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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.
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
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