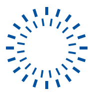

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Taxation of Capital Income

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French taxes and contributions on capital are higher than those of its neighbouring countries, particularly where the taxation of capital stock is concerned. This high level of taxation is primarily explained by the high fiscal burden borne across all tax bases in France, and in particular earned income. The other main characteristic of the French capital taxation system is its extreme heterogeneity, with low rates, for example, for property and life insurance.

There are, of course, strong arguments for taxing capital income, notably including the fact that this taxation plays a role in the redistribution of income and enables taxes and contributions on earned income to be reduced, but there are a number of different taxation systems that could be implemented. The choice of system depends on the desired level of redistribution, as well as the relative force of two types of optimisation, between earned income and capital income, on the one hand, and between different locations of residence for tax purposes, on the other (tax exile). In the event of the former taking precedence, a taxation system incorporating capital income on the income tax schedule would be appropriate; in the event of the latter taking precedence, a dual taxation system (with a fixed capital income tax rate) would be preferable. In order to choose between these two systems, it is important that the authorities make tax exile data public.

Irrespective of the average level of taxation, its heterogeneity according to the type of capital income is detrimental to the correct allocation of resources. The exemption of savings income from tax cannot generally be justified, with the notable exception of retirement savings. Our recommendations are designed to reduce this heterogeneity, which would have the effect of freeing up the tax revenue required to reduce rates. First and foremost, we would recommend limiting the fiscal benefits of life insurance schemes to products accompanied by a pension payment (equivalent to retirement savings). French companies do not suffer from a general lack of funding. The argument regarding the long-term financing of the economy does not, therefore, justify maintaining special measures. Small and young businesses and those involving a high level of risk, however, do find it difficult to find the necessary funds. Targeted systems can encourage the development of business angels.

With the same aim of reducing inequities in tax treatment, we would recommend restoring the balance of taxation in favour of property by taxing implicit rental income net of loan interest or, failing this, by raising property taxes as a result of updating rental values. In the case of gains, we would simply suggest annualising the gain net of inflation prior to applying it to the standard income tax schedule. Finally, we believe that a tax-exempt book-type capped savings scheme (*Livret A*) is justified with regards to the need to smooth household consumption. In any case, this savings scheme is not intended to finance a specific type of public investment, such as social housing.

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Introduction

The taxation of capital income is a major issue in economic policy, particularly in the long term. Indeed, the taxation of capital income plays a key role in both the income inequality dynamic and the accumulation of productive capital, and therefore long-term growth. The economic literature on the matter has often been considered somewhat inoperative, putting forward a number of recommendations that are sometimes radical, often contradictory and rarely consensual. Careful examination of recent work in the field, however, highlights a number of useful points of reference relating to the method of taxing capital income. The present *Note* favours those points that achieve the greatest consensus. It focuses on the general principles on which the taxation of capital income should, in our opinion, be based, without going into detail regarding the systems currently in place in France. Despite the fact that it is to some extent connected to the taxation system that applies to capital income, neither the taxation of capital stock (solidarity tax on wealth, property taxes, etc.) nor of transmissions (taxation of successions and donations) are taken into account in the present *Note*.

France is known for its relatively high but above all heterogeneous taxation of capital income. We believe that, in the majority of cases, the taxation system would benefit from greater neutrality and we would therefore suggest a number of systemic reforms and specific reforms targeting the most blatant differences in tax treatment in the current system.

The relatively heavy but above all heterogeneous taxation system

Capital and assets

Capital relates both to the property owned by a household and to all physical or financial assets (both private and public) that make it possible to produce goods and services, increase labour productivity and play a decisive role in economic growth. Household assets are generally greater than the productive capital of an economy since part of the public debt, held by households, has no public capital counterpart - the State does not get into debt simply for the sake of investing. For the present *Note*, we shall adopt the perspective of the household, whose assets are a store of value that enables them to maintain a certain level of consumption during periods of inactivity (unemployment, retirement, etc.), to cover non-recurrent expenses, to meet housing needs and even to bequeath an amount of capital to descendants.

Capital income primarily helps offset the depreciation of physical capital (obsolescence of machines, ageing of buildings, etc.) and therefore renew existing capital[1]. Once the depreciation of the capital has been deducted, the remainder amounts to around 440 billion euros in net capital income, that is 22% of the GDP[2]. This includes all capital income received either directly or indirectly by households.

The first type of capital income we can distinguish relates to land, which account for over 160 billion euros. These include income generated through the provision of a housing service, for both owner-occupiers and owner-landlords. Indeed, when a household owns its property, it receives a payment in kind (housing services) that can be valued at the amount that it would be required to pay were it the tenant, or at the amount it would receive if it were renting the property to another household. Such income, known as 'imputed rental income', accounts for over 120 billion euros, that is 75% of all property.

The second main type of capital income relates to all investment income, which amounts to around 155 billion euros and includes interest, dividends and other income apportioned by companies, life insurance and other financial products.

The final type of capital income, that is the mixed income of self-employed workers, accounts for nearly 125 billion euros. This latter category relates, in fact, both to earned income and to entrepreneurial capital, Eurostat classing this as capital income. In more general terms, entrepreneurs and company directors can reinvest in the growth of their company salaries that they do not allocate to themselves and recover them at a later stage in the form of dividends or gains. It is therefore difficult, in practice, to distinguish between earned income and capital income.

In addition to this capital income itself we must consider the variation in the value of the asset –gains on fixed and movable assets– which, despite the fact that they do not constitute an annual income, do, nevertheless, represent remuneration from the asset.

All such income should be considered in relation to the assets of French households, which amounted to 10,500 billion in 2011 (nearly 70% of which was comprised of fixed assets). The apparent pre-tax rate of return (excluding gains) is therefore an average 4.2%, with a lower rate for fixed assets and a higher rate for financial assets.

The present *Note* shall not take into account any return on human capital, resulting from investment in education and

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[1] National accounting figures estimate the capital depreciation —known as consumption of fixed capital— which is subtracted from the gross domestic product to obtain the net domestic product, at 13-14% of the GDP.

[2] The figures quoted here are taken from the household accounts compiled by Comptabilité nationale, 2005 basis, May 2013 version, INSEE. The breakdown of income from property is taken from the housing satellite account published by the French General Commission for Sustainable Development.

specific skills and expressed in the form of higher wages. It should, however, be borne in mind that employment taxation affects the accumulation of human capital just as capital taxation affects the accumulation of physical and financial capital.

The relatively heavy taxation of capital

There are generally considered to be three types of tax revenue, these being tax on consumption (VAT and other indirect taxes), tax on employment income (social contributions, the majority of *CSG, CRDS* and income tax, as well as payroll taxes) and tax on capital (a proportion of income tax, *CSG* and *CRDS*, capital gains tax, tax on conveyances and succession tax, corporate income tax, solidarity tax on wealth and property tax).

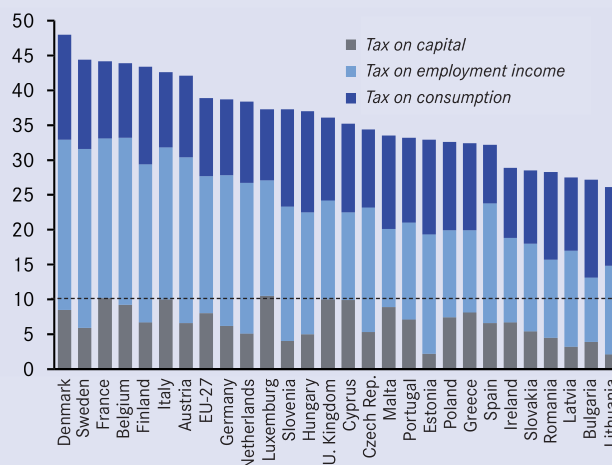
Within Europe, France is known for its high rates of tax and social security contributions, among whose capital levies which, in relation to GDP, are greater than those implemented in all other countries, with the exception of Luxembourg and Norway (Graph 1). The high rate of capital taxation is primarily the result of a high rate of capital stock taxation (only the United Kingdom and Norway impose higher rates of tax on stocks by means of a high rate of property taxation). The implicit capital tax rate in France (taxes paid in relation to a measurement of the tax basis) was estimated at 44% in 2011, that is the highest of the countries in the European Union, with an upward trend. Despite the uncertainties surrounding this assessment (*cf*. Box 1), we might conclude that capital income is heavily taxed in France in comparison with other European countries.

In relation to total tax revenue, however, capital taxes in France account for a proportion that is close to the European average, that being 23%, as opposed to the average of 20% in the EU27. The relatively heavy taxation of capital income in France is therefore primarily a reflection of the relatively heavy fiscal burden across all taxes, even though capital income is not particularly badly off.

The very heterogeneous taxation of investment income

There is a great deal of heterogeneity behind this high average rate of taxation on capital and the corresponding income in France. First and foremost, investment in property is given special consideration; indeed, since 1965, the implicit rental income of owner-occupiers has been exempt from taxation (excluding property tax), capital appreciation on the properties of owner-occupiers is entirely exempt, gains on other fixed assets benefit from substantial reductions and rental income can benefit from a number of tax reduction systems (Scellier, Duflot, etc.). Furthermore, savings income from life

1. Distribution of taxes and contributions between consumption, employment income and capital within the European Union in 2011 as a % of GDP



Reading: Distribution choices between the different bases will ideally depend on the economic repercussions of each tax. The Eurostat method involves using the conventional method of determining VAT on consumption and social contributions on employment. Other choices are more open to debate; council tax, for example, is considered to be a tax on capital stock, whilst taxes on financial, international and property transactions are assumed to affect both capital stock and consumption alike. It is also important to note that the proportion of personal income tax on capital is 150% higher in France due to the fact that the income of self-employed workers is considered to be capital income and not income earned from employment. The figures for the EU27 are weighted averages.

Source : Eurostat (2013): *Taxation Trends in the European Union.*

insurance products benefit from rates of taxation that are far lower than those of the normal regime. Finally, savings book schemes (of the *Livret* A, PEL, PEP and LDD types)[3] also benefit from significant exemption but are generally capped.

The result of this is a very high degree of heterogeneity among the effective rates of taxation applied to capital income (Table 1). In practice, the capital tax rate never reaches the employment tax rate (all deductions combined). Excluding social contributions (unemployment and retirement) from the field of employment taxation (considering them instead to be compulsory savings), some capital income appears to be more heavily taxed than employment, as is the case, for example, of interest or income received from property, for which there is no special regime in place. The same is true of dividends if we take into account the impact of taxation on companies. Finally, it would appear that those regimes involving a low rate of taxation (imputed rental income or life insurance) are treated in a far more favourable manner than all other forms of income.

What is striking, therefore, is not so much the relatively high level of capital taxation in France, which essentially reflects the high fiscal burden felt at global level, as the very high degree of heterogeneity among rates of taxation within the capital income sphere.

[3] Home ownership savings plan (PEM), Popular Savings Plan (PEP) and Livret Développement Durable sustainable development account (LDD).

1. Marginal tax rate by type of capital income

Tax basis	Tax	Higher marg. rate in %
Real estate income		
• Imputed rent	TF	10
• Actual rent	TF, IRPP, CSG, CRDS	
o excl. special measures		62.1
o special measures (Scellier Law, etc.)		from 30 to 40
Investment income		
• Interest	CSG, CRDS, IRPP	58
o incl. savings plan at attractive rate of taxation		from 0 to 15.5
• Dividends	IS, CSG, CRDS, IRPP	55
• Income from life insurance	CSG, CRDS, PFL	23
Capital appreciation		
• on property - main residence		0
• on fixed assets (excl. main residence)		from 0 to 34.5
• on movable assets		39.9

Reading: The higher marginal rate is calculated as a guide only, without going into detail regarding all potential specific cases. In terms of repercussions, we shall assume that corporation tax is paid solely by shareholders (by means of lower dividends). The corporation tax rate corresponds to the implicit rate calculated as the ratio of corporation tax paid to the taxable amount. Likewise, the property tax rate is applied based on property tax revenue in relation to the amount of actual and imputed rental income. Solidarity tax on wealth is not taken in account in these simulations.

Note: *Flat-rate withholding tax.

Source: Authors' calculation.

1. Limits on implicit tax rates

Implicit tax rates are calculated by comparing the total revenue from each tax broken down by source of income (or by destination of expenditure) to the corresponding income (or expenditure) aggregate. In theory, calculating implicit tax rates makes it possible to take into account differences not only in rates but also in bases between countries, but in practice, it can pose serious problems with regards to interpretation as a result of the need to classify taxes into different categories.

As far as the numerator is concerned, the implicit capital tax rate includes taxes deducted from income received from savings and investments, as well as deductions relating to capital stocks. The denominator is an estimation of residents' overall capital and professional incomes. Whereas taxes paid on capital (the numerator) are observed relatively accurately using fiscal data, capital income (the denominator) is measured with a significant margin of error; of particular note is the fact that it does not take wealth stocks into account any more than it does capital gains, inheritances and transactions (financial or property). As a result of this, the implicit tax rate is tarnished by a high level of uncertainty.

Taxing capital income: the arguments for the debate

In order to tackle the issue of capital income taxation, it is helpful to move away from the conventional results in favour of complete exemption. These results are, in fact, now considered to be borderline cases, with a number of arguments to the contrary in favour of the taxation, to a greater or lesser degree, of capital income. We will highlight, here, the most robust of these.

The conventional results in favour of the non-taxation of capital

Two families of arguments have been put forward to justify the non-taxation of capital income, admittedly under a series of very restrictive conditions.

Non-taxation of future consumption

The first argument, put forward by Atkinson and Stiglitz (1976)[4], is based on the role of savings as a way for a household to eventually disconnect its earned income from its consumption –in the event of a temporary drop in its income or possibly retirement, the household dips into its savings to maintain its level of consumption; conversely, in the event of any exceptionally high income, it saves part of this income in order to spread the gain in terms of consumption over time.

The decision to save is the result of a comparison between the return on said savings and the sacrifice that postponing consumption to a later date would represent. This being the case, taxing capital income would be tantamount to penalising future consumption over immediate consumption. The taxation of capital income therefore distorts a household's consumption-related decisions in favour of immediate consumption and penalises those household with the most volatile incomes.

The long-term cumulative effect of taxing savings

The second argument in favour of the exemption of capital income, put forward by Chamley (1986) and Judd (1986)[5], relates to the cumulative impact of a tax on savings income –in the case of a long-term investment where interest is not consumed but rather reinvested, the taxation of interest

[4] Atkinson A.B. and J. Stiglitz (1976): 'The Design of Tax Structure: Direct and Indirect Taxation', *Journal of Public Economics*, no 6, pp. 55-75.

[5] Chamley C. (1986): 'Optimal Taxation of Capital Income in Economies with Identical Private and Social Discount Rates', *Econometrica*, no. 54, pp. 607-22. and Judd K.L. (1985): 'Redistributive Taxation in a Simple Perfect Foresight Model', *Journal of Public Economics*, no 28, pp. 59-83.

every year cumulatively reduces the income available when the investment matures.

Both of these conventional arguments are now considered somewhat inoperative since the hypotheses required for their application are more often than not rejected[6]. More particularly, there is no evidence whatsoever that capital income taxation is cumulative, with the exception of the particular case of inflation (see Box 2). These arguments are nevertheless useful for establishing certain principles of taxation. Retirement savings, which are primarily intended to defer earned income over a sustained period of time, for example, might justify exemption from tax (see below).

The new arguments for the debate

Whilst the two conventional arguments in favour of exemption might, with the exception of specific cases (retirement savings), be easily rejected, a number of recent works offer several useful points of reference to help guide the choices to be made with regards to capital taxation. These are briefly outlined below.

Rectifying income inequality

Income from assets is largely concentrated among the highest incomes (Graph 2). With this in mind, taxing capital income is a means of taxing the wealthiest individuals and reducing tax on earned income (which itself has a disincentivising effect)[7]. Even in a world where all assets are gained as a result of saving earned income (and not from inherited wealth), inequalities in terms of earned income would justify the taxation of capital income. The capital income tax rate is therefore the result of a trade-off between reducing employment taxation and encouraging the redistribution of income, and not discouraging the accumulation of capital[8].

Redistribution as a form of risk insurance

Inequalities in the earned income of individuals is determined not only by the life cycle as a whole but also within the cycle itself, with some individuals experiencing setbacks whilst others enjoy good fortune. Such instabilities also justify the taxation of capital income, which is seen, in this case, as a form of insurance among individuals, with the lucky ones helping to support the unlucky ones[9]. This form of insurance can prove beneficial to long-term growth in that it encou-

2. Does the capital income taxation system result in the same income being taxed several times?

One widespread argument against capital taxation is the fact that it would amount to taxing the same income several times. Let us consider, for the purposes of examining this argument, the case of an individual receiving €1,000 in earned income after tax. This individual chooses to immediately consume 90% of this net income (that is €900) and to save the remainder (€100). A year later, they retrieve their savings (€100), in addition to the interest they have earned, which, for the purposes of this argument, we shall assume amounts to 4%, that is €4. This interest, we shall assume, is taxed at the constant rate of 50%. The net income from the savings is therefore not €4 but in fact only €2. The initial earned income (€100) has not been taxed a second time. Only the income generated by the savings (€4) has been taxed.

Let us now assume that the individual reinvests all of their accumulated savings, that is €102. A year later, provided that the interest rate is still 4%, these savings will give them gross interest of 102 x 4% = €4.08 and a net income of half this figure, that is €2.04. The €102 investment has not been taxed; only the interest generated in the second year of saving (€4.08) has been taxed, meaning that the accumulated savings now amount to 102 + 2.04 = €104.04. The taxation of income from savings is not, therefore, cumulative.

The notion of double taxation only becomes apparent as a result of inflation. To simplify the matter, let us assume that annual inflation is equal to the interest rate, that is 4%. The individual has decided not to spend €100 of income in the initial period, but the basket of goods they wish to buy is worth €104 in the second period, whereas their accumulated savings, after tax, are worth only €102: although the nominal interest rate offsets the inflation, the individual cannot afford to buy the same basket of goods as they could in the first period. If capital income tax fails to take inflation into account, then a nominal income tax rate will result in a greater deduction from actual income. In this case, for example, a rate of 50% applied to the €4 interest actually corresponds to a tax rate of 100%, meaning that after tax, the individual receives no actual income from their savings.

To conclude, then, the income from the part of the return that offsets inflation is, in fact, taxed twice. In order to avoid this double taxation, only the amount of income from savings that exceeds the rate of inflation should be taxed. Furthermore, it should be noted that the taxation of assets (and not the return on the assets) is indeed subject to cumulative taxation.

[6] See Banks J. and P. Diamond (2010): 'The Base for Direct Taxation' in *Dimensions of TaxDesign: The Mirrlees Review*, Besley, Blundell, Gammie and Poterba (eds), Oxford University Press.

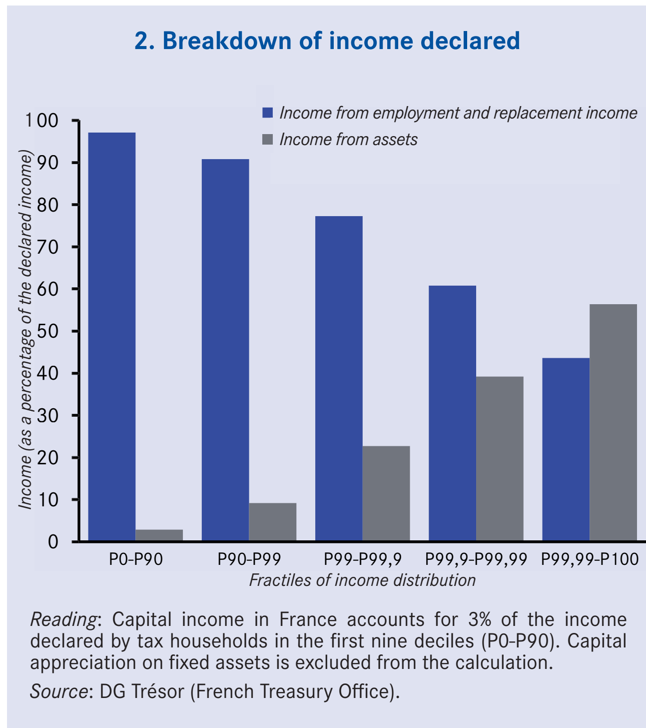
[7] See Saez E. (2002): 'The Desirability of Commodity Taxation under Non-Linear Income Taxation and Heterogeneous Tastes', *Journal of Public Economics*, vol. 83, no 2, pp. 217-30 and Diamond P. and J. Spinnewijn (2011): 'Capital Income Taxes with Heterogeneous Discount Rates', *American Economic Journal: Economic Policy*, vol. 3, no 4, pp. 52-76.

[8] Judd (1985) *op.cit*.

[9] See Golosov M., A. Tsyvinski and I. Werning (2006): 'New Dynamic Public Finance: A User's Guide', *NBER Macroeconomic Annual* and Farhi E. and I. Werning (2013): 'Insurance and Taxation over the Life Cycle', *Review of Economic Studies*, no 810, pp. 596-635.

rages investment in research and development, a high-risk activity[10].

2. Breakdown of income declared



Reading: Capital income in France accounts for 3% of the income declared by tax households in the first nine deciles (P0-P90). Capital appreciation on fixed assets is excluded from the calculation.

Source: DG Trésor (French Treasury Office).

Taxing income on inherited assets

Inequalities in capital income reflect not only past inequalities in earned income but also inherited inequalities (successions, donations, etc.). Taxing capital income therefore effectively favours those that have inherited little in the way of assets (preference for meritocracy)[11]. The greater the proportion of intergenerational transfers within the economy, the more the taxation of capital income will enable a reduction in employment tax and an increase in economic efficiency. This argument is, of course, somewhat insignificant in an economy experiencing a period of strong growth and with low rates of return on capital, which favours new generations over long-established assets. It only becomes significant when the economy starts to slow down or if the actual return on capital increases and if the weight of past or inherited capital becomes significant.

Don't discourage the accumulation of human capital

Finally, the taxation of physical capital income is justified so as not to distort investment choices to the detriment of human capital - if physical capital income is not taxed, the tax burden is borne by earned income, which includes remuneration for human capital investment. A tax on capital return results in a lower level of investment, that is a lower average level of education and of labour productivity, and ultimately a lower rate of growth. Employment taxation therefore creates dynamic distortions that justify the taxation of both earned and capital income[12].

A taxation system constrained by tax optimisation

In addition to the theoretical arguments outlined above we must also consider the constraints of fiscal policy, relating notably to the possibilities of optimisation between both different types of income and different tax jurisdictions.

Optimisation between different types of income

Whilst it might appear a pretty straightforward matter from a conceptual perspective, it is, in practice, difficult to distinguish capital income from earned income. The income of self-employed workers, for example is impossible to classify, whilst the income of company directors can take the form of a salary, dividends or capital appreciation; in more general terms, company profits represent both a degree of risk-taking on the part of shareholders and a form of remuneration for a productive enterprise. The different ways in which different types of income are treated therefore result in income being reclassified in the most fiscally advantageous category.

A number of studies on American data have shown that, since the 60s, company income has been largely reclassified as personal income in response to the increase in corporation tax[13]. The phenomenon can, in fact, reach significant proportions: Carroll and Hrung (2005)[14] find that, following a series of expansions of the tax basis in the United States, revenue has increased by 22% to 37% less than would have been the case in the absence of any tax optimisation. Likewise, a significant drive to reclassify earned income as capital income has followed a series of tax reforms in the Scandinavian countries[15]. This constitutes a strong argument in favour of minimising the difference in the tax treatment of different types of revenue, or even of aligning the taxation of capital income with that of earned income.

[10] See Aghion P., U. Akcigit and J. Fernandez-Villaverde (2012): *Optimal Capital versus Labor Taxation with Innovation-Led Growth*, Mimeo and García-Peñalosa C. and J-F. Wen (2008): 'Redistribution and Entrepreneurship with Schumpeterian Growth', *Journal of Economic Growth*, no 13, pp. 57-80.

[11] Piketty T. and E. Saez (2013): 'A Theory of Optimal Inheritance Taxation', *Econometrica*, yet to be published.

[12] Jones L.E., R.E. Manuelli and P.E. Rossi (1997): 'On the Optimal Taxation of Capital Income', *Journal of Economic Theory*, no 37, pp. 93-117.

[13] *Cf*. Gordon R.H. and J. Slemrod (1998): 'Are 'Real' Responses to Taxes Simply Income Shifting Between Corporate and Personal Tax Bases?' *NBER Working Paper*, no 6576 and De Mooij R. and G. Nicodème (2008): 'Corporate Tax Policy and Incorporation in the EU', *International Tax and Public Finance*, no 15, pp.478-498.

[14] Carroll R. and W. Hrung (2005): 'What Does the Taxable Income Elasticity Say About Dynamic Responses to Tax Changes?', *American Economic Review*, no 95, pp. 426-431.

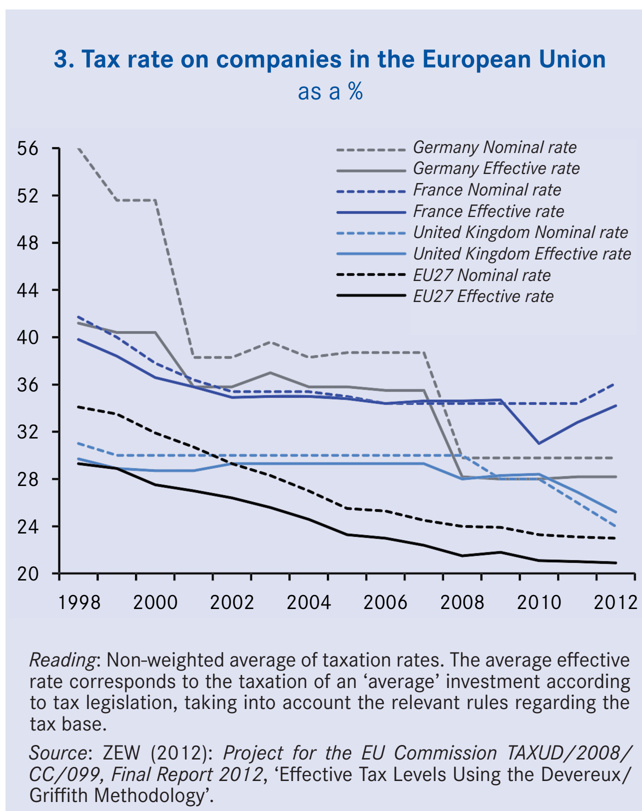
[15] *Cf*. Aarbu K.O. and T.O. Thoresen (2001): 'Income Responses to Tax Changes. Evidence from the Norwegian Tax Reform', *National Tax Journal*, no 54, pp. 319-335; Thoresen T.O. (2004): 'Reduced Tax Progressivity in Norway in the Nineties. The Effect from Tax Changes', *International Tax and Public Finance*, no 11, pp. 487-506; Blomquist S. and H. Selin (2010): 'Hourly Wage Rate and Taxable Labor Income Responsiveness to Changes in Marginal Tax Rates', *Journal of Public Economics*, no 94, pp. 878-889.

Optimisation between countries

In a world where internationally mobile capital is allocated in accordance with post-tax return, the taxation of capital income can become a key factor in an economy's ability to finance its growth.

Tax competition takes a different form depending on whether it applies to businesses or tax households. It would appear to be a given as far as businesses are concerned: lowering corporate tax rates by one percentage point would help attract around 3% in additional direct foreign investment[16]. In actual fact, the single European capital market seemed to bring with it a marked decrease in corporate income tax rates (Graph 3).

3. Tax rate on companies in the European Union
as a %

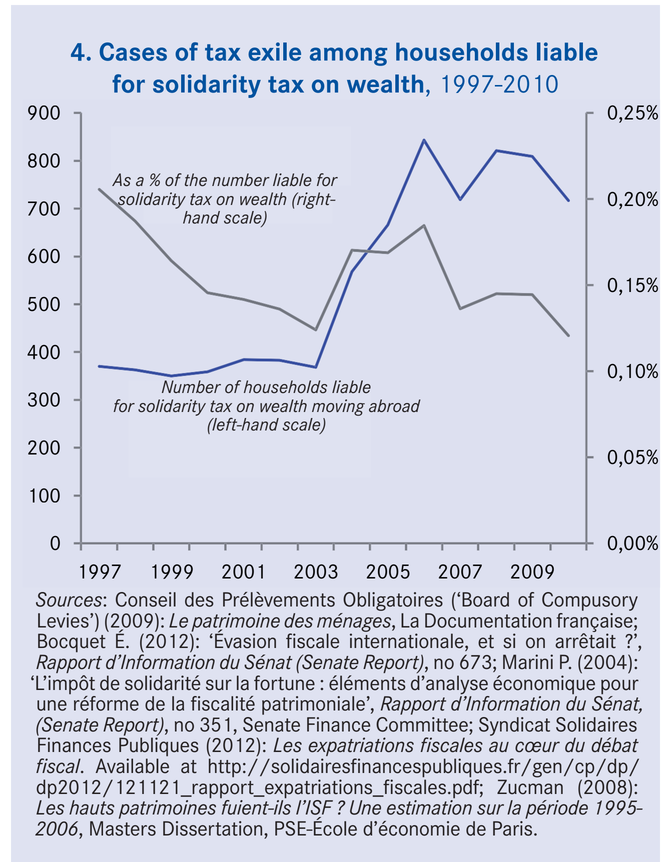


Reading: Non-weighted average of taxation rates. The average effective rate corresponds to the taxation of an 'average' investment according to tax legislation, taking into account the relevant rules regarding the tax base.

Source: ZEW (2012): *Project for the EU Commission TAXUD/2008/CC/099, Final Report 2012*, 'Effective Tax Levels Using the Devereux/Griffith Methodology'.

As far as households are concerned, the only legal way to take advantage of tax competition between countries is to physically move to a country that offers lower rates of taxation. With capital income highly concentrated at the upper end of the distribution scale, it is possible for developed countries to seek to attract these wealthy households by means of specific tax treatment systems without necessarily reducing the rate of taxation applied to the majority of their tax basis, which is considered to be less mobile. Assessing the extent of such cases of tax exile would require access to reliable ways of registering the arrivals and departures of French tax residents. Such data is not currently available. The only data published until 2010 related to the departure of taxpayers liable for solidarity tax on wealth (ISF), indicating an annual departure rate of around 800 households per year, that is 0.14% of the total number of taxpayers (Graph 4).

4. Cases of tax exile among households liable for solidarity tax on wealth, 1997-2010



Sources: Conseil des Prélèvements Obligatoires ('Board of Compusory Levies') (2009): *Le patrimoine des ménages*, La Documentation française; Bocquet É. (2012): 'Évasion fiscale internationale, et si on arrêtait ?', *Rapport d'Information du Sénat (Senate Report)*, no 673; Marini P. (2004): 'L'impôt de solidarité sur la fortune : éléments d'analyse économique pour une réforme de la fiscalité patrimoniale', *Rapport d'Information du Sénat, (Senate Report)*, no 351, Senate Finance Committee; Syndicat Solidaires Finances Publiques (2012): *Les expatriations fiscales au cœur du débat fiscal*. Available at http://solidairesfinancespubliques.fr/gen/cp/dp/dp2012/121121_rapport_expatriations_fiscales.pdf; Zucman (2008): *Les hauts patrimoines fuient-ils l'ISF ? Une estimation sur la période 1995-2006*, Masters Dissertation, PSE-École d'économie de Paris.

Few have attempted to assess the tax bases lost as a result of exile. Zucman (2008)[17] calculates the maximum losses at around 10% of ISF (solidarity tax on wealth) revenue —a figure that is significant yet moderate and above all incom plete, since it is limited to those households liable for solidarity tax on wealth, taking into account only a portion of their contributions, and disregards those returning from abroad. In order not to slip into either denial or exaggeration, it is important that the tax authorities be able to provide regular data regarding the extent of the departure (and indeed return) of French tax residents, their income and their assets.

The mobility of capital income also has an illegitimate aspect in the form of tax evasion, which has been estimated at a global figure of 8% of total household assets[18]. In the case of France, this corresponds to 200 billion euros in assets and an estimated annual tax loss of 10 billion euros.

[16] De Mooij R. S. and Ederveen (2003): 'Taxation and Foreign Direct Investment: A Synthesis of Empirical Research', *International Tax and Public Finance*, no 10, pp. 673-93.

[17] Zucman G.(2008): *Les hauts patrimoines fuient-ils l'ISF ? Une estimation sur la période 1995-2006*, Masters Dissertation, PSE-École d'économie de Paris.

[18] Zucman G. (2013): 'The Missing Wealth of Nations: Are Europe and the US Net Debtors or Net Creditors?', *Quarterly Journal of Economics*, no 128, pp. 1321-1364.

Ultimately, optimisation between capital income and earned income encourages a connection between the two forms of taxation, whilst international tax competition, on the other hand, exerts a certain pressure to decrease capital income tax rates, and particularly those applied to corporate income. The consequences for the taxation of capital income therefore vary according to the relative force of each form of optimisation.

Taxing investment income: a few basic principles

The principle of neutrality of treatment

Whilst the economic literature is rather ambiguous in terms of the optimal level of capital taxation, there is one point in particular that achieves a more general consensus, that being the fact that differences in the tax treatment of different types of income should be avoided[19].

This principle of neutrality is based on the idea whereby it is somewhat irrelevant to want to distort investment choices in favour of a particular savings product, since not only does this create a tax optimisation industry, which is itself a source of inefficiencies and loss of tax revenue, but it is also at risk of resulting in poor allocation of resources when it comes to financing the economy. In the case of France, there is a very marked tax incentive in favour of investment in property and life insurance.

In some cases, taking into account the fiscal course of each type of income can justify an apparently different type of treatment. If we consider that corporation tax is essentially a tax borne by business owners, then the tax already paid by the company on profits distributed should be attributed to dividends. This was, in fact, the idea behind the tax credit system (which was withdrawn in France in 2004) and what justifies the current deduction on dividend income (which currently stands at 40%).

The issue of capital appreciation is another fine example of what is at stake with a special tax treatment system. On the one hand, we want to avoid a situation of tax optimisation whereby profit is converted into capital appreciation (taxed at a lower rate than dividends). On the other hand, a capital appreciation that potentially represents several years' worth of gains cannot be incorporated into the annual progressive income tax calculation without adjustment. The neutral treatment of capital appreciation in relation to other capital income therefore involves spreading the gain over the effective period over which it is accumulated (1 year, 10 years, 15 years, etc.), adjusting it in relation to inflation then computing the tax payable from it. Such a mechanism is more efficient than a reduction system depending on the duration, which is likely to result in significant optimisation without necessarily resolving the actual problem of individuals achieving capital gains representing a working life and not the income generated in a year.

Taking inflation into account is another major issue, particularly when it is high and when considering savings income over the long term (see Box 2). Systematically taking it into account will help make the impact of taxation independent of the rate of inflation of the economy.

Exceptions to the principle of neutrality

Once the principle of neutrality of treatment has been established, it is reasonable to want to consider the exceptions that might justify a special regime. Generally-speaking, the State may wish to intervene to encourage an activity where the social return is greater than the private return. A significant degree of the heterogeneity of the French capital taxation system relates to a greater or lesser extent to the idea that the State can, by means of tax incentives, encourage an improved allocation of national savings. Such an approach nevertheless warrants discussion on a case-by-case basis.

Retirement savings

Retirement savings correspond perfectly well to the intertemporal smoothing of consumption. The principle of exempting retirement savings income from tax during their accumulation and taxing said income upon withdrawal (at the time the return is realised) would therefore appear entirely justified.

Property

As we have seen, the French tax system is particularly generous when it comes to ownership of fixed assets, with the commendable aim of encouraging households to secure a sustainable home. Conversely, economists agree that, of all the different forms of capital income, income received from property should be the most heavily taxed since the majority of this type of income is rent (ground rent) that can be taxed with no negative effect on the economy. It is therefore surprising that the French taxation system is more lenient on ground rent than it is on investment in productive and innovative activities. As for the paternalistic objective of a society of owners, this is questionable both because it reduces employment mobility and because it exposes households to potentially significant risks[20].

[19] For a discussion of tax shelters in France see Trannoy, A. (2012): *Il faut une révolution fiscale*, Eyrolles.

[20] This might, for example, apply to a small-town employee-owner whose primary business is closing. The employee simultaneously loses their job and suffers depreciation on their home.

The long-term financing of the economy

A number of special measures have been put in place with the clear aim of directing French citizens' savings towards long-term savings schemes in order to facilitate the stable financing of the economy. Such measures (life insurance, PEPs, capital gains rules and regulations, etc.) offer reduced rates of taxation depending on the length of time the asset in question has been held. There is, however, nothing evident about this approach. Indeed, there is no sound basis on which to conclude that there will be a problem financing the French economy in the long term. A comparison of French SMEs with their German, Spanish and Italian counterparts (Table 2) shows that French SMEs have greater equity and long-term debt than German and Italian companies. Furthermore, a recent study by Banque de France[21] of micro-economic data revealed no particular difficulties among French businesses when it came to accessing credit, with the possible exception of very young and/or very small companies.

2. Structure of SME liabilities
in 2010 as a % of the balance sheet

	Shareholders' equity	Accrual accounts and provision for liabilities	Long-term debt (> 1 year)		Short-term debt	
			Credit Ets	Other	Credit Ets	Other
Manufacturing industry						
France	41.5	3.6	10.2	9.0	2.9	32.8
Germany	38.5	13.1	7.9	3.6	7.4	29.5
Spain	42.1	4.8	11.7	5.7	8.5	27.2
Italy	34.4	6.6	9.2	3.5	15.3	31.0
Trade and commerce						
France	34.8	1.7	10.7	9.3	3.9	39.6
Germany	32.8	10.1	5.7	3.0	11.5	37.0
Spain	40.5	0.7	11.0	4.7	8.5	34.7
Italy	26.9	5.0	7.3	3.2	18.2	39.3

Sources: BdF, BACH ESD.

Admittedly, the new banking (Basel III) and insurance (Solvency II) regulations will constrain a large number of financial intermediation institutions (banks and insurance companies) in terms of their ability to invest in the long term and in high-risk assets. We might, nevertheless, doubt that the appropriate response would involve a special taxation system, firstly because the fiscal instrument makes it impossible to respond directly to the problem caused by intermediation constraints, and secondly because the current structure of the special taxation system applicable to capital income appears primarily to direct French citizens' savings towards property and low-risk life insurance investment rather than towards the long-term financing of companies. At December 1st 2012, the 1,562 billion euros managed by life insurance companies (53.4% of household financial assets) were invested in shares amounting to only 20.5%, as opposed to 67% in bonds or liquid assets[22]. There is not a great deal of difference between this composition and foreign pension funds, where the latter enjoy fiscal benefits linked primarily to retirement savings, which are, by definition, a very long-term commitment. It would appear, therefore, that the fiscal benefits enjoyed by life insurance products, which greatly exceed retirement savings products, are not necessarily favourable to the financing of businesses in general, with the possible exception of start-ups (*cf. below*). The only justification for a special taxation system would therefore be to encourage retirement savings, but that would require financial products to be appropriately structured to reflect this (pension payments).

Funding venture capital

It is important to encourage the emergence of new, innovative businesses (very small businesses or start-ups), the financing of which is a very high-risk activity, particularly during the very early stages, if we are to develop a breeding ground for future productive businesses. Such financing is provided by 'business angels' or venture capital, the return on which is based on the success of a minority of investments that offset the losses suffered on the majority of ventures. France, like a number of other European countries, is characterised by a very low level of investment in venture capital.

Among the various causes of this, the most significant factor is likely to be the low level of return on such investment, which is far inferior to that of the United States and the United Kingdom[23]. As a result, investors in France are largely attracted by tax incentives that enable them to deduct part of the amounts invested from their solidarity tax on wealth.

Having said that, the risk is then that you might attract financial investors rather than the desired 'business angels'[24]. In those countries that are the most advanced in this field,

[21] Kremp E. and P. Sevestre (2012): 'Did the Crisis Induce Credit Rationing for French SMEs?', Ban*que de France Working Paper*, no 405.

[22] *Cf*. Banque de France, www.banque-france.fr/fileadmin/statistiques/fr/base/html/cft_sct_fr_encours_actif_s125.html

[23] See the 'Fibamy' scale published by the Isaï funds and AFIC (2012): *Performance nette des acteurs français du capital investissement à fin 2011 : une comparaison internationale*. Bankruptcy law is also not very favourable in France; see Plantin G., D. Thesmar and J. Tirole (2013): 'Les enjeux économiques du droit des faillites', *Note du CAE*, no 7, June.

namely the United States and the United Kingdom, venture capital is largely funded by pension funds (see Table 3), which have the right time horizon to invest in such high-risk assets and are not subject to the same prudential constraints as banks and insurance companies. Both of these countries also offer tax incentives, but rather than allocating a tax credit from the outset, they focus on the capital appreciation associated with investment in unquoted SMEs, with rates decreasing to reflect the holding period[25].

3. Structure of investment capital fundraising in Europe in 2002-2010 as a % of the funds raised

	France	European Union	United Kingdom	United States(*)
Industrial investors	3.4	4.4	5.4	2.2
Private individuals	15.7	6.0	7.0	10.0
State bodies	6.3	7.7	9.5	–
Banks	20.6	14.3	11.0	12.5
Pension funds	14.3	22.2	29.0	41.8
Insurance companies	16.8	9.0	9.3	12.6
Universities	0.5	1.8	3.3	20.9
Funds of funds	14.0	14.2	17.3	–
Other	8.4	20.4	8.2	–

Note: (*) 2005 figures.
Sources : AFIC, BVCA, EVCA et NVCA.

Social housing and smoothing consumption (Livret A savings book)

Funding social housing by means of access to tax-free savings products (*Livret* A savings book) would appear to be an attempt to achieve two semi-contradictory aims; on the one hand, if the aim is to offer modest households a secure savings scheme with a good return to smooth their consumption, there is no reason why the capped amount of tax-free savings should be absorbed by a single investment object; on the other hand, if the aim is to fund social housing, the State could directly use its long-term capacity to borrow from the markets. This being the case, the recent increase in the cap on the *Livret A* ultimately provides social housing with a costly resource whilst inviting households that are comfortably off to reallocate their savings to a low-risk liquid investment.

Avenues for reform and recommendations

There are three lessons that emerge from our analysis: firstly, capital is subjected to a high level of taxation in France; secondly, the tax treatment of different types of capital income is very heterogeneous; thirdly, special tax measures seem somewhat unjustified. There are therefore two potential types of reform, these being, on the one hand, an overhaul of the entire taxation system, and on the other hand, a series of targeted adjustments to the current system.

Structural reform options

Recent reflection on capital taxation has resulted in a number of proposals being put forward for radical reforms that we shall outline below.

The *first approach*, put forward by the *Mirrlees Review* (*op.cit.*) for the case of the United Kingdom, involves taxing earned income and capital income at the same rate, net of a 'basic return'. This is the return on risk-free asset savings with the sole aim of achieving an intertemporal smoothing of consumption. Any return over and above this basis rate is included in the tax rate scale in the same way as earned income is.

This proposal would help smooth consumption at no fiscal cost whilst maintaining a common marginal rate of taxation for both earned and capital income, therefore eliminating incentives to optimise between the two types of income. The exemption from tax of the basic return, however, implies that high levels of income, resulting from a significant asset (an inheritance, for example) being invested at a low rate, can be entirely exempt from tax. In order to limit this problem, the *Mirrlees Review* suggests taxing the transmission of wealth between generations (successions and donations).

The *second approach* is the so-called 'dual taxation' system, which treats earned income (taxed according to a progressive scale) and capital income (subjected to a constant rate) in different ways. The introduction of the dual taxation system was one of the most striking changes witnessed in the field of European taxation over the course of the past twenty years; since 1991, Sweden has applied it at a rate of 30%, followed by Italy (20%), the United Kingdom (28%), Norway (28%) and Germany (30.5%). To a certain extent, the France of the pre-2013 Finance Bill days had something similar to this in the form of the withholding tax system.

The dual taxation system offers a number of advantages[26]. Its simplicity, for example, makes it possible to better evaluate the

[24] OECD (2011): *Financing High-Growth Firms: The Role of Angel Investors*, OECD Publishing.

[25] See *Centre d'Analyse Stratégique* (2011): '*Business angels* et capital-risque en France : les enjeux fiscaux', *Note d'Analyse du CAS*, no 237 and HM Revenue & Customs (2013): 'Enterprise Investment Scheme and Capital Gains Tax', *Helpsheet*, no 297.

[26] For a discussion, see Boadway R. (2005): 'Income Tax Reform for a Globalized World: The Case for a Dual Income Tax', *Journal of Asian Economics*, no 16, pp. 910-927.

net return on different investments. More specifically, the tax paid on an investment depends neither on returns on other investments nor on any salaries received. Both of these characteristics favour the correct allocation of resources. Another advantage relates to the homogenisation of the different types of capital income taxation. In a system incorporating multiple rates and a number of tax shelters, changes to the taxation system are difficult to comprehend and not very visible, which creates a degree of uncertainty among investors. The transparency of a single rate would require any fiscal modifications to be made perfectly visible. Governments are then more reluctant to frequently adjust rates and bases and the system becomes an instrument of commitment, which creates a more stable fiscal climate for both national and foreign investors.

The flaw in the system is that it reduces the overall progressiveness of the income tax system and can accentuate post-tax inequalities. This effect has indeed been observed in the Scandinavian countries[27]; the tax system in these countries does, nevertheless, still have a highly redistributive effect, with Sweden supporting the switch to the dual system with a reduction in employment taxation at the lower end of the income scale to offset the loss of progressiveness resulting from the proportional taxation of capital income.

A *third approach* involves the global taxation of all income, including both earned and capital, by means of a single progressive tax. This is the solution that has historically been put forward by economists Simon and Haig[28] who wanted as wide an income assessment basis as possible. It has, in fact, recently been reformulated to reflect the French situation[29]. If contribution deductions (and in particular pension contributions), which are considered to be compulsory savings rather than a tax like any other, are to be treated separately, the notion of global taxation is compatible with a heavier taxation of earned income than of capital income.

The choice between these various approaches depends on the empirical significance of certain behavioural reactions along with the desired level of redistribution:

- *tax optimisation*: in the case of optimisation between earned and capital income, a single rate for different sources of income would be optimal; if, on the other hand, the international mobility of the capital is the primary concern, a more moderate rate for capital income might be preferable;
- *preferences*: the desire for redistribution plays a fundamental role since, generally-speaking, the dual system has a less redistributive effect. On the other hand, in the event that fiscal harmonisation at European level is a primary objective, the dual system might facilitate such standardisation;
- *intertemporal transfers*: facilitating the smoothing of consumption over the course of the life cycle is the key factor behind the idea of a non-taxable basic return. In the case of France, the compulsory pension scheme is responsible for the majority of smoothing for a significant proportion of households, in such a way that this aspect is, in fact, less significant;
- *intergenerational transfers*: the difficulty to tax succession at very high level makes the issue of taxing capital income obtained following a succession all the more significant. The system whereby a basic return is exempt from tax enables this income to completely escape taxation provided that it is invested in returns that are equal or inferior to the basic return, whereas it is still taxed in the case of the dual system and in the case of the integrated taxation of all income.

The three schemes outlined can, of course, be amended to offset their less desirable aspects, by exempting from tax not the basic return but the return that offsets inflation, for example, or by introducing an initial non-taxable capital income bracket into a dual taxation system.

Specific recommendations

The French capital taxation system would benefit from a number of targeted reforms to the current system. Our specific recommendations can be put into practice in the short-term independently of the decisions made regarding a more substantial global tax reform. There are three aspects that we would consider essential, these being a reduction in the heterogeneity of tax treatments, a clarification of the taxation of savings in the long term and the taxation of actual returns rather than nominal returns. This would help free up the tax revenue required to lower rates.

General recommendation. To reduce the heterogeneity of capital income taxation. To limit exemptions to situations in which the externality is firmly established and linked to the investment in question.

Two types of investment enjoy a particularly favourable tax treatment, these being life insurance and property. In the case of life insurance, we do not consider the objective of financing the economy to be a sufficiently sound argument to justify exemption from tax. The exemption of retirement savings, on the other hand, is justified with regards to the intertemporal smoothing of consumption. We would suggest limiting

[27] García-Peñalosa C. and E. Orgiazzi, E. (2013): 'Factor Components of Inequality: Cross-country Differences and Time Changes', *Review of Income and Wealth*, yet to be published.

[28] See Haig R.M. (1921): 'The Concept of Income. Economic and Legal Aspects' in *The Federal Income Tax*, Haig (ed.), Columbia University Press and Simons, H.C. (1938): *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy*, University of Chicago Press.

[29] Landais C., T. Piketty and E. Saez (2010): *Pour une révolution fiscale*, Le Seuil, coll. La République des idées.

tax exemption measures to the latter savings motive. Property, meanwhile, accumulates distortions. Not only does investment in property often benefit from a special taxation system (*cf*. above), but imputed rental income, which owner-occupiers would have to pay if they were tenants, is exempt from tax, despite the fact that it constitutes a form of capital income[30].

Recommendation 1. To limit the fiscal benefits of life insurance schemes to pension payments, thus ensuring that it does indeed relate to retirement savings.

Recommendation 2. To increase the taxation of property and tax net imputed rental income. Failing this, to update rental values to bring property tax in line with the actual value of the property in question.

The taxation of implicit rental income should take into account any potential indebtedness on the part of the owner-occupier, meaning that only rental income net of loan interest will be taxed, with the possibility of the loss being carried forward in the event of interest exceeding rental income.

Furthermore, the taxation of capital appreciation must be made more neutral in relation to other forms of income and other types of investment. On the one hand, it is important to avoid the type of tax optimisation that involves converting profit into capital appreciation, and on the other, the duration of the investment should simply be taken into account without creating a tax shelter.

Recommendation 3. To tax real capital appreciation (and not nominal) and annualising it prior to incorporating it into the income tax scale.

The total rate of inflation for the holding period will be calculated and deducted from the nominal gain to obtain a real gain, which will then be taxed. The holding period will only become significant when it comes to taking into account the rate of inflation and the annualisation of the gain, which will determine the tax rate scale.

As far as savings books are concerned, we would consider it appropriate to separate the objective of smoothing consumption (for modest households) from the objective of funding social housing or other investments with a high rate of social return.

Recommendation 4. To gradually phase out special tax-exempt savings schemes, separating capped non-taxable savings schemes from the funding of investments with a high rate of social return.

Ultimately, the information that is currently available does not enable a comparison to be made between the risks of optimisation between different types of income and the risks associated with international optimisation, which makes the choice of taxation system a somewhat delicate one.

Recommendation 5. To systematically publish statistical data relating to the arrival and departure of tax residents in order to assess the extent of the tax exile phenomenon and its actual consequences for public finance.

Whilst these recommendations can indeed be applied relatively quickly, they should not be considered a substitution for more comprehensive reflection on the taxation of capital income in France. Indeed, our system indicates significant margins for improvement in terms of legibility, efficiency and equity. ●

[30] In addition to the distortion relating to other savings media, the exemption of imputed rental income distorts the choice between rental and ownership. See Trannoy A. and E. Wasmer (2013): 'Comment modérer les prix de l'immobilier', *Note du CAE*, no 2, February.

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