deducting 39 percent of the building costs, or £3.9 million. A neutral cost recovery element would increase that annual deduction so that over time, the business is able to deduct the full £10 million cost in real terms.

A second option would make the Annual Investment Allowance level of £1 million permanent while introducing neutral cost recovery for all other capital expenditure. This would essentially provide neutral treatment for all investment in addition to first-year expensing for investments that qualify for Annual Investment Allowance.¹⁹⁴ The first-year revenue cost of Annual Investment Allowance permanency would be roughly £0.5 billion.¹⁹⁵

Applying neutral cost recovery to both the structures and buildings allowance and the wider system of capital allowances would cost around £2 billion in year one.¹⁹⁶

Finally, while policymakers may be attracted to a temporary change on capital allowances, it is important to understand that only temporarily expanding capital allowances will greatly reduce the economic impact of this policy.¹⁹⁷ A temporary expansion of capital allowances may cause some businesses to speed up investment decisions, but would essentially amount to borrowing capital investment from the future for investment during the short-term. Policy that seeks to boost capital investment over the long-term should be permanent.

Building a Countercyclical Corporation Tax.

During times of economic stress, businesses can run serious losses. Limits on loss carryforwards increase the taxes that businesses pay when they become profitable again. Tax policy should not exacerbate the challenges that businesses face as they return to generating profits, and loss carryforwards should be uncapped.

The UK should loosen, if not remove, the limits on loss deductions. Especially in times of economic crisis, loss limits can severely impact the cash flow of businesses. Removing the limits on loss carryforwards and expanding loss

193 Estimate based on Centre for Policy Studies modelling, assuming a 3 percent neutral cost recovery uplift. On a static basis, this cost would only rise gradually over time, reaching an estimated £1.3 billion a year three decades from now.

194 A neutral cost recovery system would be somewhat comparable to adopting a general Allowance for Corporate Equity as originally proposed in Michael Devereux and Harold Freeman, "A General Neutral Profits Tax," *Fiscal Studies* 12:3 (August 1991). While neutral cost recovery provides an additional amount to the annual depreciation allowance, which reflects the time value of money, the Allowance for Corporate Equity also provides an additional deduction to reflect equity financing costs, tied to a measure approximating the discount rate. Though the basis for the additional deduction is different, and the Allowance for Corporate Equity is tied to either new equity financing or a company's equity stock, the goal is similar. Both policies try to achieve a form of investment neutrality, although the Allowance for Corporate Equity achieves an additional goal for neutrality by partially equalizing tax incentives to finance new investments with debt versus equity. Neutral cost recovery does not consider the source of financing and would therefore be a broader policy with larger potential revenue costs relative to the Allowance for Corporate Equity. An Allowance for Corporate Equity which applies to all business equity would, in turn, have higher revenue costs than one which only applies to new equity. For more on these policy options, see Daniel Bunn and Elke Asen, "Reducing the Bias Against Long-term Investments," Tax Foundation, May 8, 2020, <https://taxfoundation.org/reducing-bias-against-long-term-investments/>, and Entin, "Boosting Growth as the UK Leaves the European Union."

195 Based on official policy costings released by the Treasury when the £1m AIA was first announced. See HM Treasury, "Budget 2018: policy costings," October 2018, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752208/Budget_2018_policy_costings_PDF.pdf.

196 Estimate based on Centre for Policy Studies modelling. On a static basis, we forecast the annual revenue cost peaking at around £4.5 billion after five years.

197 For instance, a Tax Foundation comparison of temporary and permanent full expensing options in the United States showed that a 5-year policy rendered a long-run growth benefit that is 88 percent less than the growth benefit of permanent full expensing. Kyle Pomerleau, "Economic and Budgetary Impact of Temporary Expensing," Tax Foundation, Oct. 4, 2017, <https://taxfoundation.org/economic-budgetary-impact-temporary-expensing/>.

carrybacks would increase the neutrality of the system to growing businesses and businesses with high start-up costs.

The revenue losses associated with this proposed change are difficult to anticipate, especially at the current time. Loss limitations introduced in Budget 2016 estimated a revenue gain for 2020-21 of £255 million.¹⁹⁸ The current crisis suggests that removing those limits would reduce revenues by much more than that amount, potentially £1 billion annually as businesses carry forward losses from the current downturn against future corporation taxes.

Reviewing Targeted Business Tax Reliefs.

The UK has numerous targeted tax reliefs embedded in its corporation tax code. These programs should be periodically reviewed to assess whether those uses of public resources are advisable relative to other uses of revenue. At a time when revenues are being squeezed, targeted reliefs should come under pressure for reform. Reviews should consider the complexity of the reliefs, whether any benefits accrue to the country broadly or whether they are captured by a narrow sector, and whether revenue lost through the reliefs would be better directed to general reforms that have the potential to benefit all sectors.

¹⁹⁸ HM Treasury, "Budget 2016," Mar. 16, 2016, <https://www.gov.uk/government/publications/budget-2016-documents/budget-2016#policy-decisions>.



CHAPTER 8

INTERNATIONAL TAX RULES

KEY FINDINGS

- The UK ranks number 1 among 36 OECD countries on the 2020 *International Tax Competitiveness Index's* measure of international tax rules.
- The UK has a broad network of tax treaties, which can add certainty when businesses are making cross-border investments.
- Narrow and discriminatory policies like the digital services tax should be removed to avoid sparking an economically harmful tax and trade war.

One important feature of modern tax systems is the rules that are used to determine how to tax the international income of businesses and individuals. These rules include the international tax treaties that countries have entered into, rules that exclude some foreign corporate income from taxation, rules to minimize opportunities for multinational businesses to shift the geographical location of their income to minimize their tax liability, and rules that apply to individual income earned in foreign jurisdictions.

The UK has a broad treaty network, corporation tax exemptions for foreign-earned dividends and capital gains, a series of rules targeted at income shifting, and rules defining when non-domiciled residents owe tax in the UK on foreign-earned income. In recent years, developments in the UK international tax rules have led to more complexity as governments have implemented a series of policies aimed at penalizing income shifting.

According to the *International Tax Competitiveness Index*, the UK ranks best among OECD countries on international tax rules.¹⁹⁹ This is mostly driven by the UK's broad tax treaty network and its territorial tax system. While the key features of the UK international tax system are competitive, there remain challenges for the UK in attracting and supporting multinational business activity with its tax system.

Recent policies that have introduced complexity and invited international criticism—such as the Diverted Profits Tax and the Digital Services Tax—can impact business decisions on whether to choose the UK as a place to grow their footprint. Post-Brexit, the UK should be careful

to maintain and build on the strengths of the international tax system and avoid creating new tensions in cross-border tax policy.

Tax Treaties

Across the global landscape there is wide variety in domestic tax laws. A business with subsidiaries in multiple countries faces a challenge in understanding and complying with the various systems. The differences between tax laws in different countries can mean that some income will be taxed by more than one country. This creates double taxation, which directly harms the profitability of multinational companies and reduces trade and investment flows. Additionally, an individual who lives in one country but earns income from work in other countries could be caught by multiple jurisdictions wanting to tax the same income.

Countries adopt tax treaties to avoid double taxation and align tax laws between the treaty countries. This can reduce the complexity and tax burden faced by multinational businesses. Tax treaties therefore impact the effective tax rates that multinational businesses face and, by extension, Foreign Direct Investment (FDI)—since multinational investment decisions are sensitive to the combination of foreign and domestic tax policies.²⁰⁰

The UK has the broadest tax treaty network among OECD countries with nearly 150 tax treaties.²⁰¹ Across the OECD, the average size of a tax treaty network is 77 countries.²⁰²

A key mechanism that tax treaties use to address double taxation is limiting the withholding tax rates on income that moves

199 Tax Foundation, *International Tax Competitiveness Index* 2020.

200 Peter Egger, Simon Loretz, Michael Pfaffermayr, and Hannes Winner, "Bilateral Effective Tax Rates and Foreign Direct Investment," *International Tax and Public Finance*, 16:6 (December 2009), 822, <https://link.springer.com/article/10.1007/s10797-008-9092-x>; see also Bruce A. Blonigen, Lindsay Oldenski, and Nicholas Sly, "The Differential Effects of Bilateral Tax Treaties," *American Economic Journal: Economic Policy* 6:2 (May 2014), <https://www.aeaweb.org/articles?id=10.1257/pol.6.2.1>.

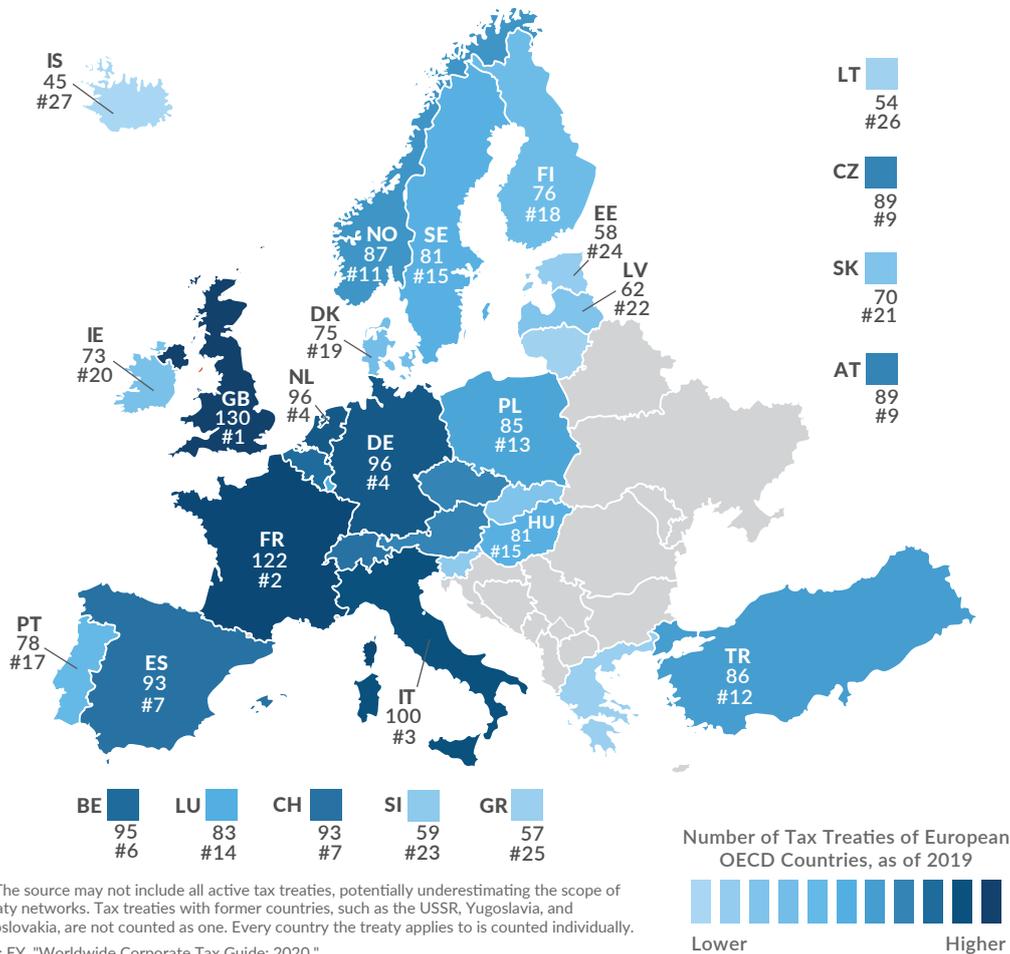
201 HMRC, "Tax Treaties," July 28, 2014, <https://www.gov.uk/government/collections/tax-treaties>.

202 Tax Foundation, *International Tax Competitiveness Index* 2020. The source for comparability in the *International Tax Competitiveness Index* identifies 130 tax treaties for the UK. Several small and developing countries are not included in that source's list of treaties.

FIGURE 8.1

Tax Treaty Networks of European Countries

Number of Tax Treaties of European OECD Countries, as of 2019



between jurisdictions. A British company that owns a subsidiary in the Czech Republic may earn interest on a loan to that subsidiary. Presumably, the earnings that are the source of the interest payment will have already been taxed in the Czech Republic. Without a tax treaty in place, the Czech Republic would apply a withholding tax of 15 percent on that interest payment back to the British company, and the earnings would be taxed both by the Czech Republic and by the UK.²⁰³

However, the tax treaty rate on interest payments between the UK and the Czech Republic is 0 percent, eliminating the potential for double taxation on interest payments.

For jurisdictions that do not have a tax treaty with the UK, a withholding tax may apply. The non-treaty rate for interest and royalty payments is 20 percent. On dividend payments, the UK's withholding rate is 0 percent.

Territorial System

The UK, like many other countries, has what is called a "territorial" corporate tax system that (in general) only taxes income from activities within the UK. Territorial systems rely on rules that exempt certain foreign earnings from domestic taxation. Though some countries only

203 PwC, "Worldwide Tax Summaries: Czech Republic: Corporate - Withholding Taxes," July 20, 2020, <http://taxsummaries.pwc.com/ID/Czech-Republic-Corporate-Withholding-taxes>.

have partial exemptions of foreign income, the UK provides a 100 percent exemption for both capital gains and dividend income from foreign sources.

For example, if a British company has a subsidiary in Germany and that subsidiary repatriates its earnings in the form of dividends back to the UK, those dividends would be exempt from taxation in the UK.

The UK adopted its territorial system in 2009 as a move away from a worldwide system of taxation that required domestic tax to be owed on foreign earnings once those earnings were brought into the UK.²⁰⁴ Several OECD countries have implemented a similar shift in recent decades in order to improve their international tax rules.

A recent study of the UK's shift to territorial taxation shows that the reform was followed by increased investment by UK firms in foreign subsidiaries.²⁰⁵ The change reduced the amount of tax that businesses pay on profits from their foreign operations, but for every £1 of forgone tax revenue, £9 of foreign investment was stimulated. According to the study, the resulting foreign investment did not come at the cost of domestic investment.

Even with these economic benefits, territorial taxation comes with trade-offs as businesses may respond by shifting their income to lower tax jurisdictions to benefit even more from the foreign income exemption.²⁰⁶

Digital Services Tax (DST)

The UK Digital Services Tax was announced in the 2018 Budget and included in the 2020 Finance Bill, effective from April 1, 2020. Like similar policies in other European countries, the UK DST selectively applies to businesses using both a global and a domestic revenue threshold and is motivated by a political desire to tax foreign-based digital companies. The global threshold is £500 million while the domestic threshold is £25 million.

The tax rate is 2 percent and the tax base is gross revenues from three targeted sectors:

- Social media platforms
- Internet search engines
- Online marketplaces

A tax policy that singles out specific sectors for special treatment is likely to create distortions in market behaviour. Unlike corporation tax, the DST is levied on revenues rather than profits, not considering profitability. A seemingly low tax rate of 2 percent can translate into a high tax burden. For instance, a business with £100 in revenue and £90 in costs has a profit margin of £10—or 10 percent. A DST rate of 2 percent means the business is required to pay £2 in revenue tax (2 percent of \$100 revenue), corresponding to a profit tax of 20 percent (£2 tax divided by £10 profit). This implies that the corresponding effective profit tax rates vary by profitability, disproportionately harming businesses with lower profit margins.

The DST policy provides an alternative charge calculation that allows businesses with low profit margins to be taxed more lightly than businesses with higher profit margins.²⁰⁷ Also,

204 Tax Foundation, "The United Kingdom's Move to Territorial Taxation," Nov. 14, 2012, <https://taxfoundation.org/united-kingdoms-move-territorial-taxation/>.

205 Li Liu, "Where Does Multinational Investment Go with Territorial Taxation? Evidence from the United Kingdom," *American Economic Journal: Economic Policy* 12:1 (February 2020), <https://www.aeaweb.org/articles?id=10.1257/pol.20180592>.

206 Daniel Bunn, Kyle Pomerleau, and Sebastian Dueñas, "Anti-Base Erosion Provisions and Territorial Tax Systems in OECD Countries," Tax Foundation, May 2, 2019, <https://taxfoundation.org/anti-base-erosion-provisions-territorial-tax-systems-oecd-countries/>.

207 HMRC, "Digital Services Tax Manual," Aug. 5, 2020, <https://www.gov.uk/hmrc-internal-manuals/digital-services-tax/dst43410>.

the first £25 million of revenues are exempt from the DST. Third, the UK policy provides a 50 percent reduction in the tax for businesses that are taxed on their revenues by a DST in another country.

The policy has attracted attention from the United States in the form of a trade investigation which could result in a harmful tax and trade war.²⁰⁸

Anti-avoidance Policies

Though the UK adopted a territorial tax system in 2009, policies to limit profit shifting followed several years after. The timing gap created an opportunity for businesses to shift their profits outside the UK. A key incentive that drove this behaviour is that the UK's statutory corporate tax rate remained high. In the absence of anti-avoidance measures, some UK businesses responded by shifting profits to lower-tax jurisdictions.²⁰⁹ However, that profit

shifting behaviour also resulted in productivity enhancements for foreign operations.²¹⁰

The UK has several rules to address profit shifting by businesses. Profit shifting occurs when a business arranges a transaction or a relationship with a foreign subsidiary so that taxable income arises in a lower tax jurisdiction. A British business that borrows from a subsidiary in the Cayman Islands to finance an expansion in the UK would be able to deduct its interest costs for UK tax purposes and pay no tax on the interest income in the Caymans.

Profit shifting can occur with several different mechanisms, and the result is that some subsidiaries of multinationals in the UK are able to report lower taxable profits than similar companies that are only operating in the UK.²¹¹

However, rules that address profit shifting create additional complexity for many businesses. For the UK, these include transfer pricing rules, Controlled-Foreign-Corporation

TABLE 8.1

Anti-avoidance Policies

Provision	Description
Transfer Pricing Regulations	Identify how transactions between connected businesses are taxed and provide the government with the opportunity to ensure the proper amount of tax is paid in the UK.
CFC Rules	If a foreign subsidiary is sufficiently controlled by a UK business and the tax liability faced by that subsidiary is 75% or less than the equivalent UK tax liability, then UK corporation tax will apply. (a)
Interest Deduction Limitation	Interest deductions are limited to 30% of EBITDA and transfer pricing rules apply to lending.
Diverted Profits Tax (DPT)	This policy targets specific transactions that tax authorities deem to be abusive. A penalty rate of 25% (or greater) applies to profits that are deemed to have been diverted from the UK tax base.
Tax on Receipts from Offshore Intangible Property	This policy applies to any foreign company with more than £10 million in sales derived from intellectual property (IP) in countries with corporate tax rates below 50% of the UK rate. A 20% tax on gross income from IP can apply. Offshore income could be exempt from the tax if there is sufficient business substance in the offshore location or if the UK has a double tax treaty with the jurisdiction that includes a nondiscrimination provision.

(a.) Various legal, economic, and accounting standards may apply when determining control. To read more about these standards, please refer to HM Revenue & Customs, "International Manual," <https://www.gov.uk/hmrc-internal-manuals/international-manual/intm236000>.

Source: PwC, "Worldwide Tax Summaries"; Deloitte, "International Tax Highlights."

208 Daniel Bunn, "The U.S. Trade Representative Expands Its Digital Services Tax Investigations," Tax Foundation, June 2, 2020, <https://taxfoundation.org/us-trade-representative-ustr-digital-services-tax-investigations/>.

209 Dominika Langenmayr and Li Liu, "Where Does Multinational Profit Go with Territorial Taxation? Evidence from the UK," CESifo, Working Paper No. 8047, January 2020, https://www.cesifo.org/DocDL/cesifo1_wp8047.pdf.

210 Ibid.

211 Katarzyna Anna Bilicka, "Comparing UK Tax Returns of Foreign Multinationals to Matched Domestic Firms," *American Economic Review* 109:8 (August 2019), <https://www.aeaweb.org/articles?id=10.1257/aer.20180496&&from=f>.

(CFC) rules, the Diverted Profits Tax (DPT), interest deduction limitations, and taxes applied to offshore intangible property.

Together, these rules create a defence against profit shifting while increasing the complexity and burden of the UK's international tax system.

All anti-avoidance programs are designed to influence taxpayer behaviour with the outcome resulting in more taxes paid to the UK. However, the UK operates in a competitive environment and businesses may choose to minimize their exposure to the UK tax system because of the penalties in the rules.

While transfer pricing regulations, CFC rules, and interest deduction limitations are common among the international rules in OECD countries, the DPT and the Tax on Receipts from Offshore Intangible Property (IP tax) are somewhat unique to the UK.²¹²

In the 2018-19 fiscal year, the DPT raised £12 million directly and an additional £2.3 billion through settlements and business restructurings which led to higher VAT payments.²¹³ In aggregate, the yield from the DPT increased by 41 percent from the 2017-18 level.

The exemptions to the IP tax encourage businesses to shift their IP to a jurisdiction where the tax would not apply. Because of that, the original cost estimate of the IP tax showed a decline in annual revenue yield from a projected

£475 million in 2020-21 to £165 million in the 2023-24 fiscal year.²¹⁴

Economic Impacts of Anti-avoidance Policies

While the anti-avoidance rules are designed to have multinationals pay more tax in the UK, they can also have negative impacts on business investments and decisions. Financial profits of businesses are quite responsive to the design of CFC rules, and the use of transfer pricing regulations can equate to a significant increase in corporate tax.²¹⁵ Interest deductibility limits can have similar adverse consequences, although limiting interest deductions also shifts the bias away from debt finance, as discussed in the corporation tax chapter.²¹⁶

The challenge for the UK, then, is to design its anti-avoidance policies to minimize complexity while meeting its policy goals. This could be done by evaluating the design of CFC legislation in light of the experience of other countries.²¹⁷ Additionally, the penalties and broad scope of the DPT will be worth revisiting as the impact of the program is evaluated.

Rules for Non-Domiciled Residents

In addition to international rules for businesses, the UK has rules that apply to non-domiciled residents (NDRs) of the UK.²¹⁸ These are individuals who have their official permanent

212 Bunn, Pomerleau, and Dueñas, "Anti-Base Erosion Provisions and Territorial Tax Systems in OECD Countries."

213 HMRC, "Tackling profit diversion by multinational companies," Jan. 27, 2020, <https://www.gov.uk/government/publications/transfer-pricing-and-diverted-profits-tax-statistics-to-2018-to-2019/tackling-profit-diversion-by-multinational-companies>.

214 HMRC, "Income Tax: offshore receipts in respect of intangible property," Oct. 29, 2018, <https://www.gov.uk/government/publications/offshore-receipts-from-intangible-property/income-tax-offshore-receipts-in-respect-of-intangible-property>.

215 See Sarah Clifford, "Taxing Multinationals Beyond Borders: Financial and Locational Responses to CFC Rules," *Journal of Public Economics* 173 (May 2019), <https://www.sciencedirect.com/science/article/abs/pii/S0047272719300088>; and Ruud A. de Mooij and Li Liu, "At A Cost: the Real Effects of Transfer Pricing Regulations," IMF Working Paper 18/69, Mar. 23, 2018, <https://www.imf.org/en/Publications/WP/Issues/2018/03/23/At-A-Cost-the-Real-Effects-of-Transfer-Pricing-Regulations-45734>.

216 Elke Asen, "The Economics Behind Thin-Cap Rules," Tax Foundation, June 27, 2019, <https://taxfoundation.org/thin-cap-rules-economics/>.

217 Sebastian Dueñas and Daniel Bunn, "How Controlled Foreign Corporation Rules Look Around the World: United Kingdom," Tax Foundation, July 15, 2019, <https://taxfoundation.org/uk-cfc-rules/>.

218 Gov.uk, "Tax on Foreign Income: 'Non-domiciled' residents," <https://www.gov.uk/tax-foreign-income/non-domiciled-residents>; and Gov. uk, "Official Statistics: Non-domiciled Taxpayers in the UK: Table 3 Non-domiciled taxpayers claiming remittance basis including those that are liable to pay and those not liable to pay the remittance basis charge, 2008-09 to 2016-17," <https://www.gov.uk/government/statistics/statistics-on-non-domiciled-taxpayers-in-the-uk>.

TABLE 8.2

Annual Remittance Basis Charge Amounts for NDRs

Length of Time as a Resident in the UK	Annual Charge
7 of the previous 9 tax years	£30,000
12 of the previous 14 tax years	£60,000

Source: HM Revenue & Customs, "Official Statistics: Non-domiciled Taxpayers in the UK: Table 4 Non-domiciled UK taxpayers taxed on the remittance basis that are liable for the remittance basis charge in the UK by charge amount, 2008-09 to 2017-18," <https://www.gov.uk/government/statistics/statistics-on-non-domiciled-taxpayers-in-the-uk>.

residence (domicile) outside of the UK but are also UK residents.

NDRs only pay UK tax on their foreign earnings under certain circumstances. If one's foreign annual income is less than £2,000, an NDR will not owe UK tax on that income. Above the £2,000 threshold additional conditions apply. An individual earning above the threshold can either pay UK tax on their foreign earnings (arising basis) or pay tax only on foreign earnings that are brought into the UK (remittance basis).

If an NDR pays tax on the remittance basis, tax-free allowances from income tax and capital gains tax will not apply and an additional annual charge may be required. The annual charge depends on how long the NDR has been a resident of the UK, as shown in Table 8.2.

In the 2017-18 tax year, approximately 64,400 individuals paid UK tax under the NDR rules accounting for £5.3 billion in total UK tax.²¹⁹ Of that group, 71 percent of individuals paid on a remittance basis, and the remainder paid on arising basis.

Revenue from the NDR regime has fallen off in recent years as taxpayers have either chosen to become domiciled or are no longer paying tax in

the UK.²²⁰ In 2018-19, the number of taxpayers under the NDR regime had fallen to 78,000 from 137,000 in 2007-08.

One policy change has impacted the number of taxpayers who are paying taxes under the NDR rules. From April 2017, NDR individuals are treated as if they are domiciled in the UK for tax purposes depending on whether they were born in the UK and a resident in the UK from 2017-18 (or later), or if they have been a UK resident for at least 15 of the last 20 years (deemed domicile rules).²²¹

While the taxpayer count has shrunk (driven partially by the deemed domicile rules), the composition has also changed. From 2008-09 to 2017-18, the share of NDR filers who are remittance-based taxpayers grew from 55 percent to 71 percent.²²²

The incentives that NDRs face impact the ability for the UK to raise revenue from those taxpayers who may temporarily reside in the UK. Policymakers should consider whether a simplification of the NDR regime could provide more certainty while minimizing the incentives for NDRs to leave the UK just before they meet one of the residency length thresholds.

219 Gov.uk, "Official Statistics: Non-domiciled Taxpayers in the UK: Table 2 Non-domiciled UK taxpayers that are UK resident and taxed on either the remittance basis or on the arising basis, 2007-08 to 2017-18," <https://www.gov.uk/government/statistics/statistics-on-non-domiciled-taxpayers-in-the-uk>. This includes capital gains tax, national insurance contributions, and remittance basis charge revenue.

220 HMRC, "Statistics on Non-Domiciled Taxpayers in the UK 2007-08 to 2018-19," July 2020, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/904443/Statistical_commentary_on_non-domiciled_UK_taxpayers.pdf.

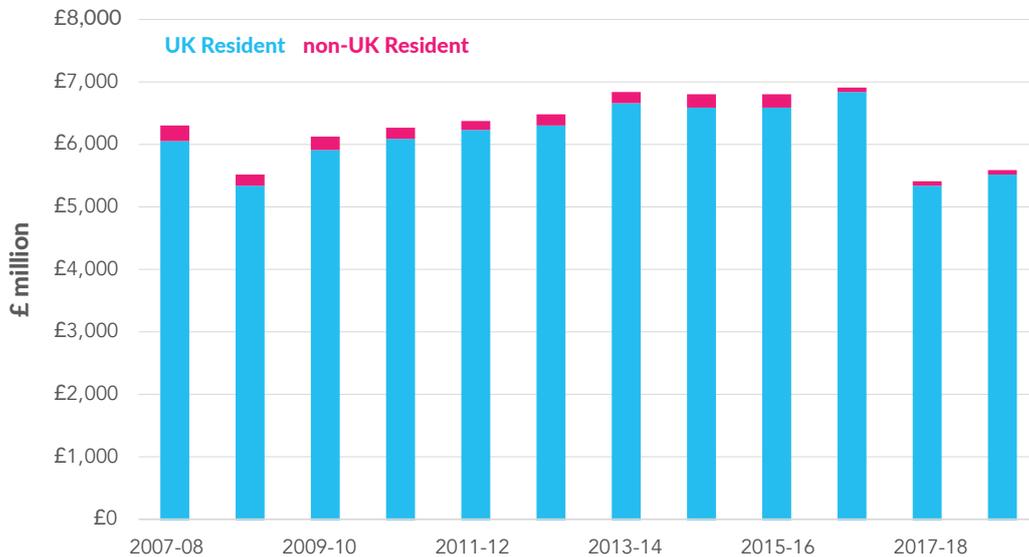
221 Gov.uk, "Guidance: Deemed Domicile Rules," Jan. 31, 2018, <https://www.gov.uk/guidance/deemed-domicile-rules>.

222 Gov.uk, "Official Statistics: Non-domiciled Taxpayers in the UK."

FIGURE 8.2

Revenue from Non-Domiciled Taxpayers Has Fallen off in Recent Years

Total income tax from non-domiciled taxpayers in the UK



Source: HM Revenue & Customs, "Official Statistics: Non-domiciled Taxpayers in the UK: Table 1," accessed Aug. 11, 2020, <https://www.gov.uk/government/statistics/statistics-on-non-domiciled-taxpayers-in-the-uk>.

Recommendations

As mentioned previously, the UK ranks at the top of the OECD in this category in the *International Tax Competitiveness Index*. That being said, two key pieces of the UK's international tax rules framework should be the focus of a reform effort.

First, the UK should reverse course on the Digital Services Tax (DST), especially in light of the ongoing work for a multilateral solution on digital taxation at the OECD.²²³ While taxation of digital business models certainly creates challenges for tax policy, a gross revenue tax aimed at specific sectors introduces unnecessary distortions and invites international tax disputes, including potential tariffs from the United States.²²⁴

Second, the UK should closely review the impact of the Diverted Profits Tax (DPT). This review should focus on whether the DPT is achieving

its goals in deterring avoidance, and whether the associated compliance challenges and penalties fit with those goals. New rules to backstop cross-border tax rules are expected to come from OECD negotiations, and the UK should ensure that the DPT is fit for purpose in light of any new international agreed-upon approach to addressing international tax avoidance.

Beyond those two recommendations, the UK should seize an opportunity post-Brexit to be an attractive place for British multinationals to expand their operations and foreign businesses to choose as a place for new investment. The UK already has a leg up with its territorial tax system and broad tax treaty network, and it should avoid undercutting its potential with policies that unnecessarily foster complexity and conflict.

223 OECD, "Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy," January 2020, <https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf>.

224 Office of the United States Trade Representative, "USTR Initiates Section 301 Investigations of Digital Services Taxes," June 2, 2020, <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2020/june/ustr-initiates-section-301-investigations-digital-services-taxes>.

CONCLUSION

The image features a monochromatic blue color scheme. In the center, the word "CONCLUSION" is written in a bold, white, sans-serif font. The background is a landscape with a prominent, dark rock formation in the middle ground, set against a lighter, hazy sky. The foreground consists of a textured, sandy or rocky terrain with some small depressions and ridges.

The goal of this report has been twofold: first, to assess the competitiveness of Britain’s tax system versus those of other OECD countries; and second, to develop a series of reform proposals that would make the UK tax system significantly more pro-growth without putting a dent in government revenues.

On the first point, our findings have not been encouraging. Despite its tax system having some appealing features—like a low corporation tax rate and a wide network of international tax treaties—the UK finishes only 22nd out of 36 OECD countries on the latest edition of the *International Tax Competitiveness Index*. Particular weaknesses include a strong bias against capital investment, which is apparent in the structure of both corporation tax and business rates; relatively high top rates of tax on earnings and dividends; and a property tax system that is both burdensome *and* highly distortive.

Our reform proposals follow naturally from this comparative analysis and are designed to address the flaws in Britain’s tax system—the rates and rules that diminish its economic growth prospects—head-on. On corporation tax, we suggest various ways of moving towards “full expensing” of capital investment. On personal income taxes, we call for a flatter tax structure that fully reflects taxes already paid at the corporate level. And on property taxes, we suggest a truly radical overhaul, changing the business rates tax base and abolishing taxes on transactions.

This is by no means a fix for every problem in the British tax system—and along the way we have pointed to other issues that a fully comprehensive programme of tax reform should address. But our focus here has been on competitiveness, and we have tried to target our reforms where they will have the biggest impact on Britain’s relative standing, and on its future growth potential.

We have also tried to make our proposals as affordable as possible, both by looking at some of the revenue-boosting dynamic effects reform could have, and by coming up with ways to achieve pro-growth ends at a lower up-front cost; neutral cost recovery as a path to full expensing is one such example. Inevitably, though, competitiveness-boosting reform will involve some tax cuts that reduce government revenue, at least in the short and medium term. How, then, to balance the books without undermining the pro-growth nature of our tax reform package as a whole?

We are under no illusions about the political popularity of our main revenue-raising suggestion—a broader VAT base, coupled with measures to compensate low-income households. Previous attempts at piecemeal base broadening have been embarrassing failures, and policymakers will undoubtedly be wary about going down that path again. Yet any worthwhile policy agenda must involve trade-offs, and if a modest extension of the VAT base can fund pro-growth tax reform *and* policies to protect the low-paid—as we argue here—then it is surely something that should be considered.

It is also striking that our analysis shows that those tax increases, such as raising corporation tax or capital gains tax, which polls suggest are more palatable to the public (and therefore to politicians), are also among the most damaging to long-term growth.

Ultimately, if there’s one message that policymakers should take from this report, it’s that the UK cannot afford to take its tax competitiveness for granted. After all, as we go to press in the autumn of 2020, the UK looks to be on the verge of a second coronavirus-induced lockdown. Britain’s future trading relationship with the European Union remains uncertain. And all this comes hot on the heels of a decade characterized by lacklustre investment, stagnant wages, and pitiful productivity improvements.

Britain needs real economic growth, and it needs it badly. But short-term stimulus is not the answer—we need growth that is broad-based, sustainable, and based on better long-term economic fundamentals. Tax reform is no silver bullet, but it is an essential part of turning that need into reality.

The proposals outlined in this report would—if enacted—leave the UK with one of the 10 most competitive and pro-growth tax systems in the developed world. That may not be the answer to all of Britain's problems. But it would be a very good start.

APPENDIX TABLE.

2020 International Tax Competitiveness Index Rankings

Country	Overall Rank	Overall Score	Corporate Tax Rank	Individual Taxes Rank	Consumption Taxes Rank	Property Taxes Rank	International Tax Rules Rank
Estonia	1	100.0	2	1	9	1	16
Latvia	2	84.4	1	5	26	6	9
New Zealand	3	82.4	24	4	6	2	20
Switzerland	4	77.1	14	14	1	34	3
Luxembourg	5	76.0	26	20	3	14	6
Lithuania	6	75.8	3	7	23	7	23
Sweden	7	74.0	8	19	16	5	11
Czech Republic	8	73.1	7	3	34	9	10
Australia	9	71.4	30	17	7	3	25
Slovak Republic	10	69.9	18	2	33	4	31
Turkey	11	69.9	15	6	20	21	12
Austria	12	68.7	21	29	13	13	5
Norway	13	68.1	11	15	18	19	14
Hungary	14	67.9	4	9	35	24	4
Germany	15	67.9	29	25	12	11	7
Finland	16	65.7	6	28	14	16	22
Netherlands	17	65.5	25	21	15	27	2
Canada	18	65.3	23	27	8	22	13
Belgium	19	64.1	13	10	28	20	19
Ireland	20	63.1	5	32	24	17	17
United States	21	62.9	19	23	5	28	32
United Kingdom	22	61.6	17	24	22	33	1
Slovenia	23	61.4	12	12	30	23	18
Korea	24	59.9	33	22	2	30	33
Israel	25	59.2	20	30	10	10	34
Japan	26	59.1	36	18	4	26	29
Spain	27	58.5	28	16	11	35	15
Denmark	28	58.3	16	35	17	15	28
Greece	29	55.9	22	8	31	32	24
Iceland	30	55.4	10	34	19	25	30
Mexico	31	51.5	31	13	25	8	35
France	32	50.7	35	36	21	29	8
Portugal	33	46.9	34	31	32	18	26
Poland	34	46.6	9	11	36	31	27
Chile	35	46.3	32	26	27	12	36
Italy	36	44.3	27	33	29	36	21

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About the Centre for Policy Studies

The Centre for Policy Studies is Westminster's most influential conservative think tank. Founded in 1974 by Sir Keith Joseph and Margaret Thatcher, its mission is to develop policies that promote enterprise, ownership, and opportunity. This report is part of a major series, "Going for Growth," devoted to rebuilding Britain's prosperity in the wake of the coronavirus crisis.

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About the Tax Foundation

The Tax Foundation is the world's leading independent tax policy research organization. Since 1937, its research, analysis, and experts have informed smarter tax policy in the United States and abroad. Its Center for Global Tax Reform produces timely and high quality data, research, and analysis on taxation in countries around the world that influences the debate toward economically principled policies.

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A Framework for the Future: Reforming the UK Tax System reveals key areas for improvement in UK tax policy and argues for reforms that would support long-term growth. The report uses the Tax Foundation's annual *International Tax Competitiveness Index* as a lens through which to examine the tax system and make recommendations. *A Framework for the Future* provides a series of reform proposals that would make taxes in the UK significantly more pro-growth without putting a dent in government revenues.



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