Business Taxes in the Mirrlees Review

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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

Example (cont)

- 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)

Allowance for Corporate Equity

- 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 ↑ 6%
  - Wages ↑ 2%
  - GDP ↑ 2%
  - Welfare ↑ 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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