



UK Tax regime:

Taxing London for Investment and Growth

November 2012

Introduction

This paper is concerned with how the UK's tax regime supports London's position as a leading global business centre. It does not provide a comprehensive analysis of every tax but instead focuses on:

- taxes that are most relevant to London's competitiveness, namely businesses tax (where progress towards the Government's goal of becoming the most competitive corporate tax regime in the G20 is assessed, as well as the impact of certain sector specific taxes),
- personal tax (specifically the top rate of income tax); and
- property tax (specifically stamp duty land tax ("SDLT") on the corporate purchase of high value properties).

In order to provide consistency, data from the Organisation for Economic Co-operation and Development (OECD) is used, where available, with additional reference made to the G20¹ position as appropriate. This report uses the most recent data for the cross-country comparisons, which in most cases relates to 2011. However where more up to date information is available this is also noted.

This report shows that since 2010, improvements have been made to the UK, and therefore London's, tax competitiveness. With regard to business tax, the reductions to the statutory corporation tax rate, introduction of the new controlled foreign companies rules, and the introduction of the patent box, have all been welcomed. With regard to income tax, the announced intent to lower the top rate of income tax to 45% in April 2013 is also a positive step.

However, shock tax changes, such as the changes to Stamp Duty Land Tax (SDLT) and poorly designed taxes, such as the frequently-changing bank levy rate, have damaged the UK's reputation for tax stability and place certain key London sectors at a competitive disadvantage. Further, despite the positive moves, the UK still remains a high tax jurisdiction and London remains at a disadvantage against its competitors, particularly with regard to income tax on high earners.

¹ The G20 includes 19 individual countries and then the EU as a "country". For the purpose of this paper, the EU has not been included and instead just the 19 individual countries.

Recommendations

London is the driver of the UK economy and getting the right tax mix for London will support UK growth, an essential element in reducing the deficit. While the current economic climate makes tax cuts difficult, getting a tax mix that supports London's ability to attract global capital, investment and talent will yield positive economic benefits.

In regard to a supportive tax mix for London we recommend five measures:

1. **Commit to delivering a stable tax regime**, free from shocks. Stability does not cost but yields benefits.
2. **Commit to a revenue-maximising top rate of income tax**. At 50%, the UK currently has the joint highest top rate of tax in the G20. The economic benefit of such a high rate is questionable; analysis from the Institute for Fiscal Studies suggests that a top rate of around 40% is the revenue maximising rate. So, while the planned reduction in the top rate of income tax to 45% in April 2013 is welcome, it should be viewed as an interim measure. The government should commit to a return to a top rate of income tax of 40% when the economic climate permits.
3. Heed the response to the recent consultation on the Stamp Duty Land Tax changes announced in the March 2012 Budget and **ensure that legitimate businesses are exempt from the 15% SDLT rate and the proposed CGT exit charge and annual levy**. Given these companies were never the intended target of this legislation, this amendment should not be a cost.
4. **Remove the UK bank levy**. Banks are already major contributors to the UK's tax base through corporation, employment and other taxes. Further taxes should not be applied to this sector, particularly if poorly structured (so resulting in frequent rate changes). In the event that the bank levy is not removed, the Government should commit to make no further changes to the rate and to undertake an analysis of how the structure of the UK levy compares to levies in other competitor jurisdictions, such as New York and Frankfurt, with the intent to amend the UK levy to support the competitiveness of London as a banking centre.
5. **Prioritise tax cuts where they will deliver the most competitive advantage**. The government is committed to reducing the corporation tax rate to 22% by April 2014. At that rate, while, the UK will not have the most competitive corporate tax rate in the G20, it would be more competitive than its key competitors. Given budget pressures and the need to prioritise tax cuts, we would recommend funds are targeted at taxes which put London at a competitive disadvantage (as mentioned above) before any further cuts to the corporate tax rate.

The importance of stability in delivering competitiveness

Before looking at the rates of UK tax compared with other jurisdictions, it is important to note that stability is at least as important in delivering an internationally competitive regime as the rate of tax. Business values certainty. Instability in the tax regime, or wider political environment², can act as deterrent to investment.

The Government's road map on corporation tax³ gave a clear direction of travel that was welcomed by business, and following a period of uncertainty surrounding the tenure of the 50% top rate of income tax, the announcements in the March 2012 Budget that this rate would be reduced to 45% from 1 April 2013 were also welcome. However, these positive steps have been undermined by a series of tax shocks: the introduction of the bank levy and subsequent changes to its rate; the VAT changes announced in the 2012 Budget, which were subsequently reversed⁴; and the introduction of the 15% rate of SDLT on non-natural persons purchasing properties valued over £2 million. These tax shocks damage the UK's reputation for stability.

UK Tax Competitiveness

Following its formation in May 2010, the Coalition Government stated its ambition to make the UK the "most competitive corporate tax regime in the G20"⁵ and, since then, frequent references have been made to restoring the overall competitiveness of the UK tax regime. This is welcome as 2010 data from the World Bank showed that the UK, at 26.7%, had the fourth highest tax revenue as a percentage of GDP⁶ in the OECD, with only Norway, New Zealand and Denmark having higher rates⁷: and the highest rate in the G20⁸. Given this high tax take and the lack of stability in the system noted above, it is not surprising that over recent years the UK's tax regime has been considered a liability⁹.

² Political Uncertainty and Corporate Investment Cycles, Brandon Julio (London Business School) and Youngsuk Yook (Sungkyunkwan University), February 2010 showed impact of political uncertainty around elections on corporate investment

³ Part I: The Corporate Tax Road Map, Corporate Tax Reform: delivering a more competitive system, HMT, 9 Dec 2010

⁴ Increases in VAT on hot foods and caravans were both reversed.

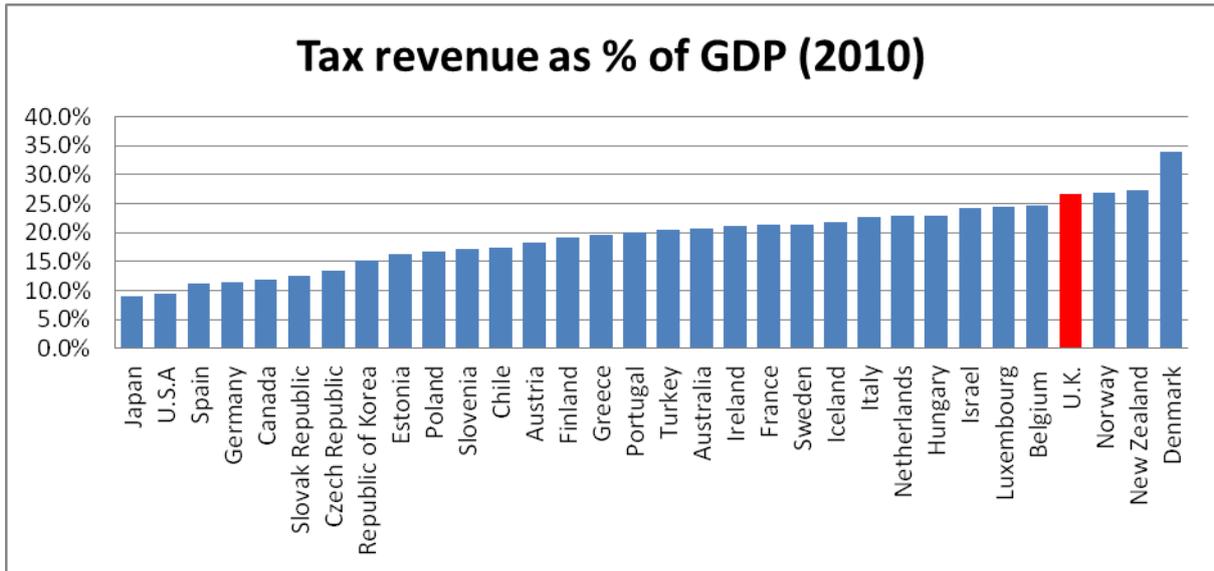
⁵ Commitment in the Coalition Agreement, 2010.

⁶ The tax revenue is defined as "compulsory transfers to the central government for public purposes. Certain compulsory transfers such as fines, penalties, and most social security contributions are excluded".

⁷ Note that data was not available for Mexico and Switzerland

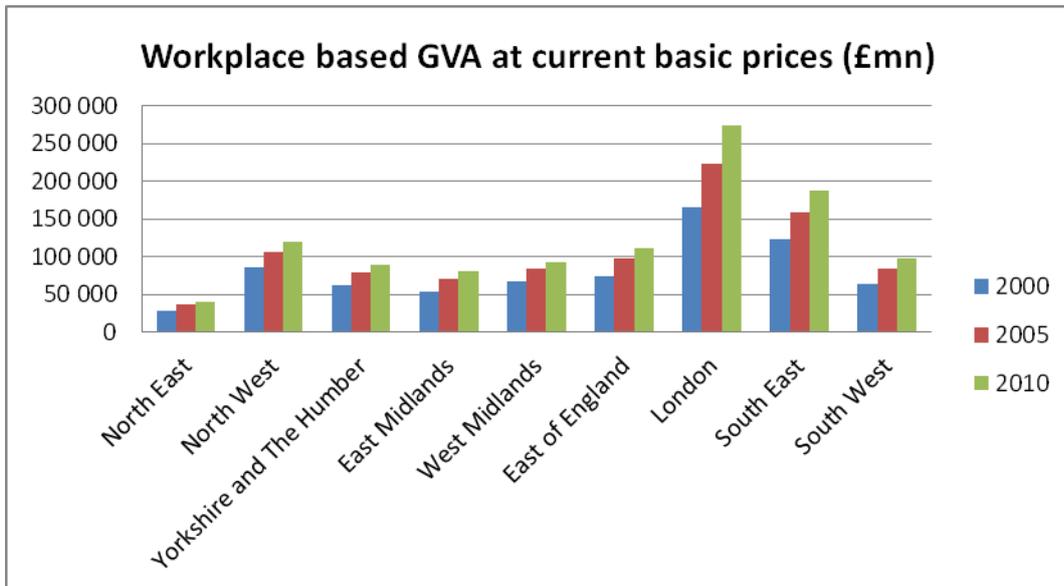
⁸ Note the data is presented from all those countries where data was available, note Argentina, Mexico and Saudi Arabia did not have data available and 2009 data has been used for China.

⁹ Recent editions of the CBI / KPMG London Business Survey (including June 2011 survey of 264 businesses) have noted the tax environment as a major perceived weakness.



Why the UK needs an internationally competitive London

London is a net contributor to the UK economy and the most productive region in the country. London's gross value added (GVA) is more than double that of any other UK region other than the South East, (1.5 times the size) and London and the South East combined provide more than a third of the UK's GVA.



In terms of tax revenues, London is a net contributor to the rest of the UK. In the decade leading up to 2009/10¹⁰, an average annual contribution on £17 billion was made. During the recent challenging years, when the UK is running a sizeable deficit, London is still predicted to make a positive contribution (£1.9 billion 2010/2011 and £5.5 billion 2011/12).

¹⁰ City of London data.

While the potential range of possible contributions is wide, projecting forward to 2019/20 the central estimate for London's tax export is £43.1 billion¹¹.

London is a global city. Its ability to attract global businesses, capital and talent is critical to its success: success that generates jobs and investment across the UK. For example, a number of the major banking institutions that have chosen to locate their head offices or regional head offices in London are supported by additional offices elsewhere in the UK (e.g. Citi by operations in Belfast and Deutsche Bank by operations in Birmingham). If the head offices had been located in another country, e.g. Germany, then the support offices would likely be located in other German cities.

While London's position as a leading global city was recently confirmed by the PwC 'Cities of Opportunity' report¹² (which showed London in joint first place with New York, an improvement from the 2011 results), London's pre-eminence must not be taken for granted. Increasing competition from emerging cities, as well as the on-going competitive pressures from established centres¹³, means that London must continually monitor its international standing in regard to key aspects of business environment, including taxation.

Getting the tax-mix right for London

London's success is based to a large extent on its ability to be a hub location hosting a concentration of globally mobile businesses and individuals. Its dependence on the service sector¹⁴ and its large portion of high earners and high value properties means it requires a different tax mix to other UK regions.

The Government's focus on the tax competitiveness of the UK has centred on delivering a lower rate of corporate tax than elsewhere in the G20. However this is only part of the answer for London; additional to a competitive corporate tax rate, other business taxes must also support the competitiveness of key sectors, e.g. financial services¹⁵, and the personal tax regime must not deter top entrepreneurs and corporate talent from locating in London¹⁶. Getting the tax environment right in London will support growth across the country; get it wrong and the UK will suffer, as even a loss of a small portion of high earners (20% of which live in London, and a further 20% in the South East)¹⁷ would have a significant impact on tax revenues. The top 1% of tax payers pay more than a quarter of all income tax¹⁸.

¹¹ London Finance Commission Working Paper: Forecasts for the range of tax and spending in London until 2023/24

¹² PwC Cities of Opportunity, 2012

¹³ London First Review of London's Competitiveness, 2012

¹⁴ Data from GLA economics, Working Paper 33 "The evolution of UK and London employment rates" showed that in 2006 in the UK one in four people were employed in 'manufacturing, transport and infrastructure' in London it is only one in six.

¹⁵ In 2011, financial and insurance services contributed £125.4 billion in gross value added (GVA) to the UK economy, 9.4% of the UK's total GVA. London accounted for 45.8% of the total financial and insurance sector GVA in the UK in 2009. Data source: house of Commons Library "Financial Services: contribution to the UK economy" Standard Note: SN/EP/06193 (21 August 2012)

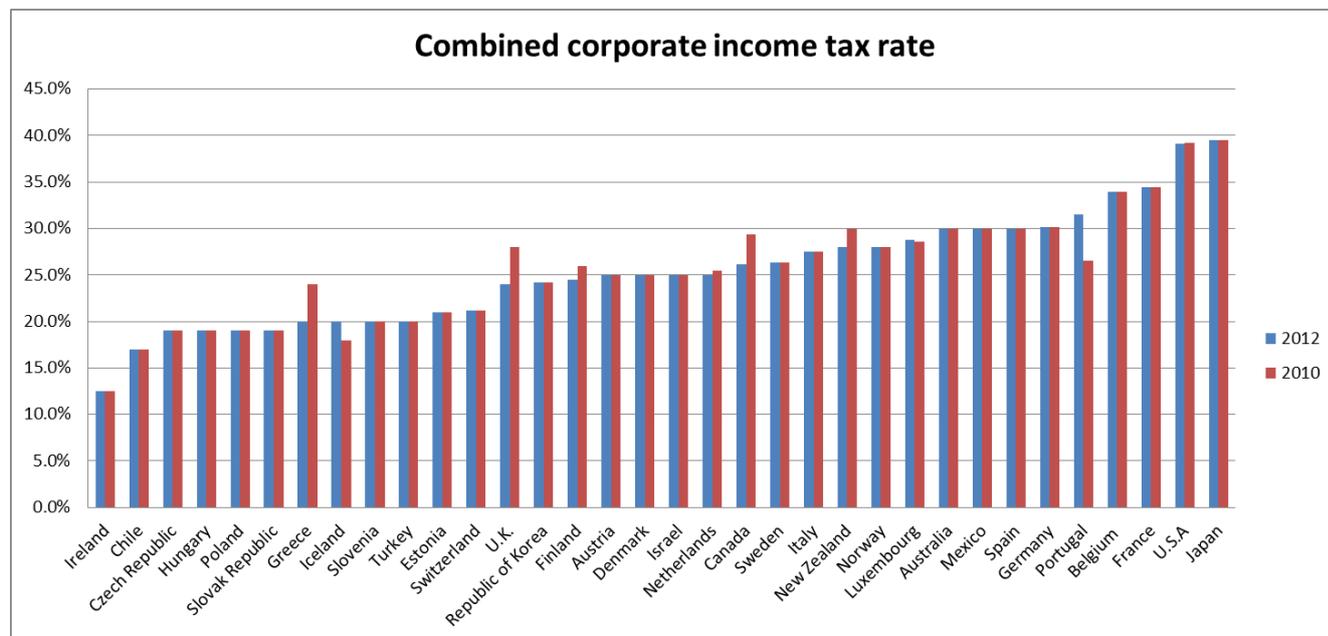
¹⁶ Policy Exchange research note: Not with a bang but a whimper, December 2010

¹⁷ See below analysis of income tax by region.

¹⁸ HMRC Income Tax Liabilities: actual results for 2009-2010, top 1% accounted for 26.7% of income tax liabilities.

Corporation tax

The UK has made positive progress over the past two years in regard to the statutory rates of corporation tax. Its reduction in tax rate from 28% (2010) to 24% (2012) resulted in the UK moving from 22nd most competitive rate in the OECD to 13th.



Source: OECD tax database. Rates are combined central and sub-central rates

Note: This chart does not include the Japanese reduction in corporate tax rate from April 2012 to 36.8% which makes the USA the highest rate jurisdiction.

With regard to the Government's desire to make the UK the most competitive corporate tax regime in the G20, the 4p reduction moved the UK from 7th place to 4th (with Republic of Korea). Over the past two years, the UK has been one of only four G20 countries to have reduced its corporation tax rate (Canada down from 31p to 26p; India down from 33.99p to 32.45p; and Japan down from 41.69p to 38.01p). The German rate has increased marginally from 29.41p to 29.48p. If the Chancellor continues with his plan to cut the main corporation tax rate by a further 1p in each of the next two years, thereby bringing the rate to 22% in April 2014, the UK will remain in 4th position, although clearly the gap between the UK and the leading three countries will have reduced.

Positive steps: CFCs and a Patent Box

The introduction of the new Controlled Foreign Companies legislation in the 2012 Finance Bill was a welcome development both in terms of the content of the legislation and the certainty this now brings (following a prolonged consultation period).

In the 2012 Budget, the Chancellor confirmed the Government's intention to cut taxes on patents and similar intellectual property through the introduction of a patent box. The new regime is due to be phased in from 1 April 2013. According to Ernst & Young, given the incentives are provided not only for the development of patents themselves but also for development of products that incorporate patented technology, the UK regime is potentially more generous than those of other European countries.

For the UK to have the (equal) most competitive statutory rate of corporation tax in the G20, it would need to be reduced to 20%¹⁹. In terms of London's international competitiveness, a rate of 22% is higher only than the rates operating in Russia, Saudi Arabia and Turkey, and more competitive than that applying to the key cities of New York²⁰, Tokyo²¹, Frankfurt and Paris (as well as the emerging cities in China and Brazil). While further reductions in corporation tax would always be welcomed, for London the cost of a further reduction would be better spent supporting reductions in other taxes, namely the top rate of income tax.

While the statutory corporation tax rate is competitive, less generous allowances available in the UK relative to other jurisdictions mean that the UK's ranking in regard to the effective average tax rate (EATR) and the effective marginal tax rate (EMTR) – measures important for business investment decisions²² – are less positive.

Data taken from Saïd business school²³ shows the EATR and EMTR across the OECD as at January 2012 (at this time, the statutory rate of corporation tax was 26% - reduced to 24% in April 2012). The chart shows that while the statutory rate at this time was reasonably competitive (OECD ranked 13th: G20 ranked 7th), the UK's EATR was less so (OECD ranked 22nd: G20 ranked 9th), and the EMTR was even less competitive (OECD ranked 31st: G20 ranked 15th).

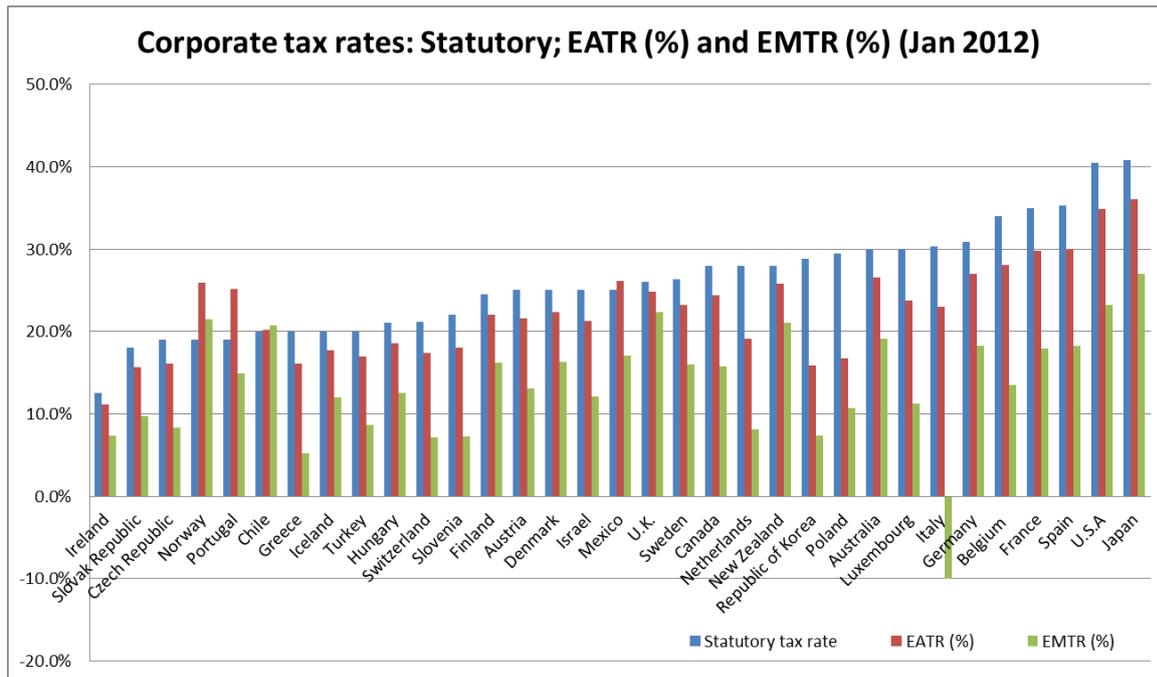
¹⁹ While the UK has a 20% rate for small businesses, there are currently no proposals suggesting the statutory rate will be reduced to this level

²⁰ Prior to the US Presidential election, both candidates announced plans to reduce the corporate tax rate. Most likely reduction is to 28%

²¹ Note Japan reduced its corporate tax rate in April 2012 to 36.8%

²² The EATR is relevant for discrete choices as to where to locate or expand business activities as it shows the location which generates the higher post-tax profit, in present value terms. The EMTR considers the size of investment, conditional on the location choice, and assumes that additional investment will be undertaken up to the point when the marginal gain from the additional investment equals the cost of capital.

²³ CBT Corporate tax ranking 2012; Saïd business school University of Oxford and ESRC



Source: Saïd business school

In measuring London’s international competitiveness, it is important to understand the relevance of different corporate tax measures. The EATR and EMTR used above are generic²⁴ and, when calculated at an individual business level, will vary significantly depending on the nature of the business (i.e. does the business benefit from capital allowances? To what extent is a business leveraged?). Many businesses in London are service-based and may be housed in leased offices, making capital allowances less relevant than for regions with a concentration of businesses reliant on plant and machinery. Likewise, the average leverage in different industries will vary. It is important to understand the relevance of the different corporate tax measures to the different sectors that make up London’s business community. While the reductions in the statutory rate of corporation tax have been beneficial not only in terms of the lower tax liability, but also in the signal they send out internationally, alone they are not sufficient to ensure London’s on-going global competitiveness.

²⁴ Saïd business school report uses the methodology proposed by Devereux and Griffith (1998).

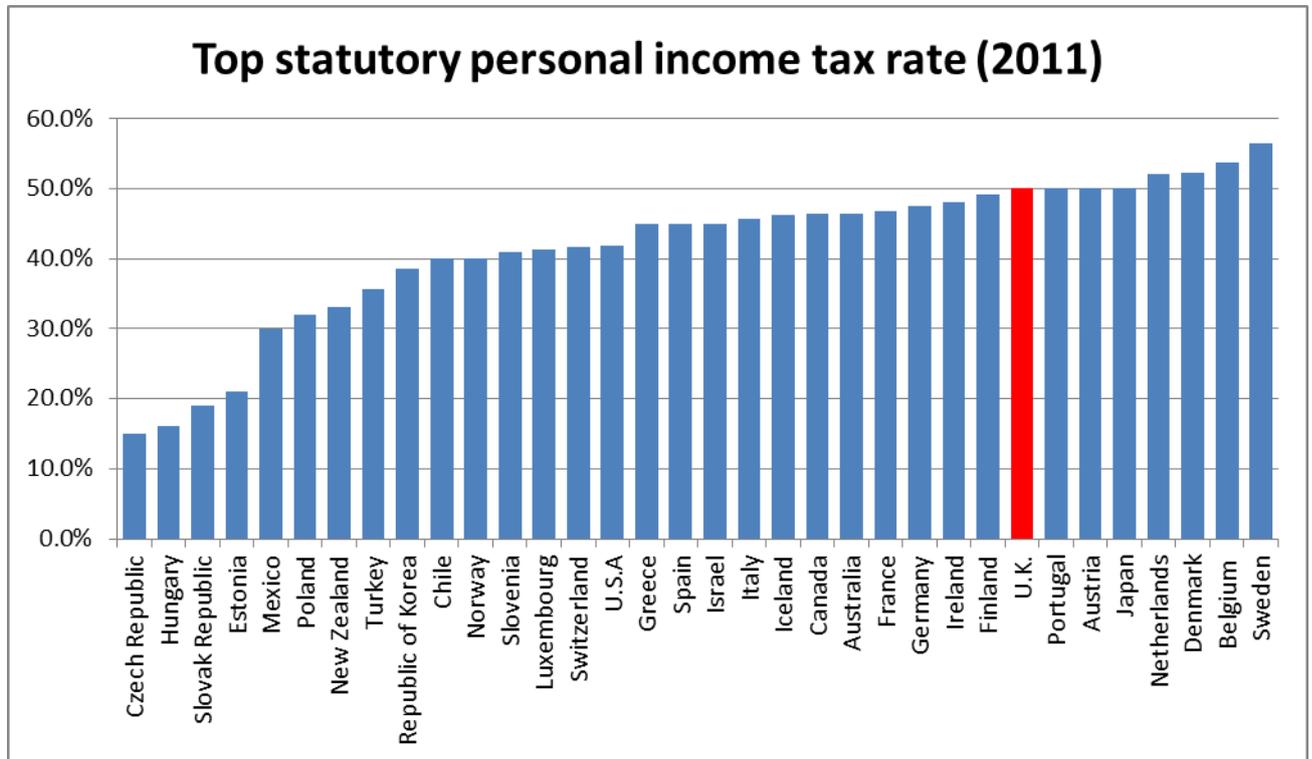
Bank Levy

The introduction of a bank levy in 2011 is of particular concern to London given the concentration of banks and bank headquarters in the city. While permanent levies (or similar charges) exist in a number of other European jurisdictions, most notably Germany and France, they are not yet present in London's competitor global financial centres, such as New York (although a financial crisis tax has been proposed in the US to take effect from 1.1.14), Tokyo or Singapore.

The structure of the levy adds cost to being headquartered in UK (as it captures global operations) as well as deterring non-UK business from being booked here (as the tax is levied on the balance sheet). London is a major centre for bank headquarters and a leading hub through which banks channel offshore business. Making these activities more expensive (HSBC has commented that the bank levy adds approx. £600mn to its costs of which £400mn would not be charged if it were not UK headquartered) will reduce London's attractiveness and threaten jobs and tax revenues.

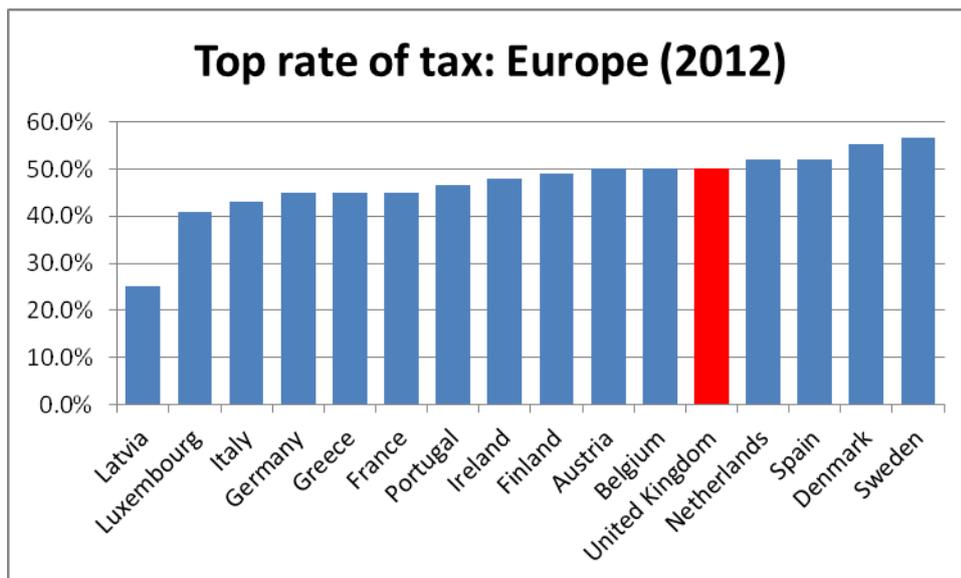
The UK Government's approach of targeting an annual collection of at least £2.5 billion from the levy, irrespective of the banks' performance, has resulted in additional uncertainty and the potential for an ever increasingly burdensome tax. As demonstrated, the need to collect an absolute sum has resulted in the rate having to be changed every time a shortfall is predicted (the rate was increased in the 2011 Budget, 2011 Autumn Statement and the 2012 Budget). Should the target continue not to be met (possibly as a result of poor economic climate, banks leaving London, moving their London headquarters offshore, or not booking trades through London) the rate will be increased on the remaining tax base, putting additional burden on the banks and potentially increasing pressure on their London operations.

Personal income tax



Source: OECD tax database

As at 2011, the UK had the joint 5th highest²⁵ top rate of personal income tax in the OECD and the joint highest²⁶ in the G20. At 50%, the UK rate is also less competitive than a number of European countries.

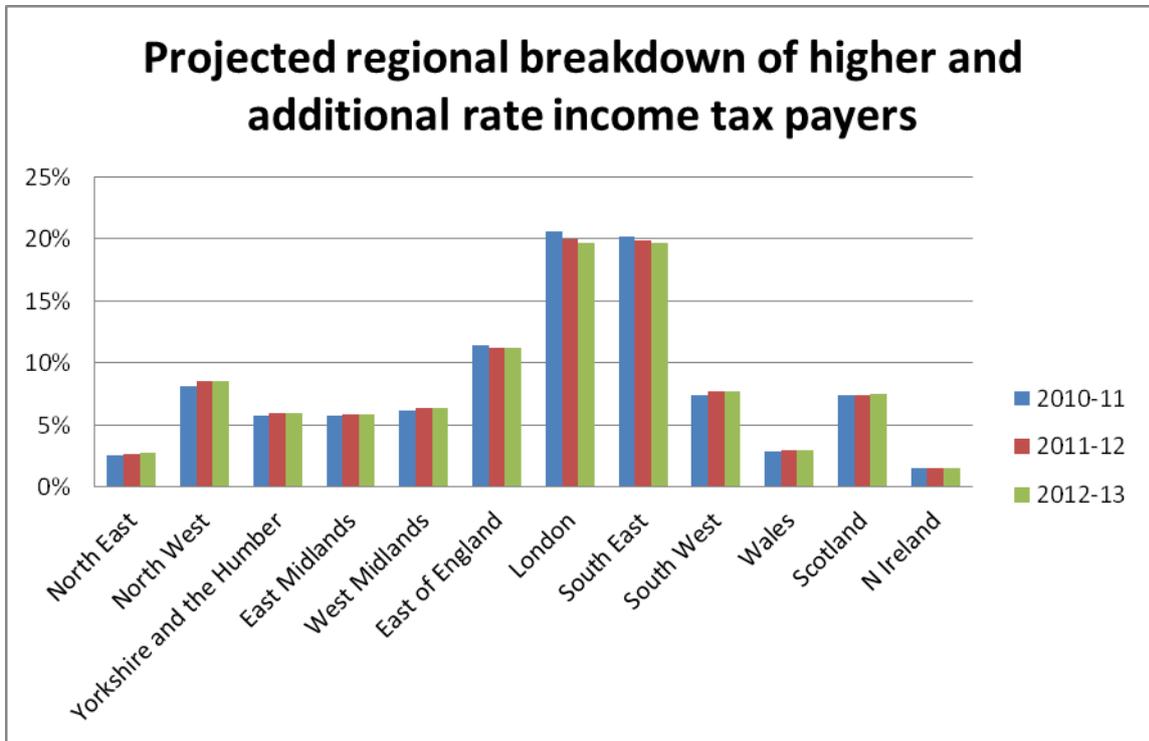


²⁵ with Portugal, Austria and Japan

²⁶ with Japan

Source: KPMG

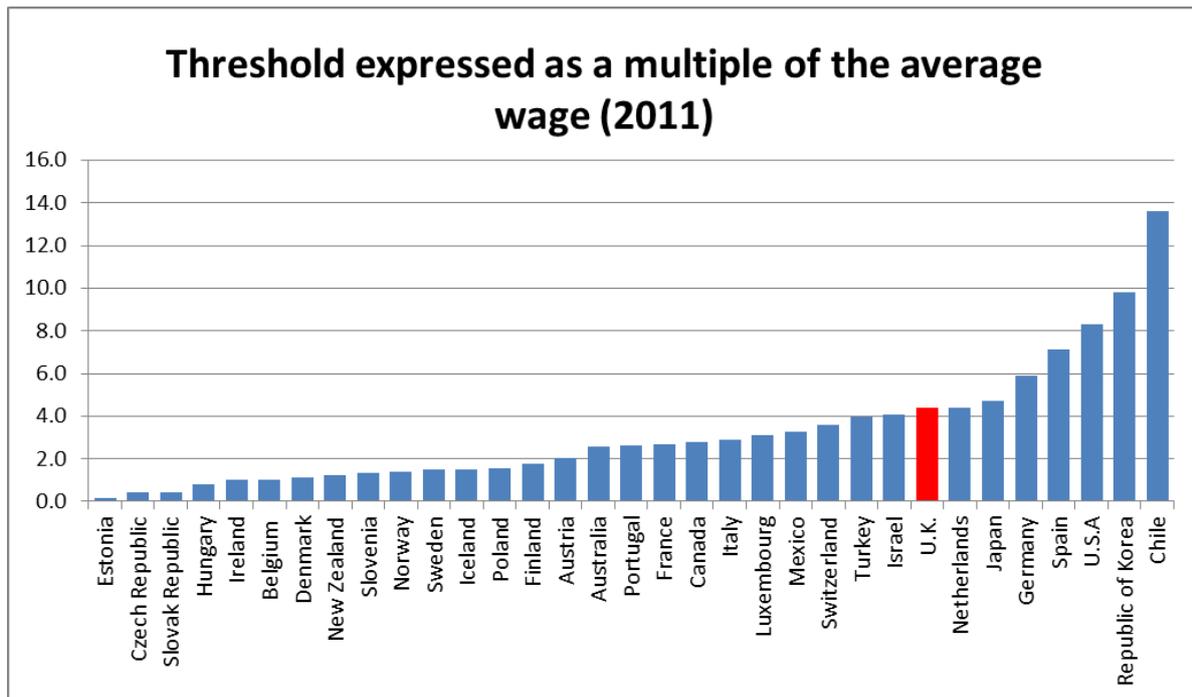
Regional figures show that London accounts for the largest share of top and higher rate tax payers, 20% (with the South East accounting for a further 20%), making the impact of the top rates of impact particularly relevant for London.



VAT

This report has not focused on consumption taxes as they are less critical to the tax competitiveness of London. However, for completeness, it is useful to note the contribution made by VAT to the overall tax take (around one sixth). The standard rate of VAT in the UK is 20% (with certain goods being exempt or changed at reduced rates). This rate was increased from 17.5% in 2011 and from 15% in 2010, and now gives the UK a VAT rate above that of Germany and France, but still marginally below the EU average (20.9%). Comparing the 20% VAT rate to equivalent rates in Japan (10%), Australia (10%) and the US (varies by state – 7% in New York) show the EU sales tax to be relatively high.

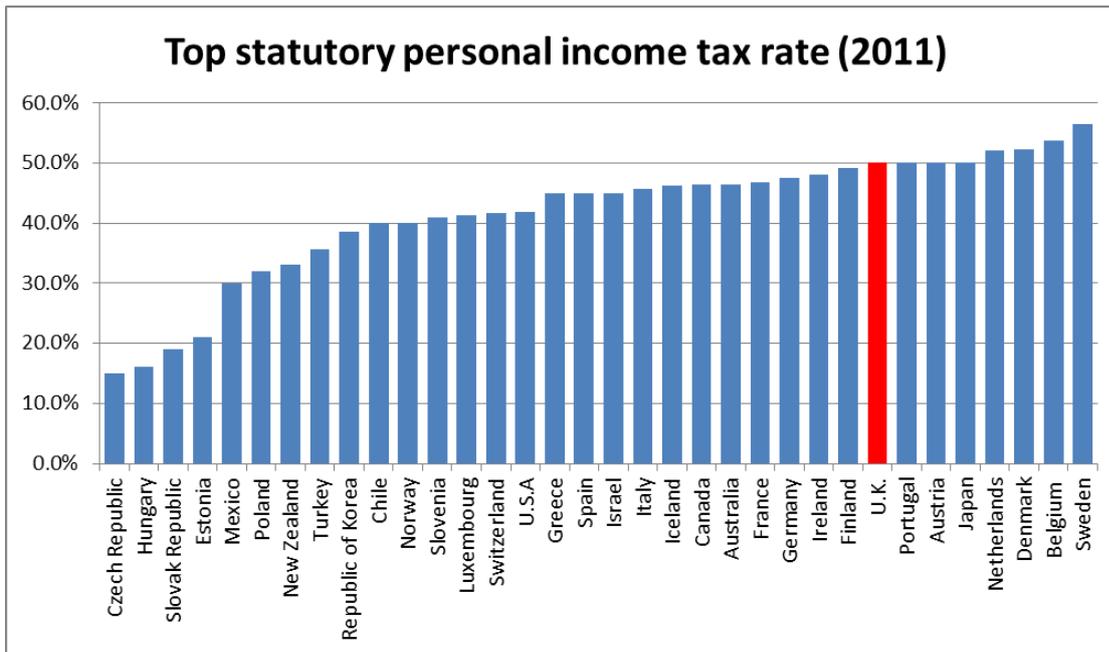
While the top rate is expected to be reduced from 1 April 2013 to 45%, this will still only leave the UK with a rate higher than many OECD countries and with the joint 2nd highest rate in the G20. In terms of London's competitiveness, at 45%, London will still have a higher top rate of tax than New York and will be equal to Frankfurt and Paris (although it is important to note that France has proposed a 75% top rate of tax on earnings over £780,000). A return to a top rate of tax of 40% would return London to a competitive position.



Source: OECD tax database

When considering the cost of the top rate of income tax, it is important to take into account the income level at which the rate has effect. The chart above shows that the UK's top rate of tax takes effect at a higher level than many jurisdictions, but at a much lower rate than two of London's key competitors, Frankfurt and New York. Looking at the threshold in terms of multiples of average wage shows that the UK (London) top rate takes effect at 4.4 times the average wage compared with 5.9 times in Germany (Frankfurt) and 8.3 times in the US (New York).

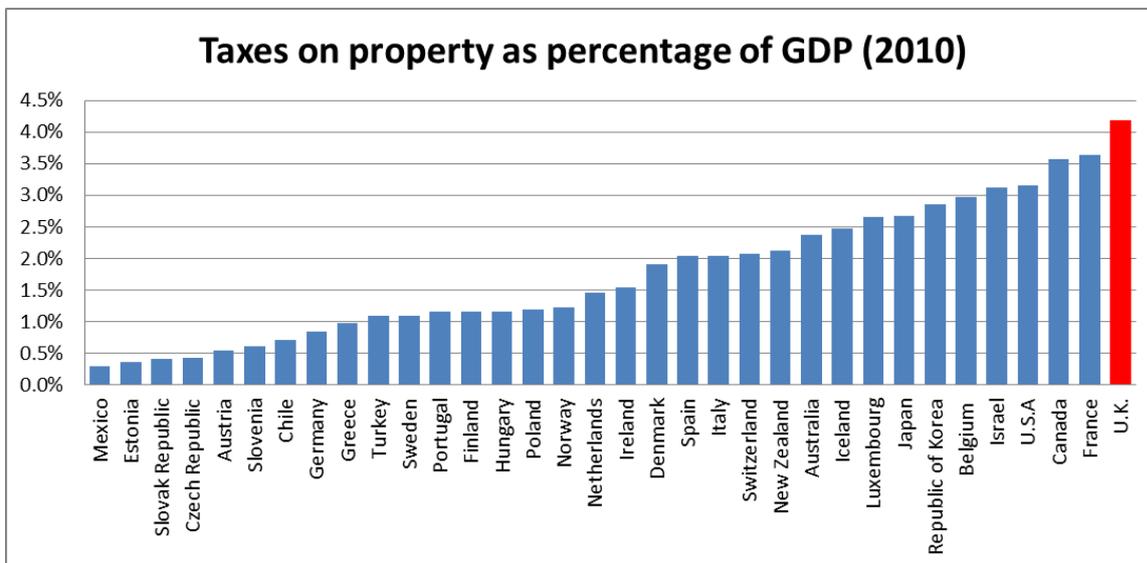
Income tax is not the only relevant tax to consider when assessing the international competitiveness of a jurisdiction to highly paid individuals. Additional social security taxes often work in a similar way to income tax and also need to be considered. Comparing the 2011 combined top rate of personal tax and social security contributions shows the UK to be joint 24th (with Ireland) in the OECD. Considering the G20 countries which are also part of the OECD shows the UK to have the highest combined rate. The announced reduction in the top rate of tax to 45% would reduce the combined personal and social security figure to 47% which, assuming all other countries remain the same, improves the UK's position to 18th in the OECD (and from worst to 7th among the 11 G20 countries that are OECD members). At 47%, London will be more competitive than key locations such as Frankfurt, Paris and Tokyo but still falling behind New York.



Source: OECD tax database

Property Tax

According to OECD data (from 2010), property taxes as a portion of GDP are higher in the UK than any other OECD country. The data, which provides rates in specific years from 1965, shows that property taxes in the UK have consistently accounted for a relatively high proportion of GDP. Considering the OECD data from the eleven G20 countries, shows the UK as having a significantly higher rate than the other jurisdictions.



Source: OECD tax database

This data is supported by EU figures which show that in 2011 UK property taxes were 11.9% of total taxation, the highest in the EU. France, which was second highest, derived just 8.1% of tax receipts from property, while the EU average was 3.6% and in Germany it was just 2.2%.

Stamp duty land tax (SDLT)

The shock increases in SDLT for properties valued at over £2 million introduced in the 2012 Budget not only added further to an already increasing revenue source (between 2000/01 and 2008/09 receipts from SDLT increased fourfold from approximately £2 billion to £8 billion), but also added uncertainty to the property tax regime. The concentration of properties valued at £2 million or more in London makes this tax of particular relevance to London.

While the introduction of a new 7% band of SDLT for £2 million plus properties clearly adds an additional tax burden to those wishing to purchase high value properties, it is the penal 15% SDLT rate applied to non-natural persons that is of particular concern. The introduction of this 15% rate, plus the proposed introduction of an annual charge and potential CGT exit charge, were aimed at penalising SDLT avoiders but, due to the untargeted approach taken, inadvertently capture legitimate business purchasers. Further information on London First's response to this tax increase can be found on the London First website – www.londonfirst.co.uk.