Mirrlees Review
Discussion

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Overview of Mirrlees Review

- Continuation of a long and distinguished tradition in the U.K., assessing the policy implications of recent academic research
  - Meade Committee Report and Stern Review are two other noted examples
- Fitting to have IFS play a central role, since it epitomizes such a synthesis of policy analysis and academic research

Overview of Mirrlees Review

- Commissioned papers from the top tax economists, exploring policy implications of recent research
- Recommendations all solidly grounded in the recent academic literature

Selected issues where debates remain

- Rate structure under the personal tax
- Role of the corporate tax
- Tax treatment of savings

Rate structure under personal tax

- Propose low tax rate on rich due to high estimated elasticity of taxable income
- What underlies this high elasticity?
  - Increased itemized deductions? If so, offsetting benefits if deductions appropriate
  - Increased evasion? If evasion rational, should be just offset by future collections at audit
  - Income shifting? If so, offset by changes in taxable income elsewhere on tax forms.

Rate structure under personal tax

- Propose age/gender specific tax schedules
  - Clear differences in the elasticity of labor supply across groups
- But desired tax rate, ignoring elasticity, can also differ by group
  - If want to approximate a tax based on ability (*w*), then tax rate on earnings (*wH*) should be inversely proportional to *H*
  - Groups with high elasticities tend to be those with low hours, generating offsetting equity and efficiency pressures

Role of the corporate tax

- Proposal is to maintain the corporate tax, but to replace depreciation with a deduction for the risk-free rate on book equity (ACE)
- Adjust tax rate on personal income from equity to compensate for corporate tax:

$$(1-\tau)(1-m_c) = (1-m_{nc})$$

- But why not just set $m_c = m_{nc}$ and $\tau = 0$?

Problems with a separate corporate tax

- Avoiding distortions requires treating the corporate tax as a withholding tax, as occurs with dividend imputation schemes. Not part of proposal. Even if a withholding tax, leaves distortions to investments by foreigners and non-profits.
- Corporate tax (but not RRA) vulnerable to tax evasion through income shifting, e.g. to lightly taxed foreign subsidiaries

Problems with a separate corporate tax

- Presentation suggests a corporate surtax aimed at “rents”
- Many costly responses to such a surtax
  - Convert to non-corporate form to avoid surtax
  - Have firm acquired by another firm, so that tax basis includes value of infra-marginal rents
  - Income shifting, to personal tax through deductible payouts, or abroad through transfer pricing. (Gordon-Slemrod (2000)
  - Decrease in search for new “rents” (entrepreneurial activity)

Why a ***source-based*** corporate tax?

- Source-based tax easily evaded through transfer pricing, location of patents, etc. Elimination of any tax at repatriation exacerbates these pressures.
- To eliminate such opportunities,
  - Make use of border corrections, as with a VAT
  - Impose a cash-flow tax on transactions with foreign subs
  - Rely fully on RRA base under personal tax

Taxation of income from savings

- Strong consensus to avoid distortions to capital invested in a particular country, to take full advantage of gains from trade
- Less strong consensus to avoid distortions to individual savings decisions
  - Tax can serve to ease liquidity constraints
  - Given labor income, higher ability save more
  - Dynamic issues: Diamond and Mirrlees (1978)
  - While existing tax vulnerable to arbitrage and income shifting, other alternatives exist, e.g. dual income tax

Alternatives under PIT to avoid taxes on savings

- Three mentioned in presentation
  - Exempt income from “savings”. Approach vulnerable to reclassification of labor income as income from savings.
  - Expenditure tax (Pension-type treatment)
  - Rate of return allowance (dual-income tax, with a zero tax rate on capital income)

Pension vs. RRA treatment

- Advantages of expenditure tax
  - Smoothes taxable income over time, to extent consumption smoothed.
  - Relative to RRA, eases liquidity constraints
  - No need to measure *r* or *A*
- Question in both approaches how migrants to U.K. will be taxed

Summary

- The Review is a remarkable (and very timely) effort.
- Will surely frame the debate over future tax policies from many years, and not just in the U.K.