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Tax By Design: The Mirrlees Review

Taxing Income from Capital

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Introduction

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

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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 never implemented

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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

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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
  - (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 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

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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

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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

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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 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)

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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

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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

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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)

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Business Taxation

- Business rates are an irrecoverable tax on an intermediate input
- No place in a well designed tax system
- We recommend replacing business rates with a land value tax for business and agricultural land

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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 Corporation Tax

- Raises cost of capital
- Bias towards debt finance
- True depreciation Vs. capital allowances
- Sensitivity to inflation

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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

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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

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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

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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

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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

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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

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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

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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
- Intelligent tax reform could make an important contribution to rebalancing the economy, strengthening balance sheets, and promoting investment and growth

Some Final Remarks

- Are reforms of this kind infeasible/impractical?
  - Norway has RRA treatment of shareholder income
  - Belgium has corporate tax with ACE allowance
- We need not be condemned to suffer flawed tax treatments of savings and investment forever
- Although there is no doubt that serious reform will require political courage

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