THE MIRRLEES REVIEW: LESSONS FOR AND FROM THE NORDIC COUNTRIES

Peter Birch Sørensen

Department of Economics

University of Copenhagen

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THE MIRRLEES REVIEW

- Organized by the **Institute for Fiscal Studies**, London
- A follow-up on the 1978 **Meade Report** from the IFS (*The Structure and Reform of Direct Taxation*)
- **Goal:** To provide an overview of the current state of international research on on taxation and tax policy
- **Organization:** One book volume with contributions from a group of international tax experts + one book volume by a group of editors presenting a proposal for reform of the British tax system

TOPICS COVERED BY THE MIRRLEES REVIEW

- The base for direct taxation
- Taxation of labour income
- Indirect taxation (VAT and excises)
- Environmental taxes
- Taxation of wealth and wealth transfers
- Taxation of corporate income and business income
- International capital taxation
- Tax administration and tax compliance
- The political economy of taxation

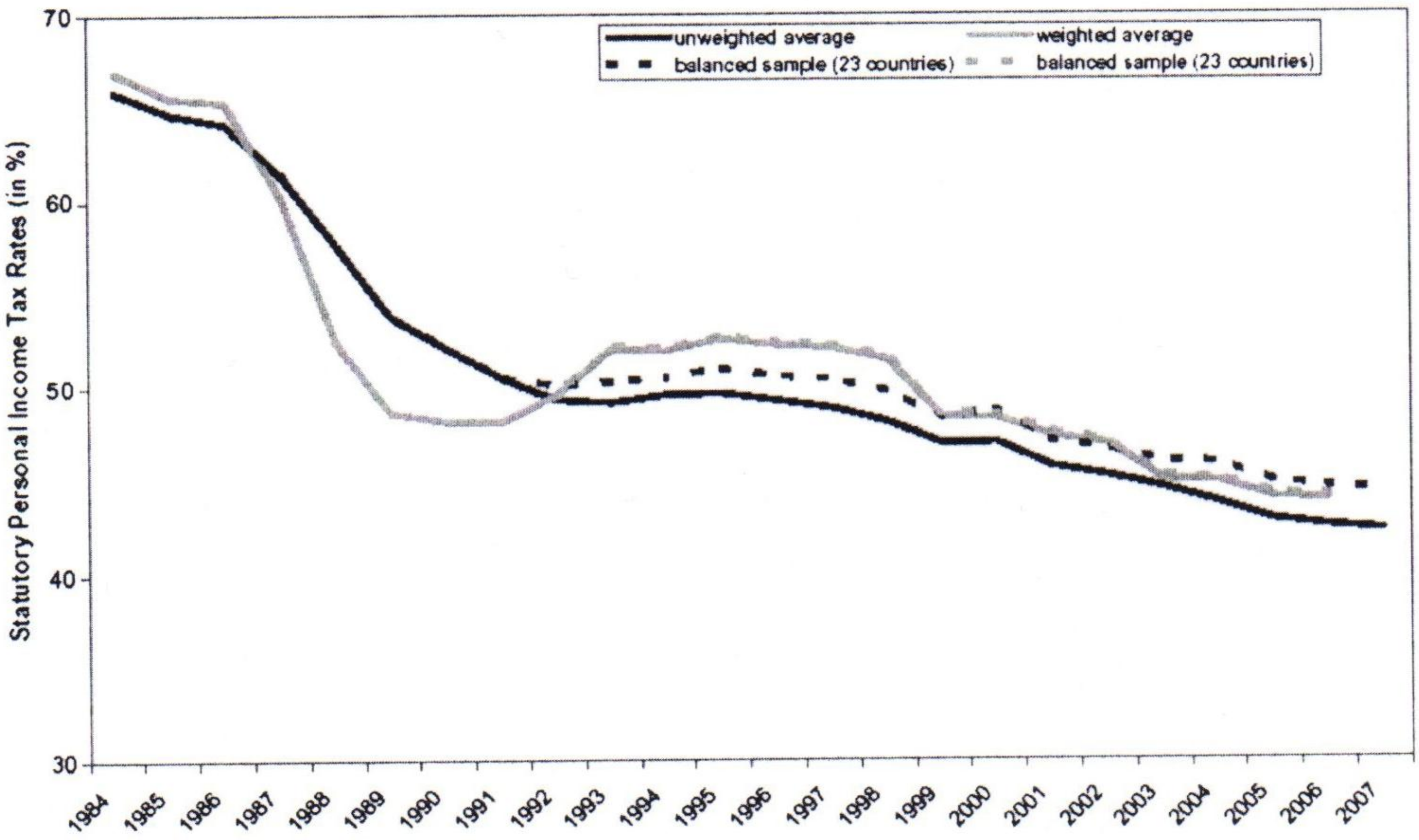
- **Focus of this presentation: Taxation of capital income**

AGENDA

- International trends in capital income taxation
- Economics of capital income taxation in the open economy
- Alternative blueprints for fundamental capital income tax reform in an open economy
- A reform proposal from the Mirrlees Review

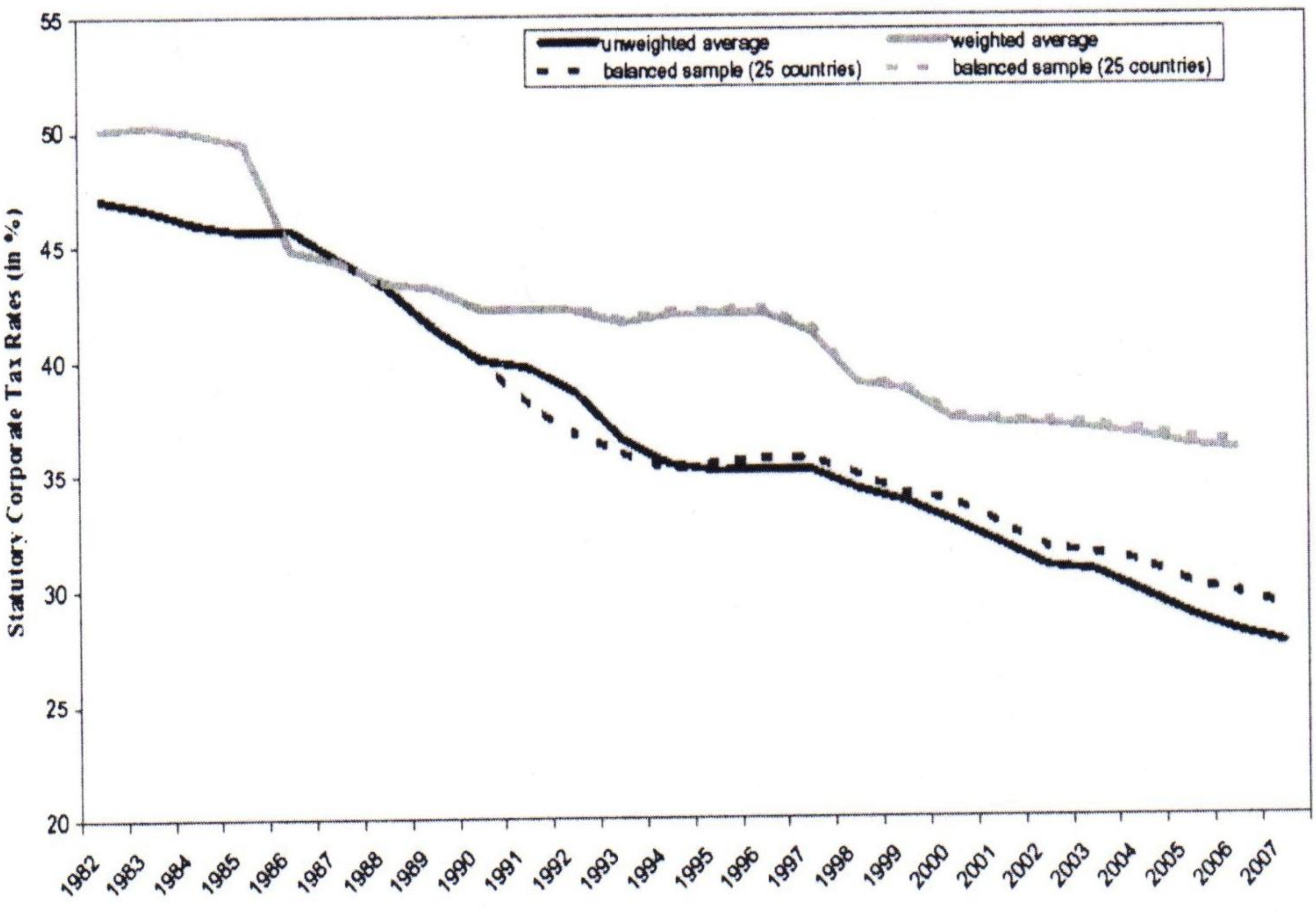
International trends
in capital income taxation

Decline in top marginal personal tax rates on capital income in the OECD

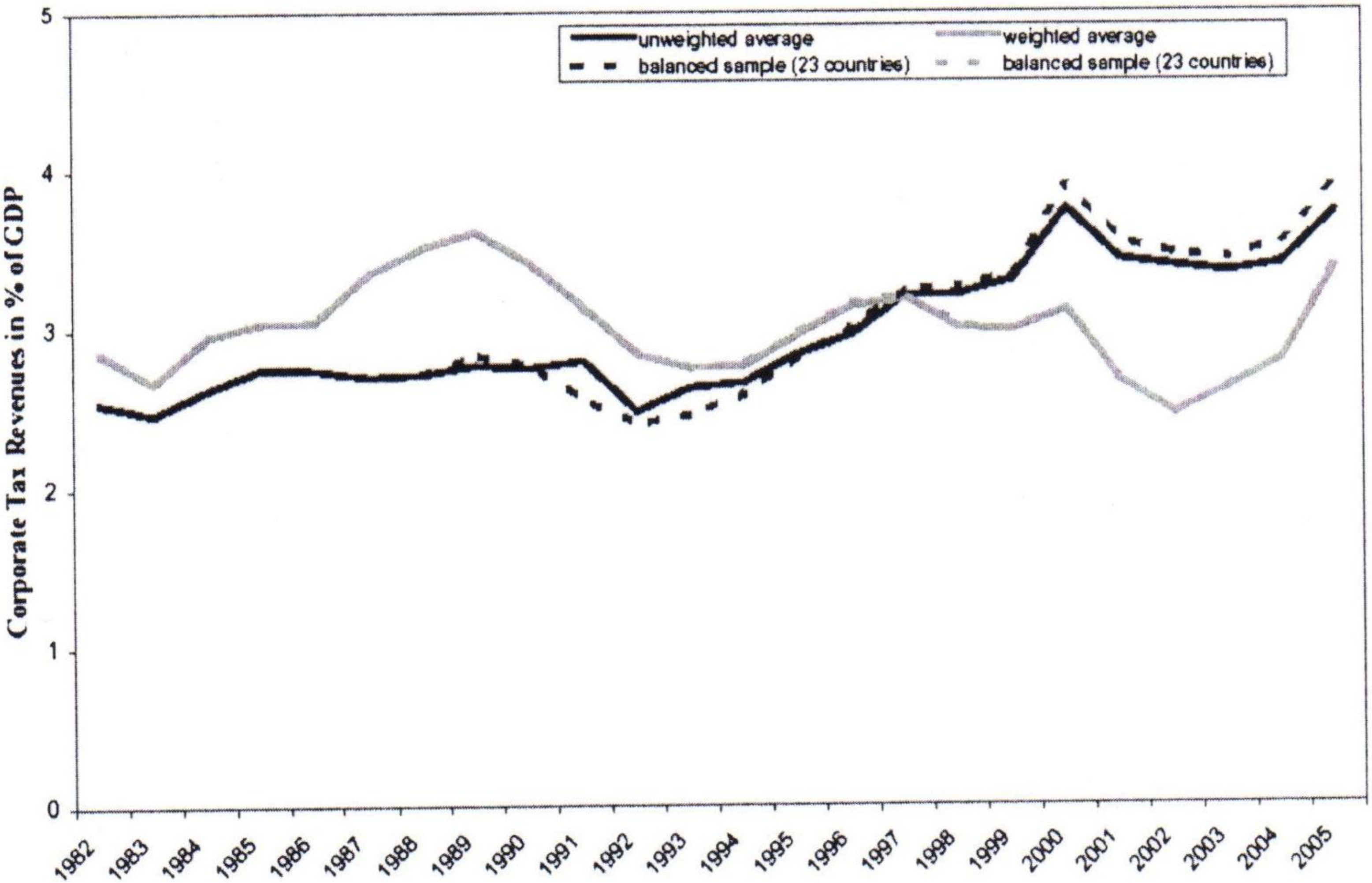


Source: Loretz (2008).

Strong decline in statutory corporate income tax rates in the OECD



Yet corporate tax revenues have held up very well



Why haven’t corporate tax revenues dropped? Some possible explanations:

- Tax base broadening (a policy of tax-cut-cum-base-broadening reduces vulnerability to transfer-pricing)

- Growing relative importance of the corporate organizational form due to structural factors

- Income shifting from personal to corporate income tax base

- Until recently: growing profitability of the financial sector

Background:

Economics of capital income taxation in the open economy

Taxes on investment versus taxes on saving

$$\underbrace{p - s}_{\text{Total tax wedge}} = \overbrace{(p - r)}^{\substack{\text{Investment tax wedge} \\ \text{(corporation tax)}}} + \overbrace{(r - s)}^{\substack{\text{Savings tax wedge} \\ \text{(personal income tax)}}}$$

$p =$ required pre-tax return on investment

$s =$ after-tax return to resident saver

$r =$ international cost of finance
(interest rate or required return on shares)

Note: r is given from the world capital market

Key propositions on capital income taxation in a small open economy

- A source-based tax on the normal return is more than fully shifted onto domestic immobile factors and so reduces their welfare
- A source-based tax on immobile (location-specific) rents is non-distortionary
- A source-based tax on mobile (firm-specific) rents distorts location decisions
- Double tax relief for domestic shareholders does not reduce the cost of capital for companies with access to the international stock market, but may reduce the cost of capital for small domestic companies

Options for fundamental capital income tax reform

THE ISSUE

- How can a small country best adapt its system of capital income taxation in a world of growing capital mobility, given the goals of equity and efficiency and the need to protect public revenue?

Capital income tax reform: Some fundamental distinctions

- **Income subject to tax:** Taxes on rents versus taxes on the full return to capital

- **Location of tax base:** country where the income is earned (source country); country where the income recipient resides (residence country), or country where the income is consumed (destination country)

Alternative ways of taxing rents

A source-based *R*-type cash flow tax

Tax base $\approx$ VAT base - labour costs + exports - imports

Net present value of investment after tax $= (1-\tau)NPV$

$NPV \equiv$ net present value of investment before tax

The government participates as a silent partner in all non-financial cash flows. Hence any project worth undertaking before tax is still worth undertaking after tax

A source-based *R*-type cash flow tax

Advantages:
- Neutral towards investment at the intensive margin
- Neutral towards financing decisions
- Captures location-specific rents, including rents accruing to foreigners

Problems:
- Distorts investment at the extensive margin
- Does not solve the transfer-pricing problem
- Significant investment distortions in case of anticipated tax rate changes
- Incentive for tax avoidance by transforming sales prices into tax-free interest payments
- Exempts financial services
- Significant transition problems, especially for heavily indebted firms

A source-based *R*+*F*-type cash flow tax

- Tax base = *R*-base + net borrowing – net interest payments = net payments to shareholders

- Hence the government participates as a passive shareholder with a share equal to the tax rate

A source-based *R+F*-type cash flow tax

Advantages:

- Neutral towards investment at the intensive margin
- Neutral towards financing decisions
- Captures location-specific rents, including rents accruing to foreigners
- Taxes financial services and allows continuation of interest deductibility

Problems:

- Distorts investment at the extensive margin
- Does not solve the transfer-pricing problem
- Transition problems and significant investment distortions in case of anticipated tax rate changes

A destination-based cash flow tax

- Tax base ≈ VAT base – domestic labour costs = domestic consumption financed out of rents

- Note: the tax base does not depend on the location of production but only on the destination of final sales

The destination-based cash flow tax

Advantages:

- Neutral towards investment at the intensive margin
- Neutral towards investment at the extensive margin
- Neutral towards financing decisions
- Solves the transfer-pricing problem

Problems:

- Does not tax rents accruing to foreigners
- Exempts financial services
- May require large tax refunds to exporting firms
- Transition problems and significant investment distortions and speculative capital flows in case of anticipated tax rate changes (and windfall gains and losses in case of unanticipated tax rate changes)

A source-based allowance for capital costs

- Allowance for Corporate Capital *(ACC)*: Tax base = Profit before capital cost – imputed return to capital (equivalent to *R*-base tax in present-value terms)

- Allowance for Corporate Equity *(ACE)*: Tax base = Profit net of interest – imputed return to equity (equivalent to *R+F*-base tax in present-value terms)

The Allowance for Corporate Equity

Advantages:

- Neutral towards investment at the intensive margin
- Neutral towards financing decisions
- Eliminates need for thin capitalization rules
- Taxes location-specific rents, including rents accruing to foreigners
- Taxes financial services and allows continuation of interest deductibility
- Compared to *R+F* tax: Fewer transition problems and much smaller investment distortions in case of anticipated tax rate changes

Problems:

- Distorts investment at the extensive margin
- Does not solve the transfer-pricing problem

Taxing the full return to capital

The case for a low flat tax rate on capital income

Arguments for a *low* capital income tax rate:

- accounts for inflation in a pragmatic way
- reduces incentive for capital flight
- improves neutrality, allows base broadening

Arguments for a *flat* capital income tax:

- Reduces lock-in effects of realizations-based capital gains tax
- Limits the scope for tax arbitrage
- Reduces clientele effects

The Comprehensive Business Income Tax (CBIT)

- Tax base = domestic source profits before interest

- The CBIT could be part of a source-based capital income tax regime where all capital income is taxed at source at the flat business income tax rate

The Comprehensive Business Income Tax (CBIT)

Advantages:

- Neutral towards financing decisions
- Broad base allows low tax rate, thus reducing the transfer-pricing problem and benefiting the most profitable companies

Problems:

- Significant increase in the cost of debt capital (increased investment distortions and capital flight)
- Distorts the choice of organizational form if income from unincorporated firms is taxed as labour income
- Transition problem for indebted companies

THE DUAL INCOME TAX (DIT)

The DIT: A personal residence-based income tax which combines a low flat tax rate on all capital income with progressive taxation of labour income

In DIT countries the DIT has been combined with a conventional source-based corporation tax on the full return to corporate equity, but the double taxation of corporate income has been relieved at the shareholder level

Note: If the DIT is combined with a source tax on interest and dividends paid to foreign residents, it becomes equivalent to the CBIT

THE DUAL INCOME TAX

Advantages (compared to the CBIT):

- Avoids investment distortions and capital flight related to debt-financed investment
- Avoids transition problem for indebted firms

Problems:

- Requires a splitting of income from self-employment
- Requires careful co-ordination of corporate and personal income tax to prevent tax avoidance by owners of closely held corporations

Alternative options for reform: Summary

- The various cash flow taxes all create significant transition problems and generate significant non-neutralities in case of anticipated tax rate changes

- The ACE and the DIT involve less radical departures from current tax law and have both been tested in practice

The tax reform proposal below therefore combines a version of the ACE with a version of the DIT

Proposal for a capital income tax reform for a small open economy

Combining an ACE with a DIT: Basic ideas of capital income tax reform

1) Shift the taxation of the normal return to capital from a source to a residence basis

2) As a consequence of 1), eliminate source-based taxes on the normal return to capital and eliminate double tax relief at the resident shareholder level

3) Maintain a source-based tax on returns above normal to capture immobile rents, including rents accruing to foreigners

4) Keep the residence-based personal capital income tax low to facilitate base-broadening with the aim of ensuring the greatest possible degree of neutrality

Calculating the base for ACE

Equity base in previous year

\+ taxable profits in previous year (gross of the ACE)

\+ exempt dividends received

\+ net new equity issues

- tax payable on taxable profits in previous year
- dividends paid
- net new acquisitions of shares in other companies
- net new equity provided to foreign branches

= **Equity base for the current year**

Calculating the base for the ACE: Implications

- No distortion from accelerated depreciation since future ACE allowances are reduced correspondingly
- Purchase of shares in other domestic companies are subtracted from the equity base to avoid double counting
- Purchase of shares in foreign companies are subtracted from the equity base, assuming that foreign dividends are exempt
- When a holding company finances investment in a subsidiary with debt, the resulting negative ACE allowance is added to its taxable profit to offset the interest deduction and maintain neutrality between debt and equity

Setting the imputed rate of return under the ACE

- Full neutrality requires that the imputed return be equal to the shareholders' discount rate
- With full loss offsets, the tax saving from the ACE is a risk-free cash flow, so the imputed rate of return should then be the risk-free interest rate
- With imperfect loss offsets, rough neutrality could be achieved by setting the imputed return equal to the average corporate bond rate

The choice of tax rate and the transition to an ACE

- To avoid exacerbating the transfer-pricing problem, the statutory corporate tax rate should not be raised. The owners of domestic factors will benefit from the ACE even if they have to make up for the revenue loss

- To limit the revenue loss the initial equity base should ideally be set at zero. This will require anti-avoidance rules to prevent tax-motivated liquidations and new start-ups

The personal capital income tax base under the Dual Income Tax

Interest

+ dividends

+ capital gains

+ rental income

+ royalties

+ imputed returns on capital invested in non-corporate firms

+ imputed returns on owner-occupied housing

= **capital income**

Taxing income from self-employment under the DIT

- **Problem:** the self-employed earn income from capital as well as labour

- **The Nordic solution:** tax an imputed return to business assets as capital income and treat the residual business income as labour income

Defining business assets

- Depreciable business assets plus acquired goodwill and acquired intellectual property rights
- Business assets must be separated from ”private” assets

Note: Income splitting should be an option but not an obligation. If a proprietor does not opt for income splitting, all of his/her income will be taxed as labour income

Taxing income from closely held companies under the DIT

- **The income shifting problem:** Active owners of small companies may transform labour income into capital income to reduce their tax bill if the sum of the corporation tax and the personal tax on dividends is lower than the (top) marginal tax rate on labour income

Solving the income shifting problem

Set tax rates so as to roughly satisfy

$$(1\text{-}\tau)(1-t)=1-m \quad \Leftrightarrow \quad \tau+t(1-\tau)=m$$

$\tau =$ corporate income tax rate (on income above the imputed return)

$t =$ personal capital income tax rate

$m =$ top marginal personal labour income tax rate

The capital gains tax problem

- **Problem:** Lock-in effect of realizations-based taxation because of gain from deferral. In particular, owners of closely held companies could gain from accumulating income within the company

- **Solution for *listed* shares:** Accruals-based taxation

Solving the capital gains tax problem for unlisted shares in domestic companies

- Step up the basis of shares each year by the company’s retained profit and impose capital income tax on the increase in basis value
- If a share is sold at a price exceeding the stepped-up basis value, the additional gain is taxed as capital income
- If a share is sold at a price below the stepped-up basis value, the loss is deductible against other capital income (or entitles the taxpayer to a tax credit against the tax on labour income)

Advantages of capital gains tax regime for unlisted shares

- No valuation problem: capital gains tax liability is based on the company’s taxable retained profits
- No liquidity problem: tax is only liable in so far as the company earns positive profits. The company can pay the flat tax on behalf of shareholders
- Taxation of additional realized gains ensures taxation of gains stemming from higher expected future earnings and loss offset protects against overtaxation

Taxing capital gains on shares in foreign unlisted companies

- **Problem:** information on retained profits hard to obtain from foreign tax authorities
- **Pragmatic solution:** Apply the Risk-Free Return Method, i.e. set the shareholder's income equal to a risk-free rate of return times the acquisition value of his/her shares, regardless of the actual capital gain or loss
- **Advantages:** No lock-in effects, tax administrators only need information on acquisition values

Taxing returns to property

- Risk-Free Return Method (RFRM): Set taxable income equal to an imputed risk-free nominal rate of return on the assessed value of the property

(ex ante neutrality, implies taxation of the value of housing services plus expected rather than actual capital gains → no lock-in effects)

Apply the RFRM to

- owner-occupied housing
- rental property

Taxation of retirement saving

- Hard to see the rationale for tax concessions to retirement saving

- Tax retirement saving under the same rules as ordinary saving to improve neutrality (perhaps allow deduction for contributions and impose tax on withdrawals, but tax the return on a current basis)

Enforcing the residence principle

- **Problem:** Foreign tax authorities have no incentive to provide information to domestic tax collectors

- **Solution:** Offer foreign governments a share in the revenue gain when information provided by foreign authorities allows detection of international tax evasion

Efficiency gains from the proposed capital income tax reform

- Reduced tax distortion to inbound investment

Improved tax neutrality between

- debt and equity
- distributed versus retained earnings
- proprietors and owners of closely held companies
- investment in financial assets and investment in owner-occupied housing

Additional background slides

Revenue effects of an ACE

Average effective tax rate under the ACE when the system is fully phased in:

$$AETR = \tau\left(\frac{p-c}{c}\right)$$

$p =$ average real pre-tax rate of return

$c =$ real cost of capital (= real imputed rate of return)

Example:

$\tau = 0.25$

$AETR$ under current system = 0.2

$p = 0.15$

$c = 0.05$

$P/GDP =$ ratio of corporate profits to GDP = 0.15

Implication:

$AETR$ under ACE system ≈ 0.17

$$\frac{\text{Long-run revenue loss}}{\text{GDP}} = (0.20 - 0.17) \times 0.15 \approx 0.005 = 0.5 \text{ percent of GDP}$$

Revenue loss from the ACE in the short and medium term

Assumption: the ACE allowance is granted only for additions to the equity base undertaken after the reform $\Rightarrow$

Fraction of equity base which will attract the ACE allowance in year t after the reform:

$$X_t = \frac{(1+g)^t - 1}{(1+g)^t}$$

$g =$ average growth rate of nominal equity base

$\approx$ growth rate of nominal GDP

Example: $g =$ 4 percent $\Rightarrow X \approx 0.32$ for $t = 10 \Rightarrow$
after 10 years the revenue loss is only 1/3 of the long-run loss

Taxing imputed returns on owner-occupied housing through the Risk-Free Return Method

Capital market equilibrium in the absence of tax:

$$i = \overbrace{h - \delta + g - p}^{\text{expected risk-adjusted nominal return to housing investment}} \qquad (1)$$

Capital market equilibrium with tax on imputed rent:

$$i(1-t) = h - \delta + g - p - t\rho \qquad (2)$$

For $\rho = i$ (neutral taxation) it follows from (1) and (2) that

$$t \cdot \rho = t \cdot (h - \delta + g - p) \qquad (3)$$

Hence neutral taxation according to the *RFRM* method involves taxation of the expected capital gain g rather than the actual gain