



Institute for
Fiscal Studies

Tax By Design: The Mirrlees Review

Taxing Income from Capital

Steve Bond, University of Oxford and IFS

Introduction

- Taxing returns on savings and investments
- Personal taxation of income and capital gains on savings
- Corporate taxation of profits
- Small business taxation
- Taxation of banks and financial services

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
- 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

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
 - 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
 - (Normal) Rate of Return Allowance
- 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 approaches 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

Neutral Taxation of Savings

- Expenditure tax and RRA approaches both achieve uniform treatment of cash income and capital gains
- And require no indexation for inflation
- Avoid distortions to the composition of savings
- Effective tax rates do not fluctuate absurdly with rate of inflation

RRA Approach

- 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 sovereign debt
- 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 necessarily as 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 distortion between gifts of cash and expenditures that benefit children (e.g. on education)

Corporate Taxation

- Why have a corporate tax at all?
 - Primarily as a backstop to personal taxation
 - Also efficient to tax location-specific rents
- Why tax corporate income on a source-country basis?
 - Only game in town, given current international practice

Problems with Standard Corporate Income Taxes

- Raise cost of capital
- Biased towards debt finance
- True depreciation Vs. fiscal depreciation
- Sensitivity to inflation

Problems with Standard Corporate Income Taxes

- In an open economy with capital mobility, capital goes elsewhere, and burden of source-based taxes is 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 Corporate Income Taxes

- Key problems stem from the inclusion of the normal return on equity-financed investment in the corporate tax base
- Solved by tax relief for the 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 (for example) 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 in the UK

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 (EC, 2009) present simulations of a similar revenue-neutral package, with ACE financed by an increase in a broad-based consumption tax, at an unchanged corporate tax 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 treatments 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
 - 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 (too much debt) have contributed to recent economic problems
- Tax systems in the UK and many other countries favour debt and discourage saving and investment

Some Remarks

- Intelligently-designed tax reforms could make an important contribution to rebalancing economies, strengthening corporate balance sheets, and promoting investment and growth
- Pioneering reforms suggest that our approach is neither administratively infeasible nor impractical
 - Norway has RRA treatment of shareholder income
 - Belgium has corporate tax with ACE allowance
- We do not have to suffer flawed tax treatments of savings and investment forever

Taxation of Banks and Financial Services

- Strong case for equalising treatments of debt and equity finance in corporate income taxes
- Strong case for ending VAT exemption for financial services (or, failing that, introducing a close substitute for VAT, like the IMF's FAT1)
- Some case for bank levies, but these need to be considered jointly with bank regulation
- No case for Financial Transaction Taxes

Corporate Taxation

- Corporate income taxes encourage banks to increase gearing and rely less on equity capital
- Financial regulation encourages banks to reduce gearing and rely more on equity capital
- Hard to see any benefits from two policies pulling banks in opposing directions
- Eliminating the tax bias in favour of debt finance within corporate income taxes would weaken one objection to imposing higher capital requirements within banking regulation



VAT

- The exemption of financial services from VAT reflects technical difficulties, not a deeper rationale
- As a result of exemption, households pay too little for financial services, while businesses pay too much
- The likely net effect is that too little VAT revenue is collected, and the provision of financial services is excessive

VAT

- Standard VATs are difficult to implement where the price charged for financial services is implicit in the spread between interest rates on borrowing and lending
- But Cash Flow and Tax Calculation Account alternatives have been proposed, and should now be given more serious consideration
- Failing that, proxies for missing VAT like the IMF's Financial Activities Tax (notably FAT1) would have some merit

Bank Levies

- Additional taxes on large, systemically important and/or risky banks also have a rationale, to offset explicit or implicit government bailout guarantees
- Although financial regulation (should) also raise costs for these institutions, acting as an implicit (and possibly better targeted) tax
- Joined-up government requires financial regulation and bank levies to be considered together

Financial Transaction Taxes

Financial Transaction Taxes

- Basic principles suggest we do the least harm by taxing activities which are the least elastic/least mobile
- Hard to think of any economic activity which is more geographically mobile than (most) financial trading

Financial Transaction Taxes

- There is no chance of an FTT being implemented in every G20 country
 - USA, Canada, Australia and others are opposed
- The Commission's excellent Impact Assessment suggests some drawbacks, particularly in relation to OTC derivatives:
 - “the application of the tax in this highly mobile market will be difficult and reduce the taxable base significantly... the tax base could largely disappear leaving no substantial revenue”

Financial Transaction Taxes

- The experience of Sweden is instructive:
 - trading in bond futures fell by 98% within a week, when Sweden attempted to tax these transactions
- The Impact Assessment considers scenarios with derivative trading decreased by 70-90%
- Finding that an FTT levied at 0.1% reduces GDP by 1.75%, while yielding revenue of less than 0.1% of GDP

Financial Transaction Taxes

- Some taxes on financial transactions can survive in highly mobile capital markets
 - e.g. stamp duties on trades in company shares, as in the UK and other major financial centres
- Here the purchaser has an incentive to pay the tax, to secure legal recognition of ownership, in the relevant jurisdiction where these securities are issued

Financial Transaction Taxes

- This does not apply to the vast majority of transactions in foreign exchange and derivatives, which can be traded successfully ‘offshore’, almost anywhere in the world
- Large financial institutions can likely escape the proposed FTT by conducting these trades through their non-EU (or non-FTT zone) subsidiaries, located in havens such as New York (or quite possibly London)

Financial Transaction Tax

- Curiously the Commission proposes to replace a form of FTT that does work (stamp duties) with a broader FTT that, at best, would be formidably difficult to implement
- Hard to understand the process that leads to this conclusion
- Particularly if the simulations and evidence presented in the Impact Assessment are given any weight at all ?



Available from all good booksellers and at
<http://www.ifs.org.uk/mirrleesReview>