Neutral taxation of labour and capital

Stuart Adam
Taxation of different ways of working

Tax due on £40,000 of income generated, 2016–17

- **Employee NICs**: £12,262
- **Employee NICS**: £8,820
- **Self-employed NICS**: £7,706
- **Income tax**: £4,000
- **Dividend tax**: £2,000
- **Corporation tax**: £0

Source: Figure 7.3 of The IFS Green Budget February 2017
Two compelling ideas

1. “Tax all income the same”

2. “Don’t discourage saving and investment”

• These are in apparent conflict
  – Tax capital income as much as labour income (1) or not at all (2)?

• Result: reduced, but not zero, tax rates on capital income and gains
  – Compromise doesn’t achieve either objective satisfactorily
  – Tax rates yo-yo as emphasis changes (e.g. history of CGT)

• But Mirrlees Review argued that we can have our cake and eat it
Neutrality

• Taxing similar activities similarly

• Tends to be better:
  – Fairer: don’t tax similar people doing similar things at different rates
  – More efficient: don’t change behaviour to get lower tax rate
  – Simpler: less need to define and police boundaries

• Not always desirable
  – e.g. good case for favouring pension saving and R&D investment

• But an essential starting point
  – Departures should be rare
  – The baseline to depart from: layer targeted exceptions on top
Neutral taxation of saving and investment

• Key to effective capital taxation is neutrality across:
  – Consumption today vs tomorrow
  – Different assets
  – Different forms of return
  – Different legal vehicles
  – Different sources of finance
  – Varying inflation rates

• Current tax system achieves none of these
  – Some are impossible with a standard income tax
  – Others are possible but not currently done

• But it is possible to achieve all of them…
A recipe for neutrality

- Give full deductions for amounts saved/invested…
- …then tax income (after these deductions) in full

Equivalently:
- Tax income above a ‘normal’ rate of return to amounts saved/invested
The ‘normal’ rate of return

• The ‘normal’ or risk-free rate of return is the interest rate:
  – used to discount future income in present value calculations
  – needed to persuade someone to save an extra £1
  – earned on a risk-free asset

• Under textbook assumptions, these are all the same for everyone

• Can approximate (in normal times) by return on medium-term gilts

• This represents the pure time value of money: just shifting resources across time

• Taxing it discourages saving and investment
  ➢ There are subtle theoretical arguments for doing this (or for subsidy)
  ➢ But neutrality more sensible in practice (with limited exceptions)
Above-normal returns

Why might people earn more than the ‘normal’ return?

• Economic rents (pure profits)
  – Generally arise from factors in limited supply: land, natural resources, monopoly power, limited licences, unique talents/ideas,…
  ➢ Efficient to tax at 99.9% as remains profitable (unless can move abroad)

• Risk-taking
  ➢ Under standard assumptions, symmetric taxation doesn’t matter

• Disguised/implicit labour income
  – Particularly relevant for self-employed and owner-managed companies
  – Also e.g. effort to pick good investments, spruce up properties, etc.
  ➢ Should tax like other labour income

Hard to distinguish from each other, and from labour income

➢ Taxing like labour income works well in all cases
Four options for savings taxation

1. Standard income tax (TTE)
   - Tax income and capital gains
   - Like interest-bearing accounts, shares and rental housing

2. Earnings tax (TEE)
   - Exempt (ignore) capital income and gains
   - Like ISAs and owner-occupied housing (and NICs in general)

3. Cash-flow expenditure tax (EET)
   - Tax relief for amounts saved; ignore returns within fund; tax withdrawals
   - Like income tax for pensions (and most ‘human capital’ investment)

4. Rate-of-return allowance (TtE)
   - Tax capital income and gains above a ‘normal’ rate
   - Like Norwegian shareholder income tax
Cash-flow (EET) expenditure tax

• Immediate tax deduction for amount saved/invested
  – Like income tax relief on pension contributions
  – Or 100% capital allowances for business investment
• No personal tax on income or capital gains within the fund/firm
• Tax all cash withdrawn from the fund/firm
  – Including full proceeds of asset sales – not just capital gain, as already deducted purchase cost
• Government in effect takes a compulsory stake in the asset
  – Provides (say) 40% of the outlay, takes 40% of the receipts
  – Investments that are profitable before tax are profitable after tax
  – Government takes share of those pure profits (excess returns)
Rate-of-return allowance

• Based on current system
  – Taxing both income and capital gains
• But with an allowance for a ‘normal’ return on the investment
  – Deduct (say) 5% of amount invested from taxable income / capital gains each year
  – Stream of allowances has same value as 100% up-front deduction
• If allowance not claimed (e.g. no income to offset), carry forward with interest
  – Or, equivalently, add unclaimed allowance to RRA base
• If only claimed when asset sold, means levying CGT with purchase price indexed for an interest rate
  – Like pre-1998 system of indexing CGT for inflation – still done for corporation tax
## Comparison of savings tax regimes

Tax rate 20%, ‘normal’ return 5%, actual return 5%

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Cash-flow tax and RRA approaches

Both have nice properties:

• Exempt normal returns

• Tax excess returns

• Robust to inflation

• No lock-in effect of capital gains tax

• Achieve these for all assets, so can give all assets equal treatment
Four options for savings taxation: assessment

1. Standard income tax (TTE)
   - Discourages saving, bias between assets, lock-in effects, inflation,…

2. Earnings tax (TEE)
   - Very simple, but doesn’t capture excess returns
   - Fine for e.g. bank accounts, but not for small businesses where would need to distinguish capital from labour income

3. Cash-flow expenditure tax (EET)
   - Quite simple, and does capture ‘excess’ returns
   - But reluctance to give up-front tax relief?

4. Rate-of-return allowance (TtE)
   - Captures ‘excess returns’; administered like standard income tax
   - But relatively complicated
The rate-of-return allowance and complexity

• RRA is somewhat complex (though mainly just unfamiliar)
  – Similar to standard CGT

• But it need not apply widely
  – Savings accounts can be tax-exempt (TEE)
  – Keep EET treatment of pensions, though with reforms
  – Keep owner-occupied housing TEE, at least in medium term
  – Keep equity ISAs (TEE)
  – So applies to landlords, self-employed, company owner-managers and large investors
  – Can choose not to claim it (so all income taxed as labour earnings)
Aligning tax rates

- Extend full NICs (including employer NICs) or equivalent to all taxable income
  - Including self-employment income, property income, etc
- Align CGT rates with these (NICs-inclusive) income tax rates
  - Includes abolishing entrepreneur’s relief
- Apply reduced rates to dividends and capital gains on shares
  - Reflecting corporation tax already paid
- Don’t have separate allowances for each income source

➢ On its own, this would create big disincentives to save and invest
  - And create big losers among savers and those running businesses
➢ Pursue alignment alongside tax base reform
Problems with standard corporate income taxes

• Disincentives for equity-financed investment

• Bias towards debt finance

• Sensitive to capital allowance regime
  – Incentive to invest in assets where capital allowances more generous relative to true economic depreciation
  – Bias towards current rather than capital expenditure

• Sensitive to inflation rate

• (International issues)
Neutral taxation of corporate income

Options for corporation tax parallel those for personal tax:

• **Cash-flow corporation tax** like cash-flow (EET) expenditure tax
  – Roughly, regime applied to North Sea oil and gas

• **Allowance for corporate equity (ACE)** like rate-of-return allowance (TtE)
  – Currently in place in Italy and Belgium

• **Equivalent of TEE income tax is abolition** of corporation tax!
Cash-flow corporation tax

• Immediate deduction for purchases of assets, like other purchases
  – 100% capital allowances for *all* investment
• Tax proceeds of selling assets, like sales of other goods and services
• In effect, government takes compulsory stake in all projects
  – Covers 18% of costs, takes 18% of receipts
  – If a project is profitable before tax, it is profitable after tax
  – Government takes share of those pure economic profits (excess returns)
• Like VAT with deduction for labour costs
• Two options for treating debt finance:
  – Abolish interest deductibility (R-base)
  – Tax principal borrowed; deduct interest + capital repayments (R+F base)
  ➢ R+F has advantage of taxing provision of financial services
Allowance for corporate equity

- Deduction for (opportunity) cost of equity finance
  - Counterpart to deduction for cost of debt finance (interest payments)
- Compensation for absence of 100% up-front allowances
  - Stream of payments with equal present value
- Allowance = ‘normal’ rate of return x equity stock, calculated as:
  
  Previous year’s stock + net equity issued/sold + retained taxable profits
- Note that higher capital allowances reduce taxable profits, and therefore stream of future allowances, £-for-£
  - Timing of payments affected but present value isn’t
  - So can keep current allowances, use accounting depreciation, move to 100% allowances (so identical to cash-flow tax), abolish altogether…
- Only returns in excess of a ‘normal’ rate are taxed
  - If a project is profitable before tax, it is profitable after tax
Integrating personal and corporate taxes

• These approaches fit naturally together
• Cash-flow (EET) personal expenditure tax + cash-flow corporation tax
• Standard income and corporation taxes + allowance for normal return
  – ACE corporation tax
  – RRA treatment of dividend income and capital gains on shares
  – RRA treatment of income from unincorporated businesses
• In principle could mix-and-match (and/or let taxpayers choose)
• Key is to ensure that:
  – All saving and investment gets deduction for personal and corporate tax
  – Combined overall rate schedule same as for labour income
Setting personal and corporate tax rates

• Combined tax rates on company profits and dividends / capital gains on shares should equal tax rates on labour income
  – Currently around 40% basic rate, 49% higher rate, 53% additional rate
  – But remember that alignment can involve reducing labour tax rates as well as increasing capital tax rates
• So choose high corporate and low personal tax rates, or vice versa?
• In economic terms, doesn’t matter for purely domestic arrangements
• So can decide based on international and administrative criteria
  – Mobility of multinationals’ profits (vs. shareholders)
  – Feasibility of monitoring shareholders’ foreign income (vs. UK profits)
  – Minimising compliance burden for shareholders (vs. companies)
• With current labour tax rates and 18% corporation tax, implies shareholder tax rates of 27% BR, 38% HR and 43% AR
Cash-flow vs RRA / ACE approach

Advantages of cash-flow approach:

- Neutrality doesn’t depend on getting the correct normal rate of return
- Simpler to operate: less record-keeping
- More familiar in the UK (pensions, AIA, North Sea regime, VAT, etc.)
- Up-front deductions help credit-constrained individuals and start-ups
- Less risk of policy change leading to double taxation

Advantages of RRA / ACE approach:

- Neutrality more robust to varying tax rates
- Smaller departure from most current UK practice, and less sharp transition
- No up-front deductions means less need to deal with tax losses and less revenue risk (and helps short-termist governments)
- Less risk of policy change leading to (double) non-taxation
Treatment of ‘losses’

• Important for neutrality towards risk-taking

• Bigger issue with more deductions:
  – Below-normal returns more common than negative returns
  – Pure deductions make even more common

• Understandable wariness of outright refunds
  – Though we do this for VAT, albeit not without problems
  – Work hard to allow offsets as generously as possible

• Carry forward (and back) with interest
  – Or, equivalently, add to base for calculating RRA / ACE

• Get arrangements for defaults, wind-ups and bankruptcy right

• Should improve under current system too!
  – Recent moves in wrong direction
Treatment of existing assets

• Need to decide whether to give deductions to existing assets or only new saving/investment
  – (and whether to apply higher tax rates)
• If give deduction for existing assets, on what basis?
  – Original purchase price, stepped-up purchase price, book value, tax-written-down value, market value,…?
• Windfall based on past behaviour, not future behaviour
  – Shouldn’t affect incentives
  – Deadweight: efficient to be harsh
  – Retrospective: debatable what is fair (depends on rate change?)
• Careful not to create incentives to convert ‘old’ assets to ‘new’ assets
• Cash-flow and RRA / ACE approaches may differ in how easy some of the transitional options look
Some problems this approach ‘solves’ (1 of 2)

- Incentive to be self-employed / incorporated rather than employed
- Incentive to shelter funds in company (or other vehicle) rather than take / pay them out
- Incentive to take / pay out dividends vs salary
- Incentive to pay out dividends vs buy back shares
- Disincentive to save in many assets
- Sensitivity of saving/investment incentives to inflation rate
- Bias against riskier investments
- Incentive to prefer tax-favoured assets
  - Including assets with more generous capital allowances relative to true economic depreciation
  - No longer need capital allowances to match true depreciation rates
- CGT lock-in effect
- Bias towards debt rather than equity finance
Some problems this approach ‘solves’ (2 of 2)

• No longer matters much whether:
  – X is really employed (IR35 and employment status test)
  – X is income or capital gain (e.g. carried interest, stock options)
  – X is income or capital withdrawal (e.g. annuities outside pension funds)
  – X is current or capital expenditure (and what type of capital)
  – X is debt or equity (e.g. hybrid instruments)
  – Assets being sold are earliest or latest purchased (FIFO vs LIFO)
  – interest payment is business or personal (e.g. qualifying loan interest)

• “A tax system fit for a modern economy”
  – Deals well with intangibles, IT, fluidity, gig economy, etc, not just manufacturing-based economy
Some problems this approach doesn’t solve

• Disincentives to work

• Incentive to shift income to lower-taxed people (e.g. spouse) or years
  – Though the latter is arguably a good thing: allowing taxpayers to smooth their incomes undoes problem of progressive annual system penalising those with variable incomes

• Need to distinguish between costs of generating income (expenses/investment/saving) and consumption spending

• International dimension
Conclusions

- Can tax income from all sources equally AND avoid disincentives to save and invest
- Give full allowances for amounts saved/invested
  - Either up-front relief (cash-flow) or stream of allowances (RRA / ACE)
- Tax all income (after allowances) at full labour income tax rates
- Solves many other problems too
- In practice, won’t work perfectly
  - But still major improvement on current position
  - Other countries’ (and some UK) experience suggests components feasible
- Transition and politics are major issues
  - Lots to say about those – but at least start off with an ideal in mind!
Further reading


Kay & King (1990), *The British tax system*, Chapters 6 and 7 ([www.ifs.org.uk/docs/kay_king.pdf](http://www.ifs.org.uk/docs/kay_king.pdf))
