Business Taxes in the Mirrlees Review

Steve Bond – University of Oxford

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Plan

- The Mirrlees Review
- Taxes on capital income
- Taxes on business income
The Mirrlees Review

Reforming the tax system for the 21st century

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

Funded by ESRC & Nuffield Foundation
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
- Inspired by the 30th anniversary of the ‘Meade Report’
Vol 1: Dimensions of Tax Design

- 13 commissioned chapters & commentaries
- Published April 2010 & available online
- 3 chapters on business taxation
  - International capital taxation (GHS)
  - Taxing corporate income (ADS)
  - Taxation of small businesses (CF)
Vol 2: Tax by Design

An integrated view of tax reform, drawing on evidence from commissioned chapters

To be published Autumn 2010

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 corporate taxation are closely related to proposals on taxation of personal savings and on small business taxation
- Overall package of reforms revenue-neutral (not each component)
Taxes on capital income

- Broad theme is to tax consumption rather than income (spirit of Meade)
- Not primarily because this is more efficient
  - There are arguments both ways
- But because there is no chance of taxing income coherently in practice
  - Realized capital gains
  - Inflation
- While taxing consumption coherently should be more straightforward
Taxing consumption

- Indirect taxes not well suited to addressing equity concerns

- Progressivity of the system as a whole achieved through the direct tax system

- Indeed we propose substantial broadening of the VAT base, with compensation to poorer households through direct taxes and benefits
Taxing consumption

Three approaches to direct taxation of consumption

- Pure expenditure tax
  - Meade; cf. pensions

- Exempt all income from savings
  - cf. ISAs; owner-occupied housing

- Exempt normal return on savings
  - cf. ACE in corporate tax context
Taxing consumption

3 approaches are broadly equivalent in the absence of super-normal returns (rents)

Expenditure tax and allowance for normal rate of return on savings both raise revenue by taxing rents

Rate of return allowance can be viewed as an expenditure tax with deferred rather than immediate tax relief for saving
Example

- Save £100 of this year’s income in an account that pays 10%.
- Next year have interest income of £10 plus principal of £100, a total of £110.
- Standard income tax at 20% gives tax on interest income of £2, after-tax interest income of £8, and a return of only 8%.
- Disincentive to save, particularly important for poorer households.
- Exempting all interest income avoids this.
Example (cont)

- Expenditure tax at 20% gives tax relief of £20 on saving of £100 in first year
- Then taxes withdrawal of £110 in second year, giving tax payment of £22
- After tax, the saver gives up £80 this year and gets £88 next year, a return of 10%
Example (cont)

Now suppose that instead of giving tax relief of £20 this year, we carry this forward, marked-up at the interest rate of 10%, and give tax relief (against the expenditure tax) of £22 next year.

The saver then gives up £100 this year and gets £110 next year, just as in the no-tax case, a return of 10%.

These two approaches are equivalent provided the individual is indifferent between tax relief of £20 in year 1 or £22 in year 2.
We can achieve this here, and much more generally, by:

Providing a Rate of Return Allowance (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

Taxing (nominal) income from savings plus any realized (nominal) capital gains, net of this Rate of Return Allowance
Rate of Return Allowance

This extends easily to portfolios rather than individual assets, and to assets held for periods that don’t coincide with tax years.

In addition to information on income and realized capital gains used to implement standard income tax, this just requires the risk-free interest rate to be specified.

– approximated by yield on govt debt
Rate of Return Allowance

Directly analogous to ACE corporate tax

Like ACE Vs. cash flow tax, RRA has some advantages over expenditure tax

– Govt not required to provide up-front tax relief in return for (promise of) future tax payments

– Looks and feels more like a familiar income tax
Taxes on capital income

- Pragmatic shift towards taxing consumption can combine different approaches for different kinds of assets

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

- For pragmatic reasons, retain this treatment for owner-occupied housing and limited holdings of other risky assets (ISAs)
Taxes on capital income

- For pension saving, retain current expenditure tax treatment (EET approach)
- For substantial holdings of risky assets (investment property, mutual funds, bonds, equity, unincorporated business assets), introduce Rate of Return Allowance
Taxes on business income

In this context, main proposal on corporate taxation is the introduction of an Allowance for Corporate Equity (ACE)

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 rates seems likely
– And more radical alternatives (DBCF or VAT) may need to be considered in longer term
Problems with corporation tax

- Bias towards debt finance
- Raises cost of capital
- True depreciation Vs. capital allowances
- Sensitivity to inflation
- In open economy/mobile capital setting, capital goes elsewhere, leaving domestic workers poorer
- More efficient to tax wages/consumption of domestic workers directly
Problems with corporation tax

Key problems stem from inclusion of normal return on equity-financed investment in corporate tax base.

Solved by tax relief for opportunity cost of using equity finance – Allowance for Corporate Equity.

Also eliminates sensitivity to tax depreciation rules and inflation.
Allowance for Corporate Equity

Advantages over Meade’s R-base cash flow tax:

- Tax losses less significant
- Easily applicable to banks
- Looks and feels more like a familiar corporate income tax

Experience in Belgium and elsewhere suggests feasible and EC treaty compatible
Allowance for Corporate Equity

- Incentives for MNCs to shift debt into UK, or to use debt of UK affiliates to equity-finance affiliates in low tax jurisdictions, would be reduced.

- Incentives to shift profits out of UK by manipulating transfer prices no worse than under corporation tax (at same rate).
Introduction of ACE allowance would have a substantial revenue cost

Mistake to recoup this by raising the corporate tax rate

Appropriate rate to tax rents earned in the corporate sector must 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 allowance with no increase in corporate tax rate
- Accept that less revenue should be collected from the corporate tax
- Rebalance shares of revenue from corporate and other taxes (notably VAT) 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%
- Wages $\uparrow$ 2%
- GDP $\uparrow$ 2%
- Welfare $\uparrow$ 0.4% of GDP
Growth implications

- Note that this package is significantly pro-investment
- EMTRs fall to zero
- EATRs reduced
- Would make the UK a more attractive location for mobile capital investments that just earn the normal rate of return
- And (though to a lesser extent) for those that earn economic rent
Small business taxation

- ACE corporate tax
- RRA treatment of dividend income and capital gains on corporate equity
- RRA treatment of income from unincorporated business

Suitable alignment of tax rates can then:

- Equalize income tax treatment of income from employment, self-employment and small companies
- Reduce incentives to convert labour income into dividend income/capital gains
Small business taxation

This requires lower personal income tax rates applied to both corporate dividends and capital gains on company shares, reflecting corporate tax already paid.

We also recommend eliminating differences in National Insurance treatments, integrating at least employees’ NICs with income tax.

Should allow considerable simplification of anti-avoidance legislation.
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