Tax By Design: The Mirrlees Review

Taxing Income from Capital

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The Mirrlees Review

- Reforming the tax system for the 21\textsuperscript{st} century
- \url{http://www.ifs.org.uk/mirrleesReview}
- Funded by ESRC & Nuffield Foundation
- Inspired by the 30\textsuperscript{th} anniversary of the ‘Meade Report’
Objectives

• To identify the characteristics of a good tax system for any open developed economy in the 21st century

• To assess the extent to which the UK tax system conforms to these ideals

• To recommend how it might realistically be reformed in that direction
Volume 1: Dimensions of Tax Design

- 13 commissioned chapters & commentaries
- Published April 2010 & available online
Volume 2: Tax by Design

- An integrated view of tax reform, drawing on evidence from commissioned chapters
- Launched Dec 2010; to be published 2011
- Editorial team
  - Sir James Mirrlees (chair)
  - Tim Besley, Richard Blundell, Malcolm Gammie, Jim Poterba
  - Stuart Adam, Steve Bond, Robert Chote, Paul Johnson, Gareth Myles
Scope of the Review

• A key aspect is that we consider the tax system as a whole

• Proposals on personal taxation of savings are closely related to proposals on corporate taxation of profits, and to small business taxation

• Overall package of reforms revenue-neutral (not each component)
Constraints

• We take as given:
  – size of government
  – degree of redistribution

• We focus on tax design for a small open economy:
  – with current level of international cooperation
  – with current EU/bilateral treaty obligations
Scope of this Talk

• Taxing returns on savings and investments
• Personal taxation of income and capital gains on savings
• Corporate taxation of profits
• Small business taxation
Guiding Principles

• Minimise distortions to decisions about when to consume

• Treat different forms of saving and investment in similar ways

• Avoid sensitivity to rate of inflation
Household Savings

• Life-cycle perspective: saving = deferred consumption

• Efficiency arguments for not distorting intertemporal consumption choices are important
  – not clear that taxing people who choose to consume later more than people who choose to consume earlier allows desired redistribution to be achieved at a lower efficiency cost

• But not decisive
Household Savings

- Income from capital cannot be taxed coherently under a standard income tax
  - realised capital gains
  - inflation

- In contrast, uniform treatment of all forms of saving can be achieved if we exempt the ‘normal’ component of returns
  - corresponding to the risk-free interest rate that can be earned on safe assets
Taxing Capital Income

• With many assets, providing different mixes of cash income (interest, dividends) and capital gains, we cannot tax the normal return component of capital income in a uniform way

• Inflation → taxation of nominal returns
  – full indexation is theoretically possible but (almost) never implemented in practice
Taxing Capital Income

- Taxing capital gains only on realisation favours gains over cash income (even if realised gains taxed at full marginal rates)
- Tax deferral on accrued gains → lock-in effect
- Incentives to convert income into capital gains
  - inequity
  - complex anti-avoidance provisions
- Taxing capital gains on an accrual-equivalent basis is theoretically possible, but never implemented in practice
Neutral Taxation of Savings

• A standard income tax reduces the rate of return earned on savings, discouraging saving and encouraging consumption.

• We discuss two alternative approaches which avoid this intertemporal distortion:
  – Expenditure Tax (Meade)
  – (Normal) Rate of Return Allowance (Sørensen)

• These two approaches are broadly equivalent.

• Both also treat cash income and capital gains equally, and avoid sensitivity to inflation.
Neutral Taxation of Savings

- Expenditure tax (EET)
  - tax relief for inflows
  - tax all outflows
  - cf. current treatment of pensions

- Rate of Return Allowance (RRA)
  - no tax relief for inflows
  - tax relief for normal component of returns
  - cf. ACE corporation tax
Neutral Taxation of Savings

• Both expenditure tax and RRA approach tax ‘excess’ component of returns (economic rents)

• RRA approach can be viewed as an expenditure tax with deferred rather than immediate tax relief for saving

• For safe assets, where excess returns are unlikely to be important, can simply exempt interest income from taxation (TEE)
Example – standard income tax

- Save £100 in an account that pays 10%
- Next year: interest income £10
- Standard income tax @20%: post-tax income £8
- Rate of return reduced from 10% to 8%
- Disincentive to save, especially important for poorer households
- Exempting all interest income would avoid this
Example – expenditure tax

- Expenditure tax @20%: tax relief of £20 on saving of £100 in first year
- Tax withdrawal of £110 in second year: tax payment of £22
- After tax, saver gives up £80 this year and gets £88 next year
- Rate of return unchanged at 10%
- No distortion to intertemporal allocation of consumption
Example – generalised cash flow treatment

- No tax relief of £20 this year
- Carry this forward, marked up at interest rate of 10%, giving tax relief (against the expenditure tax) of £22 next year
- Saver then gives up £100 this year and gets £110 next year, just as in the no-tax case
- Two approaches equivalent, provided the saver is indifferent between tax relief of £20 this year or £22 next year
Rate of Return Allowance

• This can be achieved by providing a RRA, calculated as the risk-free (nominal) interest rate times the stock of savings (at historic cost) at the end of the previous year
  – 10% of £100 = £10 in the example

• Then taxing (nominal) income from savings plus any realised (nominal) capital gains, net of this RRA

• ‘Losses’ (returns below RRA) relieved against tax on other income, or carried forward with interest mark-up
Inflation

- Expenditure tax and RRA approaches require no (explicit) indexation for inflation.
- It makes no difference to our example:
  - whether the risk-free real interest rate is 10% and inflation is zero,
  - or whether the risk-free real interest rate is 2% and inflation is (approximately) 8%.
- Effective tax rates do not fluctuate in an arbitrary way with price inflation.
Capital Gains

• Expenditure tax and RRA approaches both achieve uniform treatment of cash income and capital gains

• Avoid distortions to the composition of savings
Example

• Save £100 for 2 years
• Risk-free interest rate again 10%
• Choice of 2 assets
• Asset I pays interest
  – interest of £10 in first year is re-invested
  – gives holding of £110
  – interest of £11 in second year
  – plus principal of £110 gives total of £121
Example (cont)

- Asset G appreciates in value
  - value £110 after one year
  - value £121 after two years

- With no uncertainty and no transaction costs, expect individuals to be indifferent between these 2 assets in the absence of tax

- Would like taxation to leave individuals indifferent between these 2 assets
Example (cont)

- Standard income tax does not achieve this
- Asset I
  - tax on interest income of £10 in first year
  - tax on interest income of £11 in second year
- Asset G
  - tax on realized gain of £21 in second year
  - tax on accrued gain of £10 in first year is deferred until the asset is sold
- Capital gains favoured over cash income
- Incentive to defer sale of assets that have risen in value
Example (cont)

- **Rate of Return Allowance**
  - **Asset I**
    - RRA 10% of £100 = £10 in first year
    - RRA 10% of £110 = £11 in second year
    - no tax paid (on normal return)
  - **Asset G**
    - RRA 10% of £100 = £10 in first year
    - no taxable income → ‘tax loss’
    - carry forward, marked up at risk free interest rate → allowance of £11 in second year
Example (cont)

• Asset G
  – RRA 10% of £100 = £10 in first year
  – no taxable income → ‘tax loss’
  – carry forward, marked up at risk free interest rate → allowance of £11 in second year

  – RRA 10% of £100 = £10 in second year
  – plus allowance carried forward gives total allowance of £10 + £11 = £21 in second year
  – also no tax paid (on normal return)
Example (cont)

• Easily checked that this uniform treatment of cash income and capital gains extends to assets with above-normal returns

• Suppose the risk-free interest rate is 5%, but assets I and G return 10%, as above

• Asset I
  – tax base £10 - £5 = £5 in first year
  – tax base £11 - £5.50 = £5.50 in second year
Example (cont)

• Asset G
  - tax base £21 - £5 - £5.25 = £10.75 in second year

• Present value of the tax base for asset I also

\[
\frac{5}{1.05} + \frac{5.5}{1.05^2} = \frac{5 \times 1.05}{1.05^2} + \frac{5.5}{1.05^2} = \frac{10.75}{1.05^2}
\]

Same present value of tax on the above-normal component of the return, whether this comes as capital gain or cash income
RRA Approach - Implementation

• Requires information on cash income and realised capital gains (also needed to implement standard income tax) plus risk-free interest rate to be specified
  – e.g. nominal yield on medium-term gilts

• Administration similar to standard income tax

• Govt not required to provide up-front tax relief in return for (prospect of) future tax payments
Reforming Taxation of Household Savings

• Pragmatic path towards neutrality can combine different approaches for different forms of saving

• For standard interest-bearing accounts, simply exempt interest income from taxation (TEE approach; little or no rents)

• For pragmatic reasons, retain this approach also for owner-occupied housing and limited holdings of other risky assets (cf. equity ISAs)
Reforming Taxation of Household Savings

• For pension saving, retain basic expenditure tax treatment
  – with simplifications, and more equal treatment of employer/employee contributions

• For substantial holdings of other risky assets (equities, bonds, mutual funds, investment property, unincorporated business assets), introduce Rate of Return Allowance
Reforming Taxation of Household Savings

• For pension saving, there is a case for some additional fiscal incentive, to encourage savings to be tied up for long periods
  – though not in the form of a tax-free lump sum

• Other than this, there is also a strong case for capital income in excess of the normal rate of return to be taxed at the same marginal rates as labour income
  – important in the context of small businesses
Wealth Transfers (Gifts and Bequests)

- Principles applied to life-cycle savings may not extend to transfers between generations.
- Strong case in principle for some taxation of receipts, on a cumulative basis, in the hands of recipients:
  - a lifetime accessions tax
- Potential to achieve redistribution at limited efficiency cost:
  - promoting equality of opportunity
Wealth Transfers (Gifts and Bequests)

• UK ‘inheritance tax’ not fit for purpose
  – too easily avoided, especially by the wealthy

• Practical problems with lifetime accessions tax also require careful consideration
  – Compliance largely voluntary, except for bequests
  – Scope for distorting choices between gifts of cash and expenditures that benefit children (e.g. on education)
Corporate Taxation

- Main proposal on corporate taxation is the introduction of an Allowance for Corporate Equity (ACE), analogue of personal RRA
- We would favour this approach even in a closed economy setting, with no international considerations
- Case for not taxing the normal return on corporate investment is considerably stronger in the open economy context
Corporate Taxation

• Why have a corporate tax at all?
  – Primarily as a backstop to personal taxation
  – Also efficient to tax location-specific rents
Corporate Taxation

• Why have a source-based corporate tax?
  – Only game in town at present
  – Robustness of corporate tax revenues suggests likely to be sustainable for some time to come
  – Though further downward pressure on corporate tax rates seems likely
  – And more radical alternatives (DBCF or VAT) may need to be considered in longer term
Problems with Corporation Tax

• Raises cost of capital
• Bias towards debt finance
• True depreciation Vs. capital allowances
• Sensitivity to inflation
Problems with Corporation Tax

- In an open economy with capital mobility, capital goes elsewhere, and burden borne by domestic workers
  - lower capital per worker
  - lower output per worker
  - lower real wages

- More efficient to tax labour income of domestic workers directly
Reforming Corporation Tax

- Key problems stem from inclusion of normal return on equity-financed investment in the corporate tax base.
- Solved by tax relief for opportunity cost of using equity finance.
  - Allowance for Corporate Equity (ACE).
- Also eliminates sensitivity to tax depreciation rules and inflation.
Allowance for Corporate Equity

• Introduction of ACE would have a significant revenue cost

• Mistake to recoup this by raising the corporate tax rate

• Appropriate rate to tax rents earned in the corporate sector should balance:
  – Advantages of taxing some sources which are largely immobile
  – Disadvantages of (attempting to) tax other sources which are highly mobile
Allowance for Corporate Equity

- If the current UK corporation tax rate is about right (‘competitive’)
- The implication is that by taxing the normal return on equity-financed investment
- We are currently raising too much revenue from corporate taxation
Key Recommendations

• Introduce ACE with no increase in the corporate tax rate

• Accept that less revenue should be collected from the corporate tax

• Rebalance shares of revenue from corporate and other taxes as part of an overall revenue-neutral package
Welfare Implications

• De Mooij and Devereux (2009) present simulations of a similar revenue-neutral package, with ACE financed by increase in consumption tax, at same CT rate

  - Investment  $\uparrow$ 6.1%
  - Wages  $\uparrow$ 1.7%
  - GDP  $\uparrow$ 1.4%
  - Welfare  $\uparrow$ 0.2% of GDP
Small Business Taxation

• These proposals on personal savings and corporate investment fit together
  – scope for substantial rationalisation of small business taxation

• ACE corporation tax

• RRA treatment of dividend income and capital gains on company shares

• RRA treatment of income from unincorporated businesses
Small Business Taxation

- Suitable alignment of personal and corporate tax rates can then:
  - equalise tax treatment of income derived from employment, self-employment and running a small company
  - reduce incentives to convert labour income into dividend income/capital gains

- Less need to rely on anti-avoidance measures
Small Business Taxation

• Key ingredients of rate alignment include:
  – uniform application of NICs to income from employment and self-employment, and to distributed profits and capital gains
  – lower personal tax rates for dividend income and capital gains on company shares (than on other forms of capital income)
  – abolition of small companies CT rate

• Tax support for innovative and expanding small businesses should be better targeted
  – e.g. enhanced allowances for R&D and investment
Some Remarks

• Often suggested that excessive consumption (too little saving and investment) and excessive borrowing have contributed to recent economic problems

• Tax systems in the UK and many other countries favour debt and discourage saving and investment

• Reform of taxes on capital income could make an important contribution to promoting growth and stability

• Pioneering tax reforms in Sweden (RRA) and Belgium (ACE) suggest these approaches are feasible
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