Taxing Capital Income: Highlights from the Mirrlees Review

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Guiding Principles

- Avoid distorting decisions about when to consume; saving = deferred consumption (standard income tax discourages saving)
- Treat different forms of saving and investment in similar ways
- Avoid making effective tax rates sensitive to rate of inflation
- Pursue Rate of Return Allowance (RRA) or “IRA treatment” (EET) where possible to avoid distortions across assets

Should Normal Returns be Taxed?

- Efficiency arguments for not distorting inter-temporal consumption choices are important but not beyond question
- Situations in which intertemporal distortions may be warranted:
  - Earning Ability is Correlated with Saving Propensity
  - Wealth is Used to Insure Future Labor Market Risks
  - Non-separabilities Between (C, L)
  - Departures from Neoclassical Optimization (myopia)

Challenges in Taxing Returns to Household Saving

- Capital income is hard to tax coherently under a standard income tax
  - realised capital gains
  - assets differ in mix of interest, dividends, capital gains
  - inflationary distortions when nominal income is tax base
- Uniform treatment of all forms of saving can be achieved if we exempt the ‘normal’ component of returns (= riskless rate?)

Special Challenges with Capital Gains

- Lower CGT rate, or same rate as on other income but with deferral, creates incentives to convert income into capital gains
- Lock-in effect
- Taxing capital gains on an accrual-equivalent basis is theoretically possible, but never implemented

Neutral Taxation of Savings

- Expenditure tax (EET)
  - tax relief for inflows
  - tax all outflows
  - Example: current treatment of pensions
- Rate of Return Allowance (RRA)
  - no tax relief for inflows
  - tax relief for normal component of returns
  - Example: ACE corporation tax

Analysis of RRA and EET

- Both expenditure tax and RRA approach tax ‘excess’ component of returns (economic rents) and avoid inflation, asset mix distortions
- 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)

Rate of Return Allowance

- 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

Features of the 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 (riskless medium-term bonds?)
- Administration similar to standard income tax
- No need for up-front tax relief in return for (prospect of) future tax payments

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

Summary of Taxes on Saving

- 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)
- Retain this approach also for owner-occupied housing and limited holdings of other risky assets such as equity ISAs

Summary (Continued)

- For pension saving, retain basic expenditure tax treatment, simplify, more equality of employer & employee contributions
- For substantial holdings of other risky assets (equities, bonds, mutual funds, investment property, business assets), introduce Rate of Return Allowance
- Tax capital income in excess of the normal rate of return at the same marginal rates as labour income

Concerns with Corporation Tax

- Open economy with capital mobility: burden borne by domestic workers – more efficient to tax directly
- Raises cost of capital
- Encourages debt vs. equity finance
- ETRs depend on inflation
- Potential distortions to multinational business activities

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

Connecting Personal and Corporate Taxation

- Progressive Shareholder Tax on Shareholder Income at Lower Rates than on Labor to Reflect Corporate Tax
- Allowance for normal rate of return eliminates debt – equity distortion
- Goal is to align rate structure of corporate, personal, and labor income

Allowance for Corporate Equity

- Introduction of ACE would have a significant revenue cost – don’t recommend recouping this with higher corporate rate
- Taxing “rents” in the corporate sector should balance advantage of taxing immobile sources with distortions to mobile sources
- Evidence from Belgian experience: reduction in corporate leverage
- Simulation evidence suggests ACE financed with consumption tax raises GDP, investment

Implications for U.S.

- Modifying the tax code to address debt-equity neutrality can be, and has been, done
  - Norway has RRA treatment of shareholder income
  - Belgium has corporate tax with ACE allowance
- Multiple ways to achieve “expenditure tax treatment” of normal return to capital: possible to mix these variants in a hybrid income tax / consumption tax structure