

Institute for
Fiscal Studies

Tax By Design: The Mirrlees Review

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Scope of the Mirrlees Review

- Comprehensive review of tax reform, drawing on:
 - new evidence
 - new (applied) theory
 - new economic environment
- View the tax system as a whole
 - savings and capital
 - earnings and direct taxation
 - indirect taxation
 - corporate taxation
- For developed open economies with UK Focus
- But principles and lessons applicable to middle income countries like Turkey too

The Mirrlees Review

Reforming the Tax System for the 21st Century

Chairman: Sir James Mirrlees

Stuart Adam (IFS)

Tim Besley (LSE & IFS)

Richard Blundell (IFS & UCL)

Steve Bond (Oxford & IFS)

Robert Chote (OBR)

Malcolm Gammie QC (One Essex Court)

Paul Johnson (IFS)

Gareth Myles (Exeter & IFS)

James Poterba (MIT & NBER)

A review in two Volumes

- *Dimensions of Tax Design*: published April 2010
 - a set of 13 chapters on particular areas by IFS researchers + international experts, along with expert commentaries
- *Tax by Design*: published September 2011
 - an integrated picture of tax design and reform, written by the editors
- OUP but also open access at:
 - <http://www.ifs.org.uk/mirrleesReview>

The need for the review

- More than 30 years since last major review (Meade Review)
 - The world, and what we know about the effects of tax, has changed
- Taxes take around 40% of developed economy GDP
- Tax take in middle income countries has increased considerably
 - E.g. Now around 24% of GDP in Turkey, up from 13% in 1980
- Governments do not tend to formulate tax strategy explicitly
 - Evaluation is almost unheard of
 - (Big) mistakes happen
- Occasional focus on particular elements
- But crucial to look at the whole

Key conclusions

- There is ample scope for improvement to make tax systems
 - Simpler;
 - More equitable; and
 - Better for welfare, economic efficiency and output
- There are reasons that the system is not achieving this
 - Politics and the policy making process
 - Lack of public understanding
 - And straightforward policy mistakes
- They all contribute to a system that is complex, inequitable and inefficient
- Similar issues in countries like Turkey

We should aim for a tax system which

- Works as a system
 - E.g. corporate and personal taxes should fit together
 - Not every tax needs to achieve everything
- Is broadly neutral
 - Doesn't discriminate between similar activities except under very limited conditions
- Achieves progressivity as efficiently as possible
- And is designed on the basis of the best available evidence
 - More research needed to provide evidence on how people respond to taxes in middle income countries like Turkey
 - Particularly choice of informal versus formal work

*Where we stand: a tax system in need
of fundamental reform*

In the UK, what we have

- Does not work as a system
 - Lack of joining up between income tax and National Insurance
 - Personal and corporate taxes

Distorting employment choices...

- And so, most tax payers pay
 - 39% tax on earned income (e.g. salaries)
 - 28% tax on self employment income
 - 21% tax on income earned as a small company
- Distorts decisions about whether to be an employer or go into business...
- Unfair to tax employees more than business owners with same incomes?
- In middle-income countries, could such tax incentives discourage growth of large businesses, reducing productivity?

In the UK, what we have

- Does not work as a system
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 - Personal and corporate taxes
- Is not neutral where it should be
 - Different forms of saving taxed very differently, with ‘double taxation’ of risk-free returns a problem
 - Corporate tax system that favours debt over equity

Effective tax rates on different forms of saving in UK

	Basic rate taxpayer	Higher rate taxpayer
Individual Savings Account (tax-free)	0	0
Regular Bank account	33	67
Pension (employee contribution)	-21	-53
Pension (employer contribution)	-115	-102
Capital gains from own house	0	0
Direct equity (share) holdings	10	35

- Distorts investment/savings decisions so based on tax treatment not fundamentals: misallocation of scarce capital
- Similar issues in Turkey
 - e.g. Bias towards holding Turkish equities

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- Is not well designed where it should deviate from neutrality
 - Vastly different taxes on different sources of carbon emissions
 - Failure to price road congestion properly

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 - Failure to price road congestion properly
- Does not achieve progressivity efficiently
 - VAT zero /reduced rating a poor way to redistribute
 - Taxes and benefits damage work incentives more than necessary

Improving taxation: principles and policy changes

Our proposals

- Treat the system as a whole
 - Integrating National Insurance and income tax
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 - Not taxing the risk free normal return to capital (stop double taxation)

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- Whilst proposing sensible deviations from neutrality
 - Imposing a consistent tax on carbon emissions and on congestion
 - Imposing zero rate of VAT on childcare (help mothers to work)

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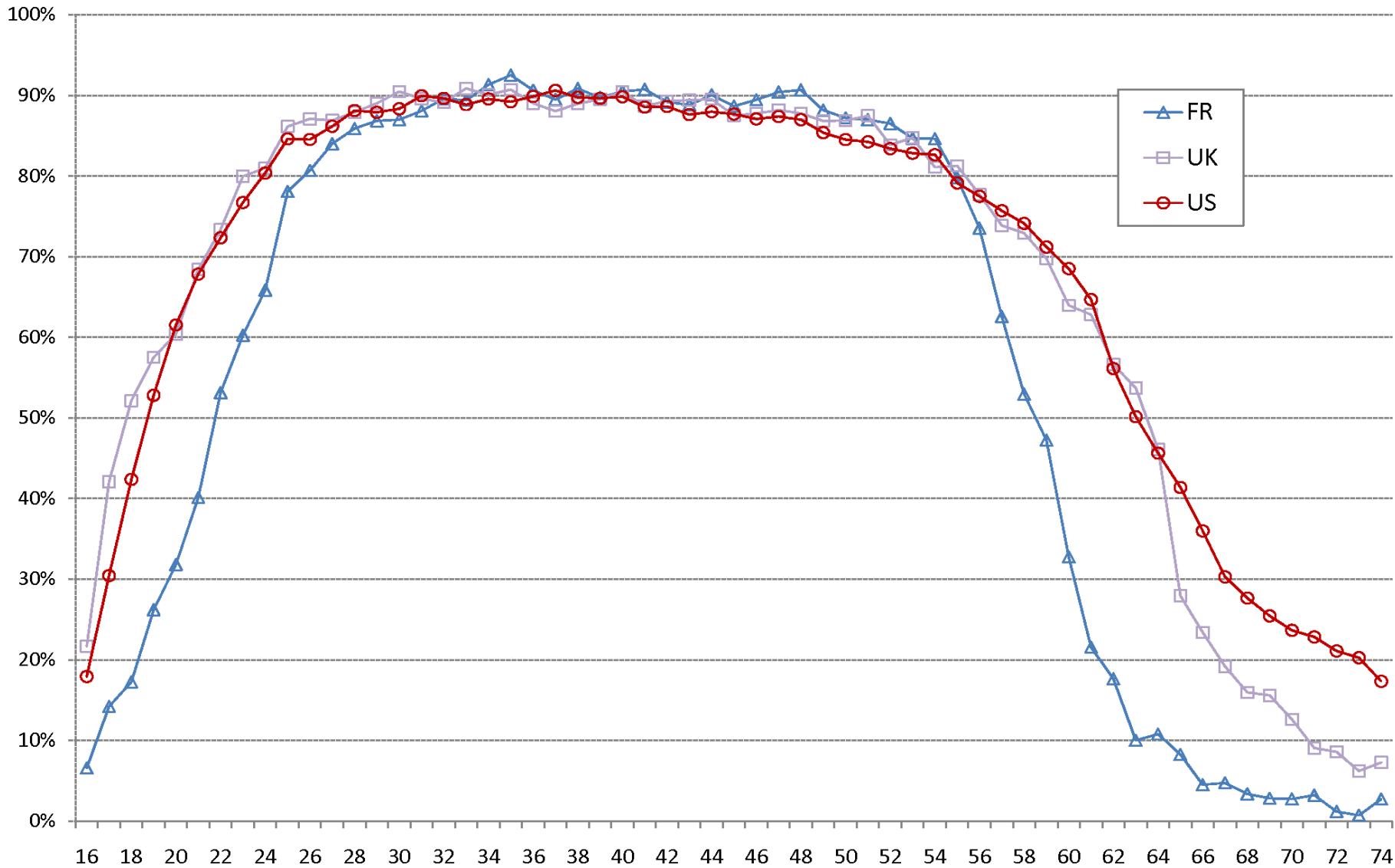
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 - Imposing a consistent tax on carbon emissions and on congestion
 - Imposing zero rate of VAT on childcare (help mothers to work)
- Achieve progressivity through the direct tax and benefit system
 - Recognising constraints imposed by responses to incentives
 - Taking account of lifetime welfare

Earnings taxation and redistribution

Key messages on earnings taxes

- We are bound by the trade-offs between incentives and redistribution
- Recognising the importance of the *extensive margin* – the decision over whether to work at all – has profound implications for the optimal tax schedule
- Designing the tax schedule in the knowledge of how different groups respond can improve incentives overall
- In middle income countries like Turkey, potential to work in informal sector may make formal work decisions particularly responsive to tax policy

Employment for men by age, FR, UK and US 2007



Summarising the evidence on responses to earnings taxes

- Taxes reduce how much people choose to work
- Especially for low earners,
 - responses are larger at the extensive margin—employment
 - than at the intensive margin—hours of work
- These responses are largest for
 - women where the youngest child is school-age
 - those aged over 55
- Other responses affecting taxable income matter
 - certainly for the rich (e.g. avoidance and tax loopholes, effort, etc)
- Most empirical evidence on responsiveness is for US / Western Europe
 - Real need for evidence on responsiveness in middle income countries
 - e.g. informal/formal work decision
 - Effects of social assistance for informal workers



At the top end of the income distribution...

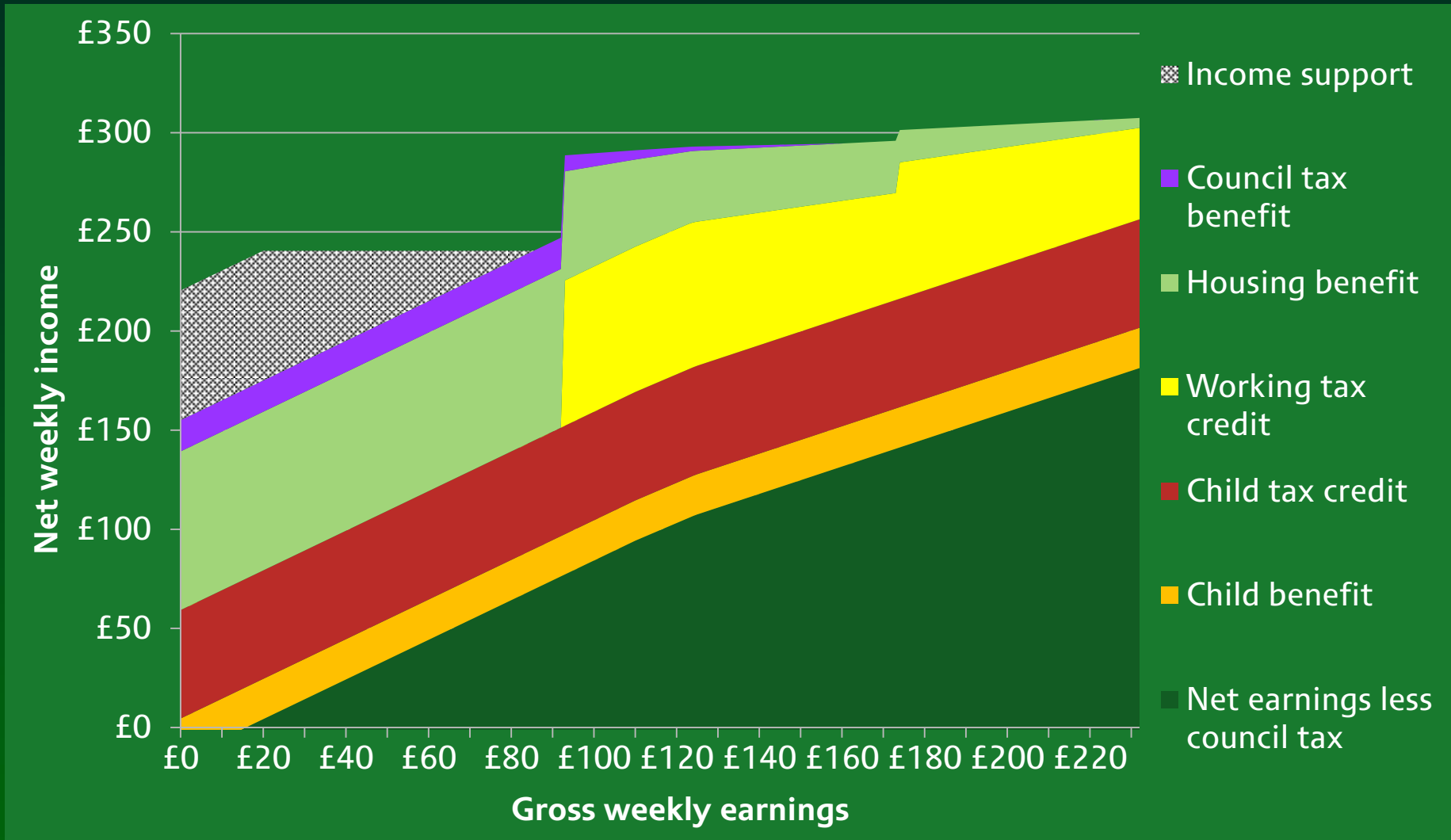
- UK has recently introduced and then abolished a top income tax rate of 50%
- Estimates based on these and earlier tax changes suggest that 50% may be above revenue maximising level
 - In large part due to tax avoidance behaviour
 - But estimates are subject to very wide margins of error
- The tax *base*, and other parts of the system, matter for avoidance opportunities
 - CGT rates (lower than income tax rates in UK)
 - Treatment of pension contributions (tax-free with restrictions in UK)
- Turkey has top income tax rate of 30%
 - CGT is taxed at income tax rates and tight limits on pension contribs.
 - But little evidence on how responsive high earners are



Taxes on earnings should:

- Involve a progressive income tax with a transparent and coherent rate structure
 - Requires only a tax free allowance and two or at most three marginal rates
 - Turkey has reduced the number of income tax rates in recent years to 15, 20, 27 and 35%
- Be designed to reflect the shape of the income distribution and evidence on responses to work incentives
 - More evidence needed for Turkey and middle income countries
- Include a single integrated benefit for those with low income or high needs
 - Could this help bring informal workers in to the formal system of taxes and benefits?

The interaction between taxes, tax credits and benefits



Notes: Lone parent, with one child aged between one and four, earning the minimum wage (£5.80 per hour), with no other private income and no childcare costs, paying £80 per week in rent to live in a council tax Band B property in a local authority setting council tax rates at the national average

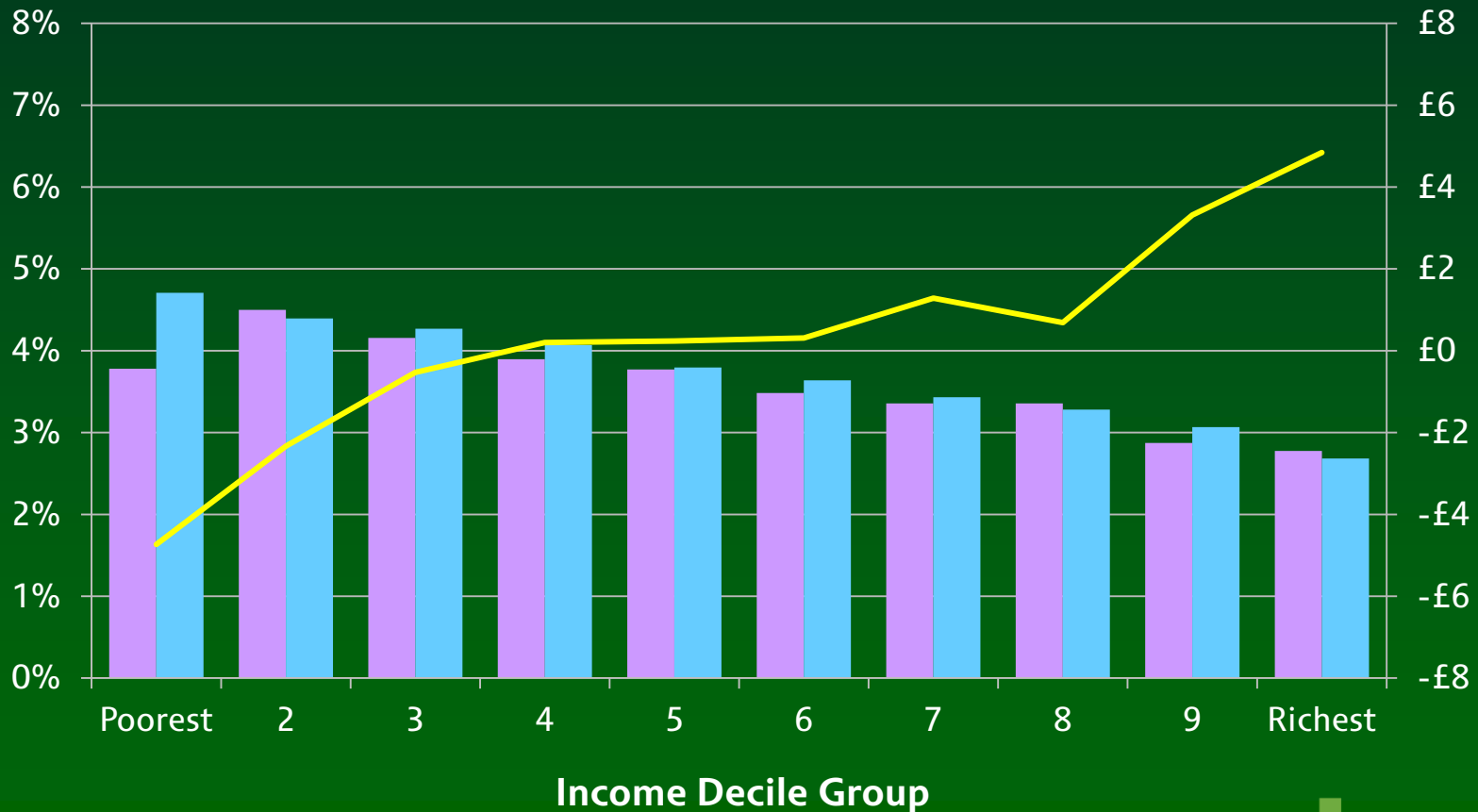
*Reforming VAT: a broader, less
distortionary tax*

Evaluating VAT

- In general the UK VAT works well
- But UK is unusual in the extent of zero rating
 - Food, books, children's clothes, domestic fuel (reduced rate) etc
- As VAT rates have risen to 20% this is increasingly distorting
 - And is a highly ineffective means of redistribution
- VAT should be extended to nearly all spending, with income taxes and benefits changed to compensate
- Exemption creates really big difficulties
- Turkey also has extensive exemptions and reduced rates and in principle, could benefit from VAT extension
 - Is there a case for lower rates on goods subject to tax evasion or more informality (e.g. basic foods)

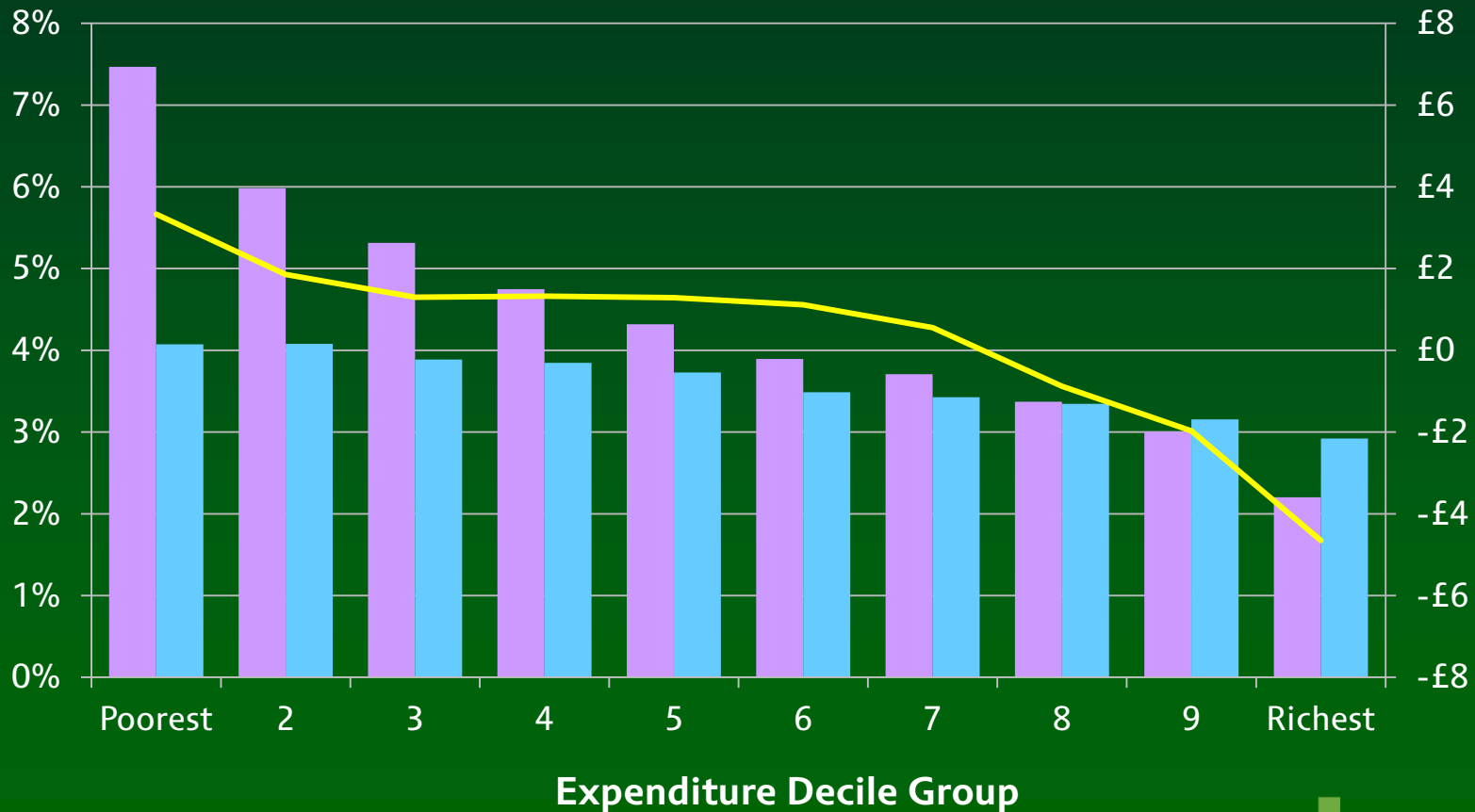
VAT reform: effects by income

■ % rise in non-housing expenditure ■ % rise in income
— cash gain/loss (£/week, RH axis)



VAT reform: effects by expenditure

■ % rise in non-housing expenditure ■ % rise in income
— cash gain/loss (£/week, RH axis)



VAT and financial services

- Consumption of financial services should be taxed
- Exemption causes serious problems
 - Financial services too cheap for households, too expensive for firms
 - Financial services provider vertically integrate
 - Become too big?
 - Costs around £10bn in UK
 - (though insurance premium tax recoups £3bn)
- Can't be taxed through standard VAT mechanism
- But there are equivalent alternatives which should be pursued
 - 5% Banking and Insurance transactions tax in Turkey does not do this properly

VAT and housing

- In principle housing should be subject to VAT
 - It is not in the UK, it is in Turkey
- In UK we have a “council tax”, a tax on housing which is regressive relative to the base and depends on relative house prices 20 years ago
- In UK we also have a damaging system of stamp duties
 - A tax on transactions and one that rises in slabs
- Both should be replaced by a “housing services tax” simply proportional to current house value
 - Standing in place of VAT

Stamp taxes more prevalent in Turkey

- Stamp tax applied to wide range of documents such as contracts, payrolls, letters of credit, financial statements, etc
 - 0.165% to 0.825% of value stated on document
- Discourages use of official documents, making business more difficult to conduct (less legal certainty)
- Incentive for firms to remain in the informal sector?
 - Limits ability to raise other taxes (VAT, income tax, social security)
 - Reduces productivity and growth potential?

How to tax savings and investments

Household Savings

- Efficiency arguments for exempting return on savings from tax are important but not decisive
- But income from capital cannot be taxed coherently under a standard income tax
 - realised capital gains (avoid tax as they accrue)
 - Inflation (means not necessarily a ‘real’ capital gain)
- Uniform treatment of all forms of saving possible if we exempt the normal component of returns
 - corresponding to risk-free interest rate on safe assets

Neutral taxation of savings

- Two approaches are broadly equivalent
- Expenditure tax (EET)
 - tax relief for inflows
 - tax all outflows
 - cf. current treatment of pensions
- Rate of Return Allowance (RRA)
 - no tax relief for inflows
 - tax outflows only in excess of normal return

Neutral taxation of savings

- Both expenditure tax and RRA approach tax 'excess' component of returns
- 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, can simply exempt interest income from taxation (TEE)

*Taxing companies: is it time to accept
a shift from corporation tax?*

Corporate Taxation

- Why have a corporate tax at all?
 - Primarily as a backstop to personal taxation
 - Also efficient to tax location-specific rents
- Why tax corporate income on a source-country basis?
 - Only game in town, given current international practice

Problems with corporation tax

- Raises cost of capital
- Bias towards debt finance
- Capital allowances don't match true depreciation
- Sensitivity to inflation
- In an open economy with capital mobility, capital goes elsewhere, leaving domestic workers poorer
 - More efficient to tax labour income of domestic workers directly

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
- Don't recoup the revenue loss by raising the rate
- Appropriate rate to tax rents earned in the corporate sector should balance:
 - Advantages of taxing some sources which are largely immobile
 - Disadvantages of (attempting to) tax other sources which are highly mobile

Key recommendations

- Introduce ACE allowance with no increase in the corporate tax rate
- Accept that less revenue should be collected from the corporate tax
- Rebalance shares of revenue from corporate and other taxes as part of an overall revenue-neutral package
- Turkey has reduced corporate tax rates considerably in 2000s in recognition of international competitiveness issues



Concluding Remarks

These are radical changes in the UK context...

- A strategy for the long term
 - Not intended to be introduced overnight
 - Though a clear sense of direction needs to be set out
- Involving a lot of winners and losers
 - Inevitable with structural reforms, especially where the current system favours certain groups
 - Makes building political consensus for reform difficult
 - Important to look at lifetime impacts of reforms as opposed to 'snapshot' impact
- And much work to be done on how to implement the reforms
 - e.g. Consultation on corporate tax reforms

... more analysis needed for middle income countries

- How do differences in administrative capacity affect tax policy?
 - Even more important to aim for simplicity and reduction in incentives for avoidance / evasion
 - But also have to ‘tax what can actually be taxed’?
- Understanding how people respond to the tax system
 - Labour supply, consumer demand, firm behaviour
 - Informal work, firms and shopping
- Informality is a key issue
 - Increase the size of responses to taxation?
 - Want to tax less heavily activities prone to shifts to informal sector?
 - Stamp taxes likely to encourage informality
 - Need to consider effects of expansion of welfare for informal workers