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**Article**

## Towards Dual Income Taxes - a Country Comparative Perspective

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## TOWARDS DUAL INCOME TAXES – A COUNTRY-COMPARATIVE PERSPECTIVE

MARGIT SCHRATZENSTALLER\*

Many western European countries have been moving away from comprehensive towards dual income tax systems since the middle of the 1980s. Within a comprehensive system of income taxation all forms and sources of income are (or should be) subject to the same – mostly progressive – income tax schedule. By contrast, a dual income tax system treats capital income and non-capital (labour) income differently. Moreover, in the pure form of a dual income tax system the capital income and the corporate income tax rate are identical, and no exemptions are granted (Cnossen 1997).

In the existing dualised income tax systems, as a rule, income from (employed or self-employed)

labour is subject to a progressive tax schedule, while some or all capital income (interest, dividends and realised capital gains<sup>1</sup>) is taxed at lower and proportional rates. Pioneers of dual income taxation were the northern countries (Denmark 1987,<sup>2</sup> Sweden 1991, Norway 1992, Finland 1999; Cnossen 1999), as well as Austria 1993–96 (Fehr 2002). Also many central and east European countries (CEEC) introduced dualised income tax systems in the course of the transformation process. This article surveys the current design of income tax systems in the 15 established EU member states, in the ten central and east European accession countries, as well as in the US, Japan and Switzerland. The focus is on capital income taxation and, thus, on the degree of dualisation. Moreover, the article discusses some equity and efficiency implications of dual income taxes.



### Taxation of private capital income in comparison

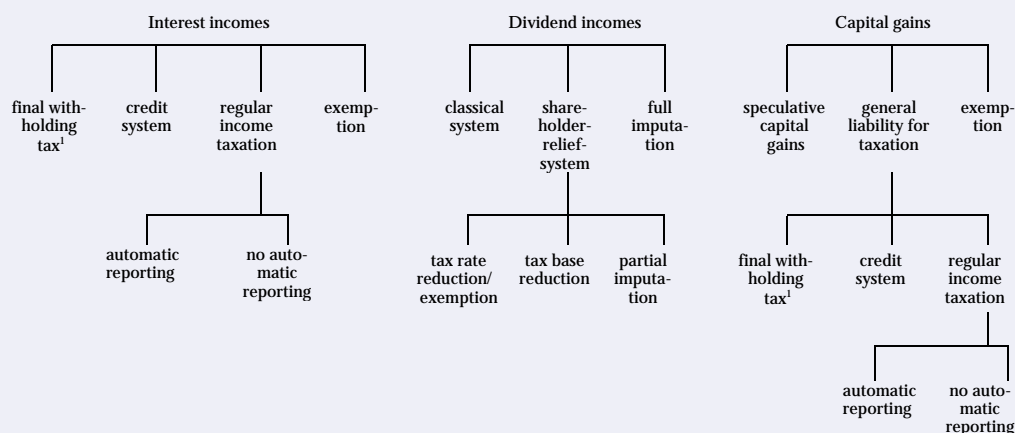
Figure 1 contains a classification of the existing systems of the taxation of capital income (interest

<sup>1</sup> The existing income tax systems only tax realised capital gains, if at all.

<sup>2</sup> In Denmark, however, progressive elements were re-introduced into capital income taxation soon after the reform of personal income taxation.

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#### Systems of capital income taxation



<sup>1</sup> In some cases option for regular income taxation.

Source: author.

Table 1

Interest taxation in Europe, the US, and Japan in 2002<sup>a)</sup>

|     | Residents             |                    |                                      |                     | Non-residents <sup>b)</sup> |  |
|-----|-----------------------|--------------------|--------------------------------------|---------------------|-----------------------------|--|
|     | source tax %          | max. %             | System of interest taxation          | automatic reporting | source tax %                | Internat. information exchange <sup>c)</sup> |
| B   | 15                    | 15                 | Final withholding tax <sup>d)</sup>  | No                  | -                           | No   |
| DK  | -                     | 59 <sup>e)</sup>   | Regular income tax.                  | Yes (1977)          | -                           | Diverse                                      |
| D   | 30/35 <sup>d)</sup>   | 51.2 <sup>e)</sup> | Credit system                        | No                  | -                           | No   |
| FIN | 29                    | 29                 | Final withholding tax <sup>d)</sup>  | Yes                 | -                           | DTA partners                                 |
| F   | 25                    | 25                 | Final withholding tax <sup>d)</sup>  | Yes (1984)          | 15 <sup>g)</sup>            | Diverse                                      |
| GR  | 15 <sup>h)</sup>      | 15                 | Final withholding tax                | No                  | 15 <sup>g)</sup>            | No   |
| GB  | 20                    | 40 <sup>e)</sup>   | Credit system                        | Yes (1952)          | 20 <sup>g)</sup>            | Diverse                                      |
| IRL | 20 <sup>h)</sup>      | 42 <sup>e)</sup>   | Credit system                        | Yes (1992)          | 20 <sup>g)</sup>            | No   |
| I   | 12.5/27 <sup>g)</sup> | 12.5/27            | Final withholding tax                | No                  | 12.5/27 <sup>g)</sup>       | No   |
| LUX | -                     | 39 <sup>e)</sup>   | "pure" reg. income tax.              | No                  | -                           | No   |
| NL  | -                     | - <sup>i)</sup>    | Regular income tax.                  | Yes (1987)          | -                           | No   |
| A   | 25                    | 25                 | Final withhold. tax <sup>d) j)</sup> | No                  | -                           | No   |
| P   | 20                    | 20                 | Final withhold. tax <sup>d) k)</sup> | No                  | 20 <sup>g)</sup>            | No   |
| S   | 30                    | 30                 | Final withholding tax                | Yes (1986)          | -                           | Diverse                                      |
| E   | 18                    | 48 <sup>e)</sup>   | Credit system                        | Yes (1985)          | 18 <sup>g)</sup>            | No   |
| BG  | 15                    | 15                 | Final withholding tax                | No                  | 15                          | n.a.   |
| EST | - <sup>l)</sup>       | 0                  | Exemption                            | No                  | - <sup>l)</sup>             | n.a.   |
| LV  | 5 <sup>d)</sup>       | 5                  | Final withholding tax                | No                  | 5 <sup>d)</sup>             | n.a.   |
| LT  | 15 <sup>m)</sup>      | 15                 | Final withholding tax                | No                  | 15                          | n.a.   |
| PL  | 20                    | 20                 | Final withholding tax                | No                  | 20                          | No   |
| RO  | 10                    | 10                 | Final withholding tax                | No                  | 10                          | n.a.   |
| SK  | 15                    | 15                 | Final withholding tax                | No                  | 15                          | No   |
| SLO | 25                    | 50                 | Credit system                        | No                  | 25                          | n.a.   |
| CZ  | 15                    | 15                 | Final withholding tax                | No                  | 15                          | No   |
| H   | 18 <sup>n)</sup>      | 18                 | Final withholding tax                | No                  | 18                          | No   |
| CH  | 35                    | 41 <sup>e)</sup>   | Credit system                        | No                  | 35                          | No   |
| J   | 20                    | 20                 | Final withholding tax <sup>d)</sup>  | Yes                 | 15                          | Diverse                                      |
| USA | -                     | 44.8 <sup>e)</sup> | Regular income tax.                  | Yes                 | 30 <sup>g)</sup>            | Canada                                       |

<sup>a)</sup> For interest from fixed-interest securities; with a few exceptions also for deposits at financial institutes. - <sup>b)</sup> In double taxation agreements (DTA) differing source taxes may be stipulated. - <sup>c)</sup> For interest payments by banks. - <sup>d)</sup> Option for regular income taxation. - <sup>e)</sup> Top income tax rate including surcharges. - <sup>f)</sup> 35% for interest from OTC-securities. - <sup>g)</sup> Several special rates and exemptions for interest from specific bonds or accounts partly reserved for non-residents. - <sup>h)</sup> No source tax on interest from specific government bonds. - <sup>i)</sup> No actual income tax but tax rate of 30% on a fictitious return of net property; factitiously therefore 1.2% on net property (i.e. property tax instead of income tax. - <sup>j)</sup> Final taxation also with respect to estate tax for specific interest incomes. - <sup>k)</sup> For interest from specific fixed-interest securities increase by 5% (substitute for estate tax). - <sup>l)</sup> 26% (Estonia), 10% (Lithuania) for interest payments by foreign banks. - <sup>m)</sup> No source tax on interest payments by foreign banks or international institutions. - <sup>n)</sup> No source tax by interest from government bonds or from the national bank.

Sources: PriceWaterhouseCoopers (1999); Lenain and Bartoszek (2000); Huizinga and Nicodème (2001); Ministry of Finance (2002); Martinez-Serrano and Patterson (2003); national tax codes.

and dividend income as well as realised capital gains<sup>3)</sup> accruing to private households.

In the group of countries considered four different interest taxation regimes can be distinguished (Figure 1 and Table 1).

A majority of the old and new member countries as well as Japan tax interest income at source, applying a relatively low final withholding tax rate. In some of these countries taxpayers may opt for regular income taxation.<sup>4</sup> Estonia is the only country that as a rule fully exempts interest

income from taxation. The other countries examined include interest income in regular income taxation, often applying a withholding tax which can be credited against the assessed income tax liability (credit system). If not, the taxation regime can be characterised as a regular income taxation system. If there is no system of automatic reporting which secures taxation by obliging the interest-paying institution to inform the tax authorities about interest payments to domestic residents (as in Denmark), such a system of "pure" regular income taxation enables investors to escape taxation (e.g. by holding capital abroad). A credit system without automatic reporting offers the possibility of partially avoiding taxes to the extent that the personal income tax rate exceeds the withholding tax rate.

<sup>3</sup> Other capital incomes, e.g. rent or leasing incomes, are neglected.

<sup>4</sup> This option is more favourable for taxpayers whose personal income tax rate is lower than the rate of the final withholding tax.

Table 2

## Dividend taxation in Europe, the US, and Japan in 2002

|     | CIT<br>% <sup>a) b)</sup> | System of dividend taxation                                | Residents                               |                      |                   | Non-residents<br>source tax<br>% <sup>e)</sup> |
|-----|---------------------------|--|---|----------------------|-------------------|--|
|     |                           |  | With-<br>holding<br>tax % <sup>c)</sup> | Max. % <sup>d)</sup> | Aut.<br>reporting |  |
| B   | 40.2                      | Shareholder Relief (tax rate reduction)                    | 25 <sup>f)</sup>                        | 55.2                 | No                | 25   |
| DK  | 30                        | Shareholder Relief (tax rate reduction)                    | 28/43 <sup>g)h)</sup>                   | 60.1                 | Yes               | 28   |
| D   | 26.4                      | Shareholder Relief (tax base reduction) <sup>i)</sup>      | 26.4                                    | 44.2                 | No                | 26.4   |
| FIN | 29                        | Full imputation  | -                                       | 29                   | No                | -  |
| F   | 35.4                      | Full imputation  | -                                       | 60.8                 | Yes               | 25   |
| GR  | 37.5                      | Shareholder Relief (tax exemption)                         | -                                       | 37.5                 | No                | -  |
| GB  | 30                        | Shareholder Relief (part.imp.+tax rate red.) <sup>j)</sup> | -                                       | 47.5                 | No                | -  |
| IRL | 16                        | Classical  | -                                       | 51.3                 | No                | -  |
| I   | 36 <sup>k)</sup>          | Full imputation  | 12.5 <sup>l)</sup>                      | 46.2                 | No                | 27   |
| LUX | 22.9                      | Shareholder Relief (Tax base reduction) <sup>i)</sup>      | 20                                      | 37.9                 | No                | 20   |
| NL  | 34.5                      | Shareholder Relief (tax rate reduction) <sup>m)</sup>      | 25                                      | 50.9                 | No                | 25   |
| A   | 34 <sup>k)</sup>          | Shareholder Relief (tax rate reduction)                    | 25 <sup>n)</sup>                        | 50.5                 | No                | 25   |
| P   | 30                        | Shareholder Relief (Tax base reduction) <sup>i)</sup>      | 20 <sup>o)</sup>                        | 44                   | No                | 20   |
| S   | 28                        | Shareholder Relief (tax rate reduction)                    | 30 <sup>f)</sup>                        | 49.6                 | Yes               | 30   |
| E   | 35                        | Shareholder Relief (Teilanrechnung)                        | 18                                      | 49.3                 | No                | 18   |
| BG  | 15                        | Shareholder Relief (tax rate reduction)                    | 15 <sup>f)</sup>                        | 27.8                 | n.a.              | 15   |
| EST | 26 <sup>p)</sup>          | Full imputation  | -                                       | 26                   | n.a.              | 26   |
| LV  | 22                        | Shareholder Relief (tax exemption)                         | -                                       | 22                   | n.a.              | 10   |
| LT  | 15                        | Shareholder Relief (tax rate reduction)                    | 29 <sup>f)</sup>                        | 39.7                 | n.a.              | 29   |
| PL  | 28                        | Shareholder Relief (tax rate reduction)                    | 15 <sup>f)</sup>                        | 38.8                 | n.a.              | 15   |
| RO  | 25                        | Shareholder Relief (tax rate reduction)                    | 5 <sup>f)</sup>                         | 28.8                 | n.a.              | 5  |
| SK  | 25                        | Shareholder Relief (tax rate reduction)                    | 15 <sup>f)</sup>                        | 36.3                 | n.a.              | 15   |
| SLO | 25                        | Shareholder Relief (Tax base reduction) <sup>q)</sup>      | 25                                      | 47.5                 | n.a.              | 15   |
| CZ  | 31                        | Shareholder Relief (tax rate reduction)                    | 15 <sup>f)</sup>                        | 41.4                 | n.a.              | 15   |
| H   | 18                        | Shareholder Relief (tax rate reduction)                    | 20 <sup>r)</sup>                        | 34.4                 | n.a.              | 20   |
| CH  | 25 <sup>s)</sup>          | Classical  | 35                                      | 55.8                 | No                | 35   |
| J   | 35.2                      | Shareholder Relief (partial imputation)                    | 20 <sup>u)</sup>                        | 57.9                 | No                | 20   |
| USA | 39.9                      | Classical  | -                                       | 66.8                 | Yes               | 30   |

<sup>a)</sup> Corporate income tax (CIT) rates including surcharges, excluding local business taxes. - <sup>b)</sup> In the CEEC often special tax rates in special economic zones apply. - <sup>c)</sup> Withholding tax; credited against personal income taxes if not noted otherwise (see also footnote 6). - <sup>e)</sup> Maximum combined statutory tax rate, resulting from CIT on distributed dividends and personal income tax of shareholder. - <sup>f)</sup> In double taxation agreements (DTA) differing source taxes may be stipulated. - <sup>g)</sup> Final withholding tax. - <sup>h)</sup> Final withholding tax; option for regular income taxation. <sup>h)</sup> 28% for dividends up to 29.700 dKr; 43% for higher dividends. - <sup>i)</sup> 50% of dividends are tax exempt for the shareholder („half-income system“). - <sup>j)</sup> Credit with 1/9 of dividend; income tax rate 10% for low incomes, 32,5% for higher incomes on dividend including tax credit. - <sup>k)</sup> Special tax rate 19% in Italy, 25% in Austria on that part of profits which corresponds to the market interest rate of additional equity capital. - <sup>l)</sup> Option for final withholding tax instead of full imputation for minor holdings. - <sup>m)</sup> 25% income tax for substantial holdings, otherwise lump-sum-taxation. - <sup>n)</sup> Final withholding tax or option for reduction of income tax rate to half of the regular income tax rate („half-tax rate-system“). - <sup>o)</sup> 9% for listed shares; increase by further 5% (substitute for estate tax). - <sup>p)</sup> Non-distributed profits are exempt from CIT. - <sup>q)</sup> 40% of dividends are tax exempt for the shareholder. - <sup>r)</sup> 35% for "excessive" dividends. - <sup>s)</sup> Average tax rate. - <sup>t)</sup> Option for withholding tax of 35%. - <sup>u)</sup> Crediting of 6.4% to 12.8% of distributed dividends.

Sources: PriceWaterhouseCoopers (1999); Lenain and Bartoszek (2000); Federal Ministry of Finance (2002); Mitra and Stern (2003); Mennel and Förster (no year); national tax codes; own calculations.

### Taxation of dividend income

Table 2 provides an international comparison of the taxation of dividends distributed to private investors.

The effective statutory tax rate for distributed dividends is determined by the interaction of corporate and personal income taxation. In pure "classical" systems dividends are double-taxed: on the corporate level (corporate income taxation) and on the shareholder level (personal income taxation). The effective combined statutory tax rate on distributed

profits depends on the levels of the corporate and the personal income tax rate. So-called shareholder-relief-systems alleviate or avoid double taxation at the shareholder level: double taxation can be mitigated by allowing the shareholder to credit a certain share of the corporate income tax against his personal income taxes (partial imputation system), by taxing distributed dividends at reduced tax rates (tax rate reduction) or by taxing only a part of distributed dividends (tax base reduction).

Double taxation is completely avoided by full tax exemption of distributed profits at the shareholder

Table 3

**Maximum statutory tax rates in percent for private realised capital gains from financial investment in Europe, the US, and Japan in 2002**

|     | Speculative capital gains <sup>a)</sup> | General tax liability               | automatic reporting |
|-----|---|-------------------------------------|---------------------|
| B   | –                                       | 17 <sup>b)</sup> /34 <sup>g)</sup>  | No                  |
| DK  | 28/43 <sup>d)e)</sup> (3 years)         | 28/43 <sup>d)h)</sup>               | No                  |
| D   | 25.6 <sup>g)</sup> (1 year)             | –                                   | No                  |
| FIN | –                                       | 29 <sup>d)</sup>                    | No                  |
| F   | –                                       | 16 <sup>d)</sup>                    | No                  |
| GR  | –                                       | –                                   | –                   |
| GB  | 40 <sup>h)</sup> (2 years)              | up to 38 <sup>b)</sup>              | No                  |
| IRL | –                                       | 20 <sup>d)j)</sup>                  | No                  |
| I   | –                                       | 27 <sup>2</sup> /12.5 <sup>d)</sup> | No                  |
| LUX | 39 <sup>h)</sup> (6 months)             | 39 <sup>b)h)</sup>                  | No                  |
| NL  | –                                       | 25 <sup>b)d)</sup>                  | Yes                 |
| A   | 25 <sup>k)</sup> (1 year)               | 25 <sup>b)k)</sup>                  | No                  |
| P   | 10 <sup>c)</sup> (1 year)               | –                                   | No                  |
| S   | –                                       | 30 <sup>d)</sup>                    | No                  |
| E   | – (2 years <sup>l)</sup> )              | 17 <sup>d)</sup>                    | No                  |
| BG  | –                                       | 10 <sup>d)</sup>                    | n.a.                |
| EST | –                                       | 26 <sup>d)</sup>                    | n.a.                |
| LV  | –                                       | –                                   | –                   |
| LT  | 10 <sup>d)</sup> (1 year)               | –                                   | n.a.                |
| PL  | –                                       | –                                   | –                   |
| RO  | –                                       | –                                   | –                   |
| SK  | –                                       | 38 <sup>h)</sup>                    | n.a.                |
| SLO | –                                       | 50 <sup>h)</sup>                    | n.a.                |
| CZ  | 15 <sup>d)</sup> (6 months)             | –                                   | n.a.                |
| H   | –                                       | 20 <sup>d)</sup>                    | n.a.                |
| CH  | –                                       | –                                   | –                   |
| J   | 20 <sup>d)</sup> (5 years)              | 10 <sup>d)g)m)</sup>                | No                  |
| USA | 44.8 <sup>h)</sup> (1 year)             | up to 20 <sup>n)</sup>              | Yes                 |

<sup>a)</sup> Tax rates for capital gains realised from securities held for a specified period of time only (“speculative” capital gains); in brackets the “speculative” period of time. – <sup>b)</sup> For substantial holdings (defined differently across countries). – <sup>c)</sup> Final withholding tax or option for regular income taxation. – <sup>d)</sup> Final withholding tax. – <sup>e)</sup> 28% for capital gains up to 39,700 dKř; 43% for higher capital gains. – <sup>f)</sup> Non-listed shares: 28% for capital gains up to 39,700 dKř, 43% for higher capital gains; listed shares: tax allowance up to a market value of the shares of 125,100 dKř, for a higher market value 28% on capital gains up to 39,700 dKř, 43% for higher capital gains. – <sup>g)</sup> 50% of capital gains (“half-income system”), i.e. statutory tax rate 51.2% (Germany) and 20% (Japan). – <sup>h)</sup> Top income tax rate. – <sup>i)</sup> After two years continuous reduction of tax liable part of capital gains in yearly 5%-steps to 60% after ten years. – <sup>j)</sup> Capital gains from government bonds are tax exempt. – <sup>k)</sup> Half average income tax rate (“half-tax-rate-system”). – <sup>l)</sup> Out of the following two tax rates, the higher one applies: average tax rate resulting from applying the income tax schedule to 50% of capital gains; mean of tax rate. – <sup>m)</sup> Capital gains from government bonds and obligations are tax exempt. – <sup>n)</sup> 20%/10% final withholding tax between 12 months and 5 years; 18%/8% final withholding tax afterwards (the lower tax rate applies if the other incomes are taxed at the basic tax rate).

Sources: Mennel and Förster (n.y.); Lenain and Bartoszuk (2000); national tax codes.

level. Full imputation systems subject distributed dividends fully to personal income taxation; as corporate income taxes are fully credited against personal income taxes, however, dividends are taxed at the shareholder’s personal income tax rate.

Shareholder-relief-systems dominate in the country group examined. The number of countries with a pure classical system (Ireland, Switzerland and the US) as well as with a full imputation system (Finland, France, Italy and Estonia) has decreased in the past.<sup>5</sup> To prevent or at least to restrict tax eva-

sion a number of countries levy a source tax on distributed income which is either credited against personal income tax or operates as final withholding tax. It is striking that almost all CEEC apply relatively low final withholding taxes. In systems without final withholding taxes comprehensive taxation of dividends requires automatic reporting of dividend income to the tax authorities, which, however, has been established in only a few countries.

In pure classical systems the maximum combined statutory dividend income tax rate for the shareholder always exceeds the regular top income tax rate. This also holds for some of the existing shareholder-relief-systems. In contrast to interest income taxation, final withholding taxes do not necessarily reduce the tax burden on dividend income (due to the prior encumbrance with corporate taxes), but may only limit double taxation (e.g. Czech Republic).<sup>6</sup> Only full imputation systems equalise regular income tax and dividend tax rates.

#### *Taxation of private capital gains*

Table 3 informs about the taxation of private capital gains in the group of countries investigated.

Only a minority of countries leave capital gains fully untaxed.

In some countries liability for as well as level of taxation are dependent on the volume of the shares held and/or the duration of the financial engagement. In these cases often only so-called speculative capital gains are taxed. Almost all countries that generally tax capital gains have relatively low final withholding taxes. Automatic

<sup>5</sup> For an overview over the design of corporate income tax systems in the OECD countries in the middle of the 1980s, see Hagemann, Jones and Montador (1987); for the late 1990s see OECD (2001).

<sup>6</sup> Other tax exceptions for capital incomes, e.g. tax allowances or the exemption of certain investments (particularly for old age pension schemes), are neglected.

Table 4

## Maximum statutory tax rates in % for different kinds of incomes for residents in Europe, the US, and Japan in 2002

|                                   | top income<br>tax rate<br>% (1) | interest<br>incomes<br>% | dividend<br>incomes<br>% | capital gains<br>% <sup>a)</sup> | mean max. income<br>tax rate on capital<br>incomes <sup>b)</sup> % (2) | Diff.<br>(2) - (1) <sup>c)</sup> |
|-----------------------------------|---------------------------------|--------------------------|--------------------------|----------------------------------|--|----------------------------------|
| B                                 | 59.7                            | 15 <sup>d)</sup>         | 55.2 <sup>d)</sup>       | 17 <sup>d)</sup>                 | 29.1   | -20.6                            |
| DK                                | 59                              | 59                       | 60.1 <sup>d)</sup>       | 43 <sup>d)</sup>                 | 54   | -5                               |
| D                                 | 51.2                            | 51.2                     | 44.2                     | 0                                | 31.8   | -19.4                            |
| FIN                               | 52.5                            | 29 <sup>d)</sup>         | 29                       | 29 <sup>d)</sup>                 | 29   | -23.9                            |
| F                                 | 60.8                            | 25 <sup>d)</sup>         | 60.8                     | 16 <sup>d)</sup>                 | 33.9   | -26.9                            |
| GR                                | 40                              | 15 <sup>d)</sup>         | 37.5                     | 0                                | 17.5   | -22.5                            |
| GB                                | 40                              | 40                       | 47.5                     | 24                               | 37.2   | -2.8                             |
| IRL                               | 42                              | 42                       | 51.3                     | 20 <sup>d)</sup>                 | 37.8   | -4.2                             |
| I                                 | 46.2                            | 27 <sup>d)</sup>         | 46.2                     | 27 <sup>d)</sup>                 | 33.4   | -12.8                            |
| LUX                               | 39                              | 39                       | 37.9                     | 39                               | 38.6   | -0.4                             |
| NL                                | 52                              | -                        | 50.9                     | 25 <sup>d)</sup>                 | 37.8   | -14.2                            |
| A                                 | 50                              | 25 <sup>d)</sup>         | 50.5                     | 25                               | 33.5   | -16.5                            |
| P                                 | 40                              | 20 <sup>d)</sup>         | 44 <sup>d)</sup>         | 0                                | 21.3   | -18.7                            |
| S                                 | 56                              | 30 <sup>d)</sup>         | 49.6 <sup>d)</sup>       | 30 <sup>d)</sup>                 | 36.5   | -19.5                            |
| E                                 | 48                              | 48                       | 49.3                     | 17 <sup>d)</sup>                 | 38.1   | -9.9                             |
| <i>Average EU-15<sup>f)</sup></i> | <i>49.1</i>                     | <i>31</i>                | <i>47.6</i>              | <i>20.8</i>                      | <i>33.9</i>  | <i>-15.2</i>                     |
| <i>Median</i>                     | <i>50</i>                       | <i>29.5</i>              | <i>49.3</i>              | <i>24</i>                        | <i>33.9</i>  | <i>-</i>                         |
| <i>Standard deviation</i>         | <i>7.4</i>                      | <i>13.3</i>              | <i>8.2</i>               | <i>12.7</i>                      | <i>8</i>   | <i>-</i>                         |
| BG                                | 38                              | 15 <sup>d)</sup>         | 27.8 <sup>d)</sup>       | 10 <sup>d)</sup>                 | 17.6   | -20.4                            |
| EST                               | 26 <sup>d)</sup>                | 0                        | 26                       | 26 <sup>d)</sup>                 | 17.3   | -8.7                             |
| LV                                | 25 <sup>d)</sup>                | 5 <sup>d)</sup>          | 22                       | 0                                | 9  | -16                              |
| LT                                | 33 <sup>d)</sup>                | 15 <sup>d)</sup>         | 39.7 <sup>d)</sup>       | 0                                | 18.2   | -14.8                            |
| PL                                | 40                              | 20 <sup>d)</sup>         | 38.8 <sup>d)</sup>       | 0                                | 19.6   | -20.4                            |
| RO                                | 40                              | 10 <sup>d)</sup>         | 2.8.8 <sup>d)</sup>      | 0                                | 12.9   | -27.1                            |
| SK                                | 38                              | 15 <sup>d)</sup>         | 36.3 <sup>d)</sup>       | 38                               | 29.8   | -8.2                             |
| SLO                               | 50                              | 50                       | 47.5                     | 50                               | 49.2   | -0.8                             |
| CZ                                | 32                              | 15 <sup>d)</sup>         | 41.4 <sup>d)</sup>       | 0                                | 18.8   | -13.2                            |
| H                                 | 40                              | 18 <sup>d)</sup>         | 34.4 <sup>d)</sup>       | 20 <sup>d)</sup>                 | 24.1   | -15.9                            |
| <i>Average CEEC<sup>e)</sup></i>  | <i>36.2</i>                     | <i>16.3</i>              | <i>34.3</i>              | <i>14.4</i>                      | <i>21.7</i>  | <i>-14.5</i>                     |
| <i>Median</i>                     | <i>38</i>                       | <i>15</i>                | <i>35.4</i>              | <i>5</i>                         | <i>18.5</i>  | <i>-</i>                         |
| <i>Standard deviation</i>         | <i>7.1</i>                      | <i>12.6</i>              | <i>7.5</i>               | <i>17.5</i>                      | <i>10.6</i>  | <i>-</i>                         |
| CH                                | 41                              | 41                       | 55.8                     | 0                                | 32.3   | -8.7                             |
| J                                 | 50                              | 20 <sup>d)</sup>         | 57.9                     | 10 <sup>d)</sup>                 | 29.3   | -20.7                            |
| USA                               | 44.8                            | 44.8                     | 66.8                     | 18                               | 43.2   | -1.6                             |
| <i>Average all<sup>e)</sup></i>   | <i>44.1</i>                     | <i>26.2</i>              | <i>44.2</i>              | <i>17.2</i>                      | <i>29.7</i>  | <i>-14.4</i>                     |
| <i>Median</i>                     | <i>41.5</i>                     | <i>25</i>                | <i>45.2</i>              | <i>17.5</i>                      | <i>30.8</i>  | <i>-</i>                         |
| <i>Standard deviation</i>         | <i>9.2</i>                      | <i>15.3</i>              | <i>11.3</i>              | <i>14.7</i>                      | <i>10.7</i>  | <i>-</i>                         |

<sup>a)</sup> For capital gains from financial investment realised after the „speculative“ period of time or from long-term financial investment and/or for substantial investment. - <sup>b)</sup> Non-weighted mean from maximum statutory income tax rates for interest incomes, dividend incomes and private capital gains. - <sup>c)</sup> In percentage points. - <sup>d)</sup> Final withholding tax. - <sup>e)</sup> Non-weighted average. - <sup>f)</sup> Flat tax.

Sources: Federal Ministry of Finance (2002); Martinez-Serrano and Patterson (2003); tables 1, 2, and 3; own calculations.

reporting of capital gains is rarely practised so that capital gains taxes are easily evaded.

#### The taxation of capital income in comparison

Table 4 compares the maximum income tax rates for different types of income in the countries studied.

The average regular top income tax rate of all 28 countries examined (44.1 percent) is markedly higher than the average mean maximum personal income tax rate across the different types of capital income (29.7 percent). The averages of the maximum dividend income tax rate (44.2 percent) and of the regular top income tax rate across countries

are almost identical. The interest tax rate and even more the capital gains tax rate, however, are considerably lower on average. A differentiation between EU-15 countries and CEEC shows similar structural characteristics of income tax systems, however on different levels. In the old EU member states the regular top income tax rate (49.1 percent) and the mean of maximum capital income tax rates (33.9 percent) on average are remarkably higher than in the accession (candidate) countries (36.2 percent and 21.7 percent, respectively). Moreover, the relative distance between the mean capital income tax rate and the regular top income tax rate is on average considerably larger in the CEEC than in the established EU member states.

To sum up, a clear trend towards the dualisation of the taxation of labour and capital income can be observed in all countries considered. Throughout the whole country group the regular top income tax rate exceeds the maximum capital income tax rate on average, albeit to a differing extent in the individual countries. This development is not new but has accelerated during the past two decades.<sup>7</sup> It is interesting to note, however, that only Finland has achieved a consistent dualisation of its income tax system, in the sense of a uniform lower and proportional income tax rate on all types of capital income. In all other countries income tax systems are schedular tax systems, which in some cases tax certain types of income – i.e. dividend income – even at a higher rate than labour income. Also those CEEC which do not apply a progressive tax schedule but have introduced a flat tax have schedular income tax systems. Hence the basic principle of a flat tax – to subject (as a comprehensive income tax) all types of income to a uniform and proportional tax rate – is violated. The income tax systems that can be found in the three Baltic States represent a schedular variant of the flat tax.

Of course statutory tax rates do not adequately reflect the effective tax burden resting on the different types of income. Despite remarkable methodological progress made in the literature (see e.g. European Commission 2003 and 2004), it is still not possible to determine either the effective tax burden which different types of income carry and their contribution to total income tax revenues. Thus neither the hypothesis of a shift of the tax burden between different types of (capital) income nor the hypothesis that capital income taxes are losing in significance in the long run can be examined and confirmed empirically. However, it seems plausible to assume that lower statutory tax rates for capital income imply lower effective capital tax burdens compared to labour income.

### **Equity and efficiency aspects of low tax rates for capital income**

This section identifies some efficiency and equity aspects connected with the existing taxation of (international) capital income and the trends towards dual or schedular income tax systems.

<sup>7</sup> For cross-country comparisons for 1980 and 1990 see Carey, Chouraqui and Hagemann (1993).

### *Equity aspects*

The lower taxation of capital income can be regarded as problematic from an equity perspective. As incomes of identical sizes but from different sources may bear differing tax burdens the horizontal dimension of the ability-to-pay-principle is violated. Taxing capital income at a proportional and labour income at a progressive tax rate neglects the vertical dimension of the ability-to-pay-principle. This problem is aggravated by the fact that capital income is generally concentrated at the upper income groups. Particularly in the CEEC, where the tradition to tax personal income is weak, this unequal tax treatment of different types of income may undermine the general tax morale of private households.

These reservations about dual income tax systems usually are countered by two arguments that are also based on equity considerations (Sorensen 1994): First, the phenomenon of cold progression affects capital income more negatively than labour income, which is considered to be less sensitive towards inflation. Second, capital income is subjected to greater risks. However both arguments are not very convincing if the current macroeconomic situation in most countries examined is considered. Both EU-15 countries and accession (candidate) countries have succeeded in containing inflation in the last years. At the same time many established as well as new EU member countries suffer from persistently high unemployment rates, exposing also labour income to considerable risk.

Equity problems also occur within capital income taxation. The majority of the countries studied tax different types of capital income at differing (maximum) income tax rates (see Table 4). In addition some countries (e.g. Italy) do not tax all types of capital income uniformly either at proportional or at progressive rates.

### *Efficiency aspects*

Proponents of dualised income tax systems expect them to dampen incentives for international capital flight and tax evasion. In most countries interest income of non-residents is taxed at relatively low source taxes or not at all so that non-declaration in the investor's residence country (which is made easy by the lack of a system of automatic informa-

tion exchange between countries) can yield substantial tax savings compared to domestic capital investments. In many cases this tax advantage is enlarged by bilateral double taxation agreements which further reduce or even dispense with foreign source taxes. Thus investors from all countries can choose from a quite large menu of potential “tax havens”. In some countries (e.g. Luxembourg or Switzerland) they are protected by strict banking secrecy laws. These extensive options for evading interest taxation establish *de facto* a regime of source taxation for interest income, with the tax burden on foreign interest income being determined by the tax rate of the host country, although in principle foreign interest income are subject to the residence principle, i.e. they have to be fully taxed in the investor’s country of residence. Particularly small countries may take advantage of the resulting violation of capital export neutrality and promote their financial markets by offering low or no source taxes, a strategy which can be viewed as a specific form of a “beggar-thy-neighbour-policy” (Giovannini 1989).

The problem of international tax flight is less severe for foreign dividend income which is burdened with corporate income taxes regardless of the investor’s residence country. Between certain countries, however, tax differentials may well be significant, taking into account that source taxes on foreign dividends may be reduced or even abolished by double taxation agreements and that most countries do not exchange information on foreign dividend income.

International tax evasion may cause an inefficient international allocation of savings if capital investment is not undertaken in the countries with the highest rate of return before taxes but in the countries offering the highest after-tax rate of return (Carey, Chouraqui and Hagemann 1993). The example of Luxembourg shows that tax flight need not distort international capital allocation if the savings of private households are channelled into the most efficient real capital investment by financial intermediaries (Schatzenstaller and Wehner 2000). However, this requires the existence of a stable financial sector as well as the absence of barriers to capital mobility and currency risks; in this respect some of the CEEC (still) have deficits.

Furthermore, international tax flight violates “inter-nation equity” (Musgrave and Musgrave

1990), i.e. an equitable international distribution of overall capital tax revenues, and reduces overall tax revenues. This is a particularly serious problem for the CEEC where a weak tax administration often contributes to the existing budget imbalances. The existing deficits within tax enforcement in the CEEC (Schaffer/Turley 2001) are a point in favour of final withholding taxes and dualised income tax systems, which, however, may diminish the incentive to improve tax administration.

It must also be considered that dual income tax systems cannot completely eliminate the possibilities and incentives for capital and tax flight. Thus the pressure on capital tax rates remains, which may lead to a mutual downward competition in the long run. Small countries may profit from international tax competition if tax losses caused by tax rate reductions are compensated by additional capital inflows. Many of the old and some of the new member countries, however, undermine – as large countries – their own fiscal basis by decreasing capital income taxes.

Another argument supporting an only moderate taxation of capital income is the promotion of private savings which is justified by the current efforts of most governments to strengthen private old age pension schemes. Tax privileges for capital investment exceeding a certain volume of old age provision, however, are hard to justify from an economic as well as from a political point of view. Moreover, they are problematic from an equity perspective, considering that many countries do not levy separate property taxes any more (Federal Ministry of Finance 2003).

Finally inefficiencies may result from the discrimination between interest and dividend income in the existing income tax systems. In many countries examined maximum interest tax rates are considerably lower than maximum dividend tax rates (see table 4), so that financial neutrality is distorted (Gérard 2002). If as a consequence firms rely too heavily on debt finance, risk allocation may be inefficient, and in times of high interest rates or in recessions firms may not be able to serve their debt obligations. Moreover thin capitalisation may negatively affect firms’ willingness to accept high risks that are particularly associated with investment in innovative products and production processes.



## Conclusion

The tendency to introduce dual or schedular income tax systems has seized many western industrialised countries, but also a number of transition countries. It is debatable whether the pros of renouncing comprehensive income tax systems that subject all types of income to a uniform and progressive income tax schedule outweigh the cons. In any case the current harmonisation efforts on the European level aiming at reducing international capital flight seem to be well-founded.

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