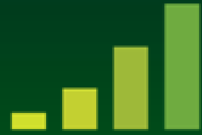

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Tax By Design: The Mirrlees Review

Taxing Income from Capital

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The Mirrlees Review

- Reforming the tax system for the 21st century
- http://www.ifs.org.uk/mirrleesReview
- Funded by ESRC & Nuffield Foundation
- Inspired by the 30th anniversary of the 'Meade Report'

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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
- http://www.ifs.org.uk/mirrleesReview

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

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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

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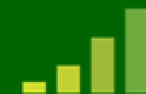
Taxing Capital Income

- 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



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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

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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)

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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

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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

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Capital Gains

- Expenditure tax and RRA approaches both achieve uniform treatment of cash income and capital gains
- Avoid distortions to the composition of savings

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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

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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

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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

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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 ↑ 6.1%
  - Wages ↑ 1.7%
  - GDP ↑ 1.4%
  - Welfare ↑ 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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