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Neutral taxation of labour and capital

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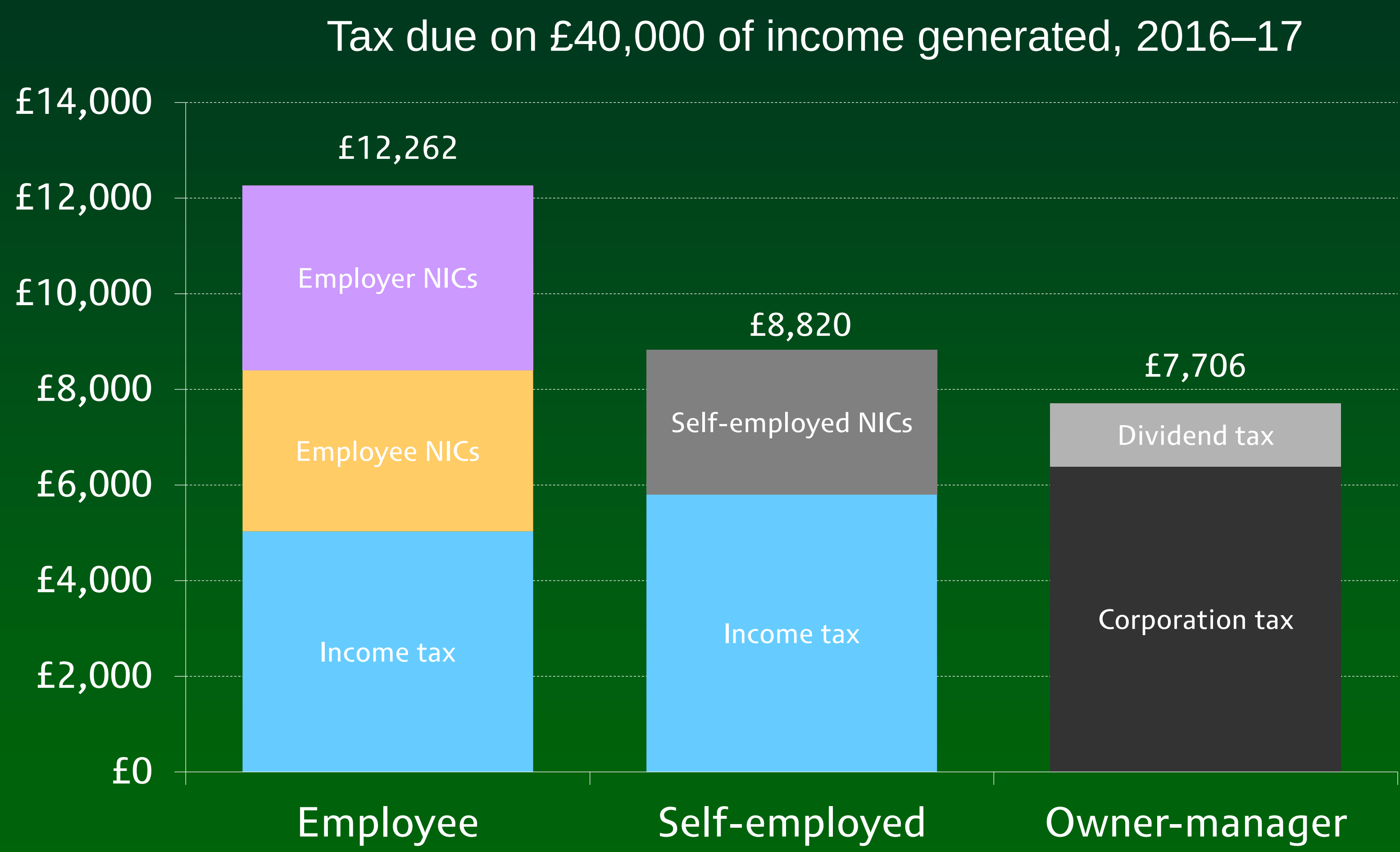
Taxation of different ways of working



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

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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

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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

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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%

	TTE	TEE	EET	TtE
Purchase price				
Tax relief in year 1				
After-tax contribution				
Value of asset in year 2				
After-tax withdrawal				
Tax paid in year 2				
Present value of year 1 tax relief				
Present value of tax paid				

Comparison of savings tax regimes

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

	TTE	TEE	EET	TtE
Purchase price	100			
Tax relief in year 1	0			
After-tax contribution	100			
Value of asset in year 2	105			
After-tax withdrawal	104			
Tax paid in year 2	1			
Present value of year 1 tax relief	*0*			
Present value of tax paid	*1*			

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Comparison of savings tax regimes

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

	TTE	TEE	EET	TtE
Purchase price	100	100		
Tax relief in year 1	0	0		
After-tax contribution	100	100		
Value of asset in year 2	105	105		
After-tax withdrawal	104	105		
Tax paid in year 2	1	0		
Present value of year 1 tax relief	*0*	*0*		
Present value of tax paid	*1*	*0*		

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Comparison of savings tax regimes

Tax rate 20%, 'normal' return 5%, actual return 5%

	TTE	TEE	EET	TtE
Purchase price	100	100	100	
Tax relief in year 1	0	0	20	
After-tax contribution	100	100	80	
Value of asset in year 2	105	105	105	
After-tax withdrawal	104	105	84	
Tax paid in year 2	1	0	21	
Present value of year 1 tax relief	*0*	*0*	*21*	
Present value of tax paid	*1*	*0*	*0*	

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Comparison of savings tax regimes

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

	TTE	TEE	EET	TtE
Purchase price	100	100	100	100
Tax relief in year 1	0	0	20	0
After-tax contribution	100	100	80	100
Value of asset in year 2	105	105	105	105
After-tax withdrawal	104	105	84	105
Tax paid in year 2	1	0	21	0
Present value of year 1 tax relief	*0*	*0*	*21*	*0*
Present value of tax paid	*1*	*0*	*0*	*0*

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Comparison of savings tax regimes

Tax rate 20%, 'normal' return 5%, actual return 10%

	TTE	TEE	EET	TtE
Purchase price	100	100	100	100
Tax relief in year 1	0	0	20	0
After-tax contribution	100	100	80	100
Value of asset in year 2	110	110	110	110
After-tax withdrawal	108	110	88	109
Tax paid in year 2	2	0	22	1
Present value of year 1 tax relief	*0*	*0*	*21*	*0*
Present value of tax paid	*2*	*0*	*1*	*1*

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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

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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)

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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!

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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

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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

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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

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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

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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

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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!

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Further reading

Adam, Miller & Pope (2017), *Tax, legal form and the gig economy*, in The IFS Green Budget 2017 (*www.ifs.org.uk/publications/8825*)

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Sorensen (2007), *The Nordic dual income tax: principles, practices, and relevance for Canada* (*https://www.ctf.ca/ctfweb/Documents/PDF/2007ctj/2007ctj3-sorensen.pdf*)

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