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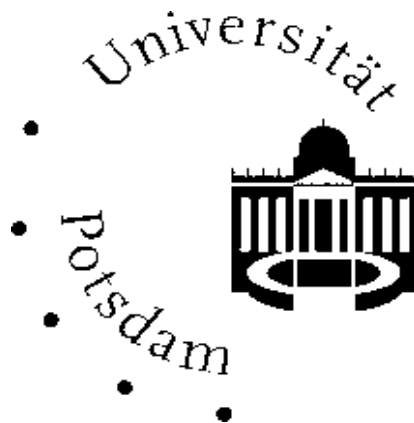
# UNIVERSITÄT POTSDAM

WIRTSCHAFTS- UND SOZIALWISSENSCHAFTLICHE FAKULTÄT

Lehrstuhl für Finanzwissenschaft

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## Capital Flight and Capital Income Taxation



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## **Capital Flight and Capital Income Taxation**

Februar 2004

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# Capital Flight and Capital Income Taxation

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## I. Introduction

The collapse of the Iron Curtain as well as the free mobility of persons and capital have strengthened international competition, which recently has also increased the pressures on the national tax and transfer schemes to reduce costs by abolishing existing inefficiencies. Even there is not much fear on a “race to the bottom”,<sup>1</sup> at least more or less large groups within the societies favoured by the old systems inevitably will become losers, loudly complaining in the public on the unjustified social dismantling. Globalisation pressures, recessions and accelerating structural problems have also forced several European and other extra-European countries to reform their direct tax systems, especially the taxation of capital income and companies.<sup>2</sup> Sole traders, partnerships and legal entities but also capital income from capital investment, renting and leasing, and other entrepreneurial activities are or at least have been burdened by a whole basket of taxes, which are (were) more or less closely related to capital ownership or the connected income: income tax (for natural persons), corporation tax (for legal entities), property tax, business tax (or similar taxes), capital gains tax, and inheritance tax are taxes, which are levied on the earnings or the capital stock itself. Beside such general taxes on capital income and property further taxes do exist, which burden specific kinds of real and financial assets like land taxes, second habitation tax, motor vehicle tax, stock exchange tax, insurance tax, etc. By comparatively simple transformations all these taxes can be related to capital income, so that the total burden on capital income can be easily derived.<sup>3</sup>

Taking the growth performance of different countries into consideration, obviously Germany is seriously lagging behind and recently France as the second core country of the EU is also confronted with stronger growth retardation.<sup>4</sup> Other EU countries like Austria, Belgium, Denmark, Finland, Greece, Italy, Ireland, the Netherlands, Portugal, Spain, Sweden, and last but not least

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<sup>1</sup> See, e.g., *Sinn* (2002 and 2003). Such fears are overwhelmingly unsubstantiated because much of the current income redistribution is not directed to the real poor but to middle and higher income brackets, which do not require public assistance; for more detail see *Petersen* (1989 and 2003).

<sup>2</sup> Under the term capital income all kinds of income from real and financial assets are subsumed. Following the traditional income definitions of most of the existing income tax laws, capital income consists of profits from agriculture and forestry, trade and self-employment, income from financial assets, rents and leasing as well as capital gains. In a modern and simple income tax system principally only two main income sources do exist: beside capital income the income of the employees (wages) are the second source. For more details see *Rose* (2002) and *Petersen/Rose* (2003).

<sup>3</sup> See *Anton/Petersen* (forthcoming).

<sup>4</sup> Since 1995 the growth performance in France has been much better than in Germany; see *OECD* (2003): Economic Outlook No. 73, Annex Table 1.

the United Kingdom have been much more successful, partly dependent on fundamental economic reforms which have been applied since the mid 80s, the latter especially true for Denmark, Finland, Ireland, the Netherlands, Sweden, and the UK. In other countries like Austria, Luxembourg and Switzerland relatively stable economic framework conditions have successfully worked, while in Greece, Italy, Portugal and Spain the European Stability and Growth Pact (SGP) has created positive incentives for fiscal discipline.

On the whole fundamental reforms in the tax and transfer systems have led to a growth stimulation, which often were closely connected with tax privileges for foreign direct investment (e.g., Ireland and the Netherlands) or at least with a more favourable taxation of capital income (Austria, Denmark, Finland, Luxembourg, Netherlands, and Sweden).<sup>5</sup> In the same period these countries and the UK have substantially reduced the transfers and implemented measures against the poverty trap phenomenon, which enforced the reintegration of unemployed into the official labour markets.<sup>6</sup> The more efficient taxation of capital income and companies have improved capital formation as well as the assumption of risk, both being the most important prerequisites for a stable and increasing pattern of private investment.

Especially the dual character of the Scandinavian tax systems, the box system of the Netherlands and low source taxes on interest payments in Austria, Luxembourg, and some other EU countries have especially met critical scepticism of German and French politicians, obviously prejudiced by their thinking in patterns of traditional income taxation. Non-EU countries with a similar favourable taxation of capital income like Switzerland, Liechtenstein, countries in the Caribbean, Singapore, Hong Kong or at least partly Australia and New Zealand etc. have often be blamed as tax shelters due to their reserved and often comparatively low tax burdens on capital income and business profits. Obviously those countries have profited by enormous capital inflows, while the high tax countries are increasingly confronted with capital outflows. But even within the EU beside Ireland and the Netherlands some regions like Jersey, Guernsey, and Gibraltar do exist, which set similar tax incentives without being blamed by the high tax countries within the EU, perhaps because they play more a role as collecting bank than as competitor for productive investment.<sup>7</sup> However, the detour of capital to EU external or internal tax shelters increases capital costs.

The most effective way to avoid thus additional transaction costs would be to reform the own tax and transfer systems in the high tax countries at least to narrow the gap between low and high tax countries.<sup>8</sup> A total harmonisation in the direction of the lowest existing tax rates connected with an then inevitable dismantling of the social security system is not necessary, because the high tax countries in the EU are the largest countries with big internal markets and good infrastructures, which allow a higher level of taxation than in the small tax shelters, at least because of their advantages in scale and scope.<sup>9</sup>

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<sup>5</sup> For details see *Bach/Seidel/Teichmann* (2000).

<sup>6</sup> This is especially true for the Netherlands, which has developed the most efficient integration of direct taxation and social security contributions; see *Petersen* (forthcoming).

<sup>7</sup> Malta as EU accession country 2004 is often named as most favourable tax shelter; but in the accession negotiations Malta has not been obliged to change its tax policy patterns. Therefore, inside the EU Malta might become a much stronger competitor for Switzerland and especially Liechtenstein.

<sup>8</sup> For an international comparison of tax pressures see *Lafay/Pérvier* (2003).

<sup>9</sup> As mentioned above, such fears of inevitable downgrading in the social security systems due to the globalisation process are expressed by *Sinn* (1997, 2002, and 2003). This argumentation becomes invalid if differences in between risk sharing (insurance) and redistribution are taken into consideration, which are totally neglected by *Sinn*; see *Petersen* (2003, pp. 212).

## II. Problems of Traditional Income and Profit Taxation

### II.1. Basic Principles

Mobility of persons and of capital are basic components of human rights; consequently the tax basis of wage and capital income taxation (both bases linked to traditional income and corporation taxes) are mobile as well. While high tax burdens push potential taxpayers away, high transfer payments attract potential transfer recipients. Due to the residence principle (unlimited tax liability) and the world income principle as cornerstones of direct taxation and (at least partly) for social protection, tax burdens and transfer generosity at residence determine the behavioural adaptations of citizen. In a world of almost legally unlimited mobility – or in other words in a globalised world – the outcome is local, regional and international competition of tax and transfer systems, setting pressures on efficient regulation and limiting the always threatening Leviathan.<sup>10</sup>

Obviously the mobility is dependant on the individual endowment with human, monetary, and real capital. Because of free movement of capital, monetary capital has doubtlessly the highest mobility, even if physical persons are not mobile.<sup>11</sup> Regarding physical persons, people with overwhelming capital income are highly mobile, whilst employees with lower qualifications and mainly dependant on their wages have a comparatively low mobility. Realities and buildings are immobile by definition. In case of tax increases or transfer reductions the mobile owners naturally can sell real estate, but the additional burden is then shifted by lower prices as consequence of tax (and transfer) amortisation to the former owners.<sup>12</sup> Therefore, the actual behavioural adaptations of the citizen are determined by tax and transfer policy patterns of the past and their expectations for the future burden developments. If their individual projections will make them to believe in further burden increases, then even immobile citizen will reconsider the location advantages (in form of personal and public infrastructure) and disadvantages (in form of factual or at least presumed future burden increases).

*Lafay* (2003) has correctly pointed to the problem that the absence of tax revolts in France as well as in Germany does not mean that the electorate are completely inactive. In the contrary, since decades they are active in the informal sector and increasingly voting by feet, even accelerated by the fastened globalisation as consequence of the changes after 1989. Already at the end of the 70s and the beginning 80s growing shadow economies have been observed with a permanent increase until today.<sup>13</sup> Increased voting by feet is an expression of inefficiencies within the tax and transfer systems especially of high tax countries leading at least in short and mid term to expatriation of capital and in the long run even to migration of persons (especially the well-to-do). In spite of the above mentioned necessary adaptations in the national tax and transfer policy patterns, usually tax and social politicians in the respective countries are blaming the countries with immigration of capital and high skilled persons as tax havens or shelters, which they often denote as immoral political strategies. Such tax shelters with an obviously

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<sup>10</sup> See *ibid.* and *Petersen* (1998).

<sup>11</sup> The shift of monetary capital and connected interest payments into foreign countries implies a breach of the world income principle and is to classify as tax evasion. The very limited control possibilities for the fiscal administrations as well as the lack in awareness and illusions on side of the taxpayers limit the factual and moral costs of such illegal behaviour; for the uninformed electorate with regard to taxation see *Lafay* (2003, pp. 10).

<sup>12</sup> For details see *Petersen* (1993, pp. 309 and 324).

<sup>13</sup> See *Feige* (1979 and 1984), *Petersen* (1981, 1982, and 1984), and *Schneider* (2000).

more attractive environment for capital income and investment are often asked to make any necessary adjustments for a harmonisation on the level of their inefficient regulations, neglecting the fact that because of the avalanche effects<sup>14</sup> described below their own capital income taxation by the existing traditional income and corporation taxes is highly questionable and immoral itself. The hope for an increased national and global capital formation partly due to overcome problems within the PAYGO pension systems at higher tax burdens on capital income is a contradiction in terms.

## II.2. Consequences of the Existing Traditional Tax and Transfer Schemes

The existing tax and transfer schemes in Germany as well as in France include numerous regulations, which create enormous inefficiencies and behavioural adaptations connected with tax avoidance and tax evasion – apart from the complexity that on the one hand discourages the taxpayers and impairs the compliance and on the other hand overstrains the fiscal administration. As a result an increasing number of tax assessments are false, thus inducing arbitrariness, impairing equity and creating state sullenness (*Staatsverdrossenheit*) – all connected with harmful consequences for tax mentality and morality. Spreading moral hazard behaviour yields in accelerating tax evasion and transfer fraud.

Lifetime avalanche effects and the cumulative burdens of multiple capital income taxation (by income, corporation, firm, property, capital gains, and potentially inheritance taxes) cause behavioural adaptations: Capital, large enterprises (especially multinational corporations), and well-to-do people leave the high tax countries due to a strategy of tax optimisation. This double and multi-burdening of capital income has been justified for generations by the extra security, which is connected with property and funded income, and additionally with the fact that capital income at least in a very specific literature was characterised as “unearned”. Such justifications were overwhelmingly accepted as long as the property of real and financial assets was heavily concentrated on the happy few rich. Nowadays a majority of taxpayers dispose of different forms of capital income and property has become a usual income source of almost everybody; beyond that property was not created by overnight miracles but heavily earned by own hands work and personally saved by abnegation of consumption. No wonder that double and multi-burdening today is evaluated quite differently and has led to an enormous spectrum of behavioural adaptations from tax avoidance to tax evasion. Additionally capital risks are often comparable to labour market risks, so that the additional security of capital ownership is also very limited.

The negative impacts of high burdens on interest payments and profits have led many countries to overcome old ideological positions, which at least today still motivate many tax politicians to demand additional property taxes and surcharges on capital income. But in spite of such lip services, in many countries the corporation tax rates have been seriously decreased and source taxes on interest payments have been introduced with flat rates formerly only typical for the heavily hated tax havens. Dual income tax systems like in Scandinavia or even triple box systems with different tax schedules like in the Netherlands have been implemented, which favour interest payments, dividends and profits from real and financial assets compared to the marginal tax rates applied already for lower and middle wage earners. Connected with serious social and labour market reforms such measures have been comparatively successful, especially if the unemployment figures are taken as performance measure.

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<sup>14</sup> See Petersen (2003a) and Petersen/Rose (forthcoming).

At least with regard to corporate taxation, in Germany the tax burden for legal entities was drastically reduced especially if the scheduled tax rates are taken into consideration. While in the mid 90s of the last century the average corporation and business tax burden (including the solidarity surcharge) was often above 70 %, the reforms of 2000 have reduced that burden to about 43.5 %.<sup>15</sup> But even this tax cut has not yielded the expected expansive impacts on growth and labour markets, and this negative outcome is not only caused by the necessary but also heavily delayed social and labour market reforms.

### II.3. Avalanche Effects

Due to historical reasons within the German income and corporation tax system many tax concessions and loopholes did exist, overwhelmingly motivated to reduce the effects of high marginal tax rates on certain kinds of profits and capital gains. For individual savings comparatively generous saving exemptions left a considerable amount of financial assets untaxed and especially favoured were (and are) different expenses for old age provision. Especially many tax theorists made the diagnose that the income and corporation tax base was heavily eroded and the switch to a more comprehensive tax base would yield that additional revenue, which would allow for a substantial decrease of the marginal tax rates. This argumentation, obviously in accordance with the mainstream theories of efficient taxation, overlooked the fact that many of the existing concessions have functioned like spiracles and mitigated the long-term burdens on capital income, which are connected with traditional income taxation.<sup>16</sup> If such concessions are abolished, the tax burden on such income parts remain an additional one even if the newly applied marginal rates are much less than the rates levied before on other kinds of (non-favoured) capital income.

Beyond that many of the abolished concessions were connected with long-term investment perspectives. Obviously many entrepreneurs at least partly invest in their companies in the intent to withdraw the invested amounts and the connected interest or profit in case of old age. Therefore, at least in case of long term investment and old age provision, the periodically orientated ability to pay argumentation seems not to be appropriate.<sup>17</sup> Instead, the accumulated burden over the whole investment period or active life span is of utmost relevance for such investment decisions. A simple example should shed some light on this argumentation.

Precautionary measures within private companies or insurance schemes are principally connected with capital formation and capital income. If a standard (traditional) income tax system is applied, this system exclusively depends on annual incomes. The previous history of the backgrounds of capital formation does not play any role. Therefore, capital formation is usually made from taxed income. In the following periods this capital itself forms a new tax base and the interest payments (or profits, dividends, rent, etc.) on that capital are taxed again. Capital itself and capital income is consequently several fold burdened.<sup>18</sup> Chart 1 demonstrates this so-called avalanche effect of capital income taxation in a simple example.

An income tax rate of 25 % (e.g., flat-rate) is assumed; an entrepreneur (or employee) is saving 1,000 Euro and invests that amount profitably at an interest rate of 5 % for 40 years in his company (or on the capital market). Without any taxation his interest earnings would grow to

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<sup>15</sup> See *Bundesministerium der Finanzen* (2003).

<sup>16</sup> Thereto a quotation of Barry *Bracewill-Milnes*: „An economy breathes through its tax loopholes“ (see <http://www.taxanalysts.com/www/website.nsf/Web/TaxQuotes?OpenDocument>).

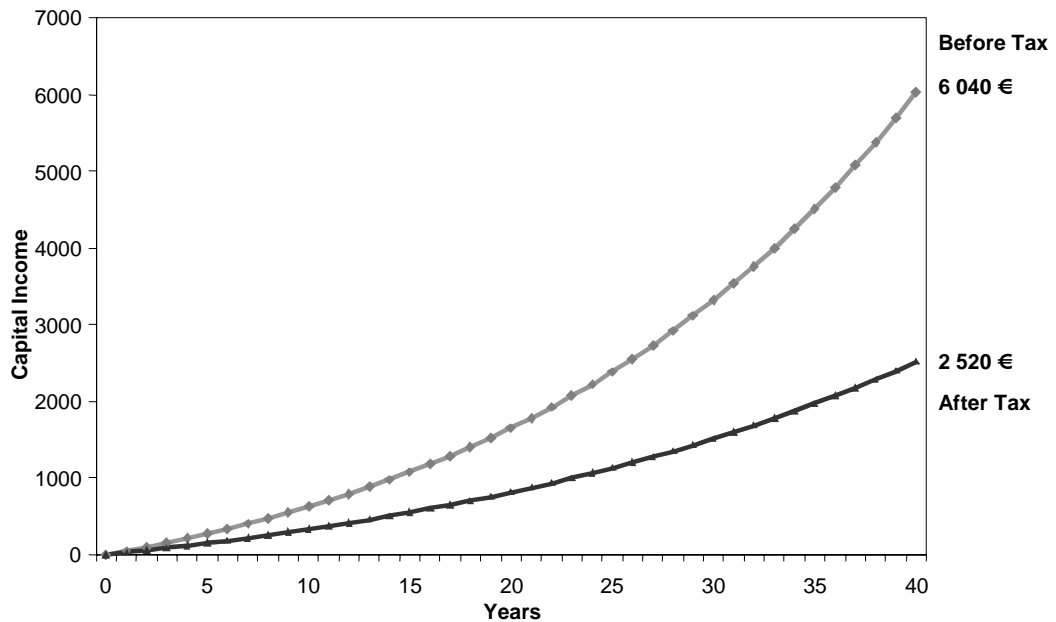
<sup>17</sup> See *Petersen* (2003a).

<sup>18</sup> See for more details *Petersen/Rose* (*forthcoming*).



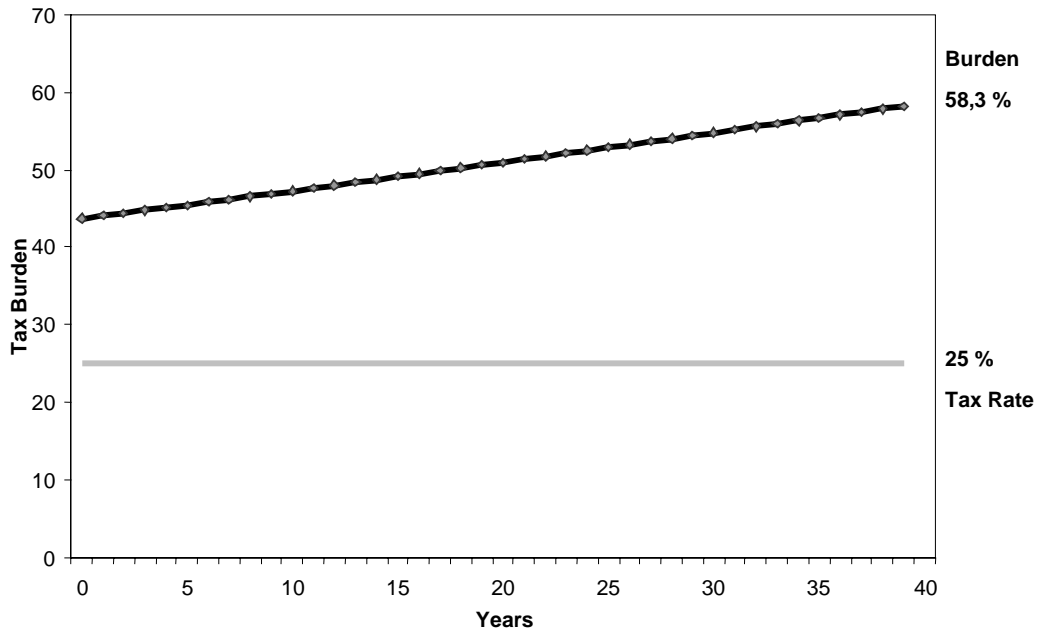
6,040 Euro (see chart 1) and be to the disposal for his old-age consumption. In case of a traditional income tax saving is accumulated from taxed income, so that at the assumed wage tax rate of 25 % only 750 Euro can be invested for that 40 years period.

**Chart 1: Income Tax Burden of Interest Income in an Traditional Income Tax System (Flat-rate 25 %)**



Due to the tax reduced investment amount, the interest payment for the first year is not any longer 50.00 Euro but only 37.50 Euro. In spite of that original 25 %-burden the gross interest payment of 37.50 Euro is taxed again by the 25 % flat-rate mentioned above; consequently his saving account is only growing by 28.13 Euro. The effective tax burden including the originally already paid amount is then after the first year 43,7 %. In all the following 39 years income tax has to be paid on the annual interest income as well, so that his disposable amount for his old-age consumption is reduced to 2,520 Euro. Compared to the 6,040 Euro in the situation without any income tax, the effective lifetime tax burden on the interest income is 58,3 % (see chart 2), which is more than twice as much as the annual 25 % flat-rate.

**Chart 2: Lifetime Burden on Interest Income of a Traditional Income Tax (Flat-rate 25 %)**



In fact in most of the current traditional income tax systems small saving amounts are protected by special saving allowances or other tax privileges, but for savings beyond the exemptions much higher income tax rates are applied, so that the avalanche effects are even more severe. If we take the current German tax burden on corporate profits as estimated by the *Bundesministerium der Finanzen*, the above-mentioned average rate is about 43.5 %. For a 40 years investment period then the accumulated burden is with 80.8 % much higher than in the simple example – and this burden is not the end of the flagpole. Compared to the situation before the tax reform, at least for such investments the decrease of marginal rates has played no role, in the contrary an enormous increase in tax burdens has taken place. Dependent on the relevance of such investment at least a certain restraint with regard to long-term investments might be a likely consequence.

#### II.4. Cumulative Effects

The above described avalanche effects are even more intense if beside an income and corporation tax an additional property tax is levied on the personal property or equity capital. Due to reasons of simplicity we neglect all possible exemptions and deductions and argue just with flat-rates on capital income or property beyond such basic amounts. Problems of the appropriate definition of different kinds of property are also not taken into consideration. In the annual perspective the tax revenue of a property tax  $T_p$  results from

$$T_p = t_p \cdot C,$$

where  $t_p$  is the property tax rate and  $C$  the total amount of wealth or equity capital. The capital income (profit) tax revenue is defined as follows:

$$T_c = t_c \cdot C \cdot r$$

with  $t_c$  as flat-rate on capital income ( $C \cdot r$ ). In case of identical tax revenue ( $T_p = T_c$ ) it follows for the two tax rates:

$$t_p = t_c \cdot r$$

and

$$t_c = t_p / r.$$

If we assume an interest rate of 5 %, a property tax rate of 1 % on total wealth corresponds with an income tax rate of 20 % on interest payments and profits. For lower effective interest rates this burden is even higher. Like the capital income tax also the property tax is connected with the above-mentioned avalanche effects. While in the annual perspective the property tax burden of a 1 % rate on investment returns is 20 %, in a lifetime perspective (over 40 years of investment) this burden increases to 38.6 %.

Capital gains taxes<sup>19</sup> and inheritance taxes create additional burdens, which in a lifetime perspective again show elements of the avalanche effects.<sup>20</sup> If in addition to the above-mentioned flat-rate of 25 % a 1 % property tax on total property is levied, the annual burden on capital income is increasing by 20 percentage points. The avalanche effect then produces a lifetime burden of both taxes, which is clearly above 70 %; in case of an additionally levied capital gains tax and in consideration of the burdens of inheritance taxes the total lifetime burden of all income and property taxes often reaches more than 90 %.<sup>21</sup>

Hence, in many contemporary tax systems capital income would be obviously overburdened if the numerous existing loopholes were abolished. It also becomes obvious that the frequently made proposal to broaden the tax base is a very dangerous advice, because the long-term burden of capital income taxation is heavily increased even if the annual tax rates are strongly decreased. The avalanche effects overcompensate short-term tax rate cuts as longer the investment period is. Therefore, one should not wonder that in countries with an extreme long-term burden on capital income, saving and capital formation is increasingly impaired. If in such countries (like Germany) comparatively high saving ratios still exist, this overwhelmingly depends on the fears of the working generations that the social pension system in view of the demographic development has a very gloomy perspective and a sufficient level of retirement income can only be secured by own capital formation. While capital formation at least in the short run might still be satisfactory, especially long term investment is avoided, so that the number of jobs is decreasing, thus creating an ever increasing number of unemployed people.

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<sup>19</sup> Capital gains are often taxed within the income and corporation tax systems (like in Germany) or by specific capital gains taxes (like in the UK and US).

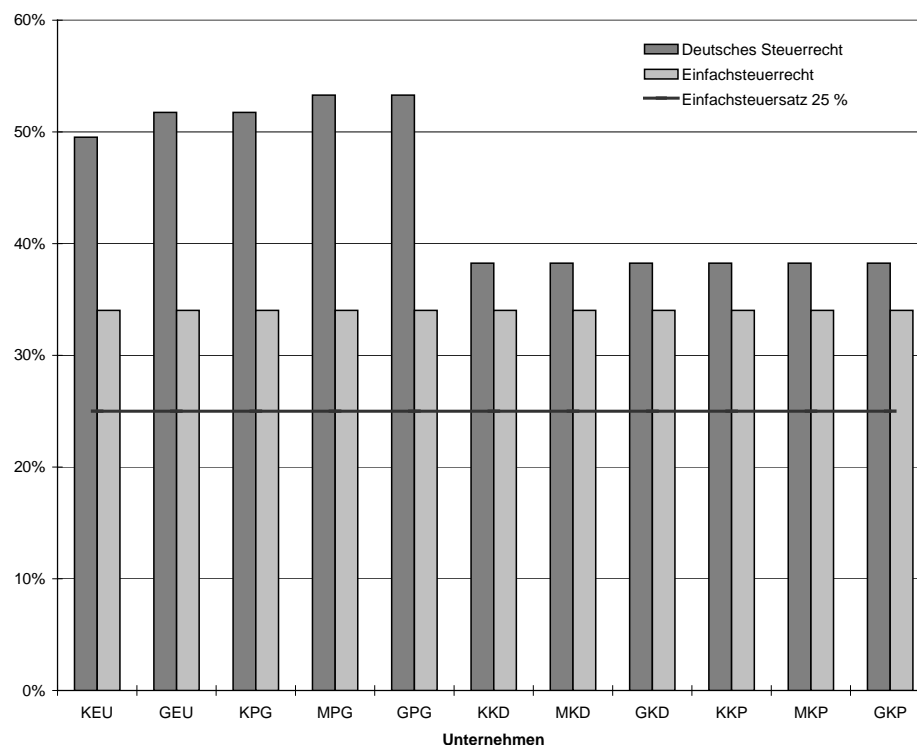
<sup>20</sup> Not to forget the specific property taxes like the land taxes, motor vehicle taxes, etc.

<sup>21</sup> See, e.g., *Anton/Petersen* (2003) und *Petersen* (2003a).

## II.5. Arbitrary Companies Taxation

For the assessment simulation of the tax burden on the firm sector a data file of the German Institute for Economic Research (DIW Berlin) has been used, which contains the information of 51,458 small and large sole traders (SST and LST), 28,450 small, medium sized and large partnerships (SPS, MPS, and LPS) and 50,504 small, medium sized, and large limited liability companies and corporations (SC, MC, and LC).<sup>22</sup> Sole traders and partnerships are burdened by the personal income tax (PIT), corporations by the corporation income tax (CIT), whilst both also have to bear the firms tax levied on the local level. Within the assessment simulation the single interrelations between the income, corporation and firms tax have to be taken into consideration; the comparison is done on the basis of the 2004 tax law, assumed that the last steps of the current tax reform process will have been implemented.<sup>23</sup> For a correct comparison, the personal characteristics of the taxpayer (married, one child, voluntarily insured within the social insurance schemes, no other income sources) are kept constant for all firm types and the average local firm tax rate is applied. For sake of simplicity it is assumed that profits are not distributed but retained in the firms.<sup>24</sup>

**Chart 3: Marginal Tax Burden of the Model Enterprises**



<sup>22</sup> For the pros and cons of that data file see *Petersen/Fischer/Flach (2003)*.

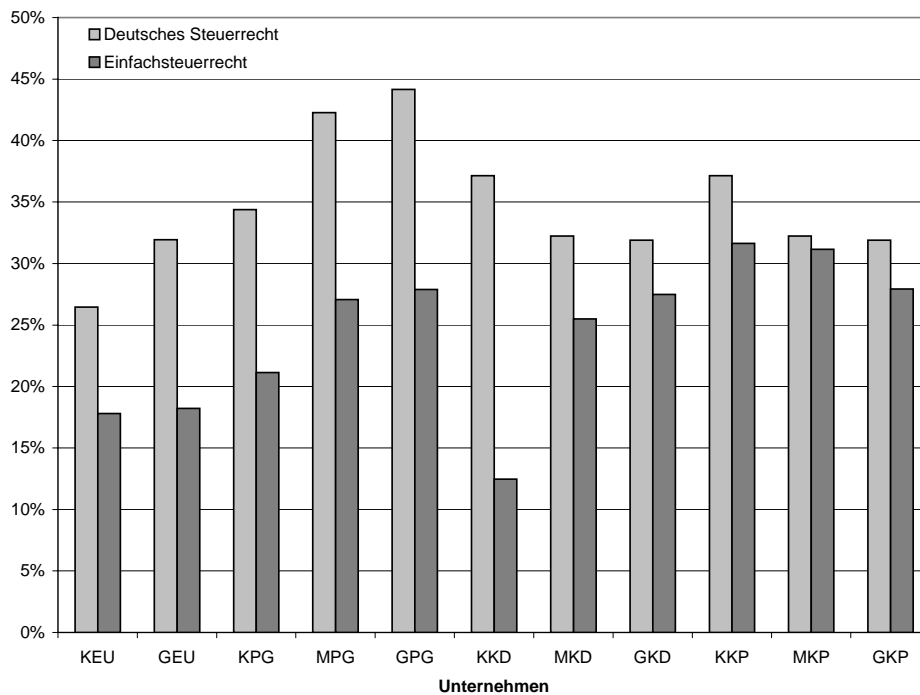
<sup>23</sup> For details on the German tax reform process see *Petersen (2000)* and *Petersen/Bork (2000)*.

<sup>24</sup> Due to the fact that half of the dividends are treated as income within the PIT, the marginal and average tax burden of corporations also depends on the part of distributed profits to total profits; see *ibid*.

Chart 3 represents the marginal annual tax burden of the different average firm types as defined above for the 2004 tax law (dark-grey columns).<sup>25</sup> While the profits in case of sole traders and partnerships are taxed by the PIT and firms tax at marginal rates of about 50 percent and more, the profits of corporations are burdened with marginal rates of the CIT and firms tax of less than 40 percent.<sup>26</sup> Hence, it becomes obvious that the average marginal burden of small sole traders (SST) and small as well as medium partnerships (SPS and MPS) is much higher than in case of corporations at completely retained profits. In case of fully distributed profits the marginal burden for the corporation increases but still remains more or less below the levels for the partnerships.<sup>27</sup> Therefore the 2004 tax law discriminates firms due to the different legal status and between the corporations those ones, which are distributing a remarkable part of their profits.

Chart 4 displays the average tax rates for the different firm types under consideration. If the average tax burden on sole traders is compared to that of small corporations, it becomes obvious that in spite of lower marginal tax rates the latter do have a higher average tax rate. This result partly depends on the lower profits of the small corporations compared to the small sole traders, but also on the fact that the corporations are taxed on the firms level by the CIT; consequently the individual deductions of the PIT system do not apply, which leads to the higher average tax burden. Even within the same firm size, extreme discriminations due to the different legal status exist, which are especially turned against small and medium corporations.

**Chart 4: Average Tax Burden of the Model Enterprises**



<sup>25</sup> The light-grey columns represent the corresponding marginal rates for the easy tax system, which will be discussed below.

<sup>26</sup> All tax rates also reflect the solidarity surcharge.

<sup>27</sup> For more detail see *Petersen/Fischer/Flach* (forthcoming).

If all the problems of the traditional PIT and CIT are summarized, the fact remains that in spite of the long-termed almost constant macroeconomic tax ratio and a middle position within the usual OECD tax burden rankings the burden of ancillary wage costs and profit taxation has reached or even exceeded a critical level. This is especially true because the current firms tax burden is much more unequally distributed than before. The burdens have been shifted from the highly mobile large multinational corporations, which use all tax saving instruments, on the much more immobile small and medium enterprises (SME). Consequently the SME, whichever have been the backbone of the German economy, are more and more unable for positive net investment, so that new jobs are not created in Germany in a sufficient dimension. Therefore, a fundamental reform of capital income taxation is a necessary prerequisite for additional growth dynamics, which is also inescapable to promote increasing capital formation to overcome the future demographic problems.

### III. The Last Resort: Easy Tax

Almost all of the currently discussed proposals to reform the existing PIT and CIT systems in Germany do not address the above described problems of capital income taxation; despite the enormous long term burdens on capital income especially in Germany certain political groups are still discussing the reintroduction of the 1997 abolished property tax or at least a strong increase in the inheritance tax rates. Political illusions and shady promises that the “rich” will be more severely taxed are clear signals for behavioural adaptations. Therefore, it is not astonishing that the mobility of capital and persons is further increased. If such political patterns would become dominant, the German perspective would become really gloomy. However, a sustainable relief from growth retardation and increasing unemployment figures is only possible if the above-mentioned problems are really tackled.

As mentioned above, many countries (like the Netherlands and the Scandinavian countries) have introduced a so-called dual income tax system, which taxes wages and capital incomes with different tax schedules.<sup>28</sup> While for wages overwhelmingly the traditional directly progressive tax schedules (with strongly increasing marginal rates) are applied, for capital gains usually a much lower flat-rate has been adopted, or like in Austria and Luxembourg a withholding tax on interest payments with a comparatively low flat-rate was introduced. The outcome is that at least middle and higher wage income is marginally taxed with rates, which are often much higher than for individual capital income or profits. Therefore, equal income amounts consisting of different sources are often unequally treated, so that the equality of treatment is hurt. Obviously the efficiency target (growth enhancement, capital formation, and job creation) is dominating fairness and justice of ability.

Such a fundamental breach of equality would at least in Germany raise serious constitutional problems. Thus alternative political patterns have to be developed. Because of the close relations between the tax and transfer schemes, an integrated approach is necessary to develop a long-term reform perspective. If for instance the pension system is reformed by expanding capital funding and at least partly substituting the PAYGO system, a harmonisation with the tax system (treatment of contributions as well as pension payments) is inevitable. A simplification of tax and transfer law is much that necessary to improve the information and knowledge of the electorate, which also will lead to a more efficient control over political actions.

But the core aims of tax reform for the household sector are equal treatment of lifetime income (from wages and capital), independent from the respective source, and the intertemporal neutrality on consumption. Within the enterprise sector neutrality is the most important target, so that at the end of the reform process all enterprises would be confronted with an equal marginal burden. Compared to the current German situation that would mean a lower marginal burden for sole traders and partnerships as well as for small corporations (the so-called S-corporations) and a strong decrease in the average tax burden for SME.<sup>29</sup>

Therefore, the “Heidelberger Steuerkreis” has developed an “Easy Tax Proposal”,<sup>30</sup> which on the one hand integrates income and corporation tax into one law and on the other hand secures an equal treatment of wages and capital income as far as ever has been possible. The conflict between efficiency and justice is reduced to an absolute minimum. Here only the basic ele

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<sup>28</sup> For details see *Bach/Seidel/Teichmann* (2000).

<sup>29</sup> See *Petersen/Fischer/Flach* (forthcoming).

<sup>30</sup> The members of the „Heidelberger Steuerkreis“ are *Joachim Lang* (Köln), *Hans-Georg Petersen* (Potsdam and DIW Berlin), *Bernd Raffelhüschen* (Freiburg and Bergen), and *Manfred Rose* (Heidelberg); the permanently updated draft law and additional information are to be found under [www.einfachsteuer.de](http://www.einfachsteuer.de).

ments for capital income treatment are presented.<sup>31</sup> If the above-implied lifetime perspective for undistorted preferences is striven for, consequently an integrated income and corporation tax system has to be developed, which for wages and capital income applies the same tax criteria. The Easy Tax has two specific forms of tax collection: the personal income tax and the profit tax. The taxable income is composed of three sources: income from wages, income from self-employment, and retirement income. The expenses for vocational education are to be subtracted. The profits of the so-called small corporations, which are corporations with a small number of shareholders, are taxed as income from self-employment. The S-corporation is an element of the US corporation tax; the profits of the S-corporations, named as pass-through companies in the Easy Tax draft law, are distributed on the shareholders and taxed as their other personal incomes.

The integration of profits as far as possible into the personal income tax due to the pass-through company has the overall important feature that small and medium firms are taxed equally independent from their legal construction (neutrality of the legal construction). The big corporations (public companies) are taxed with the highest marginal rate of the income tax, whereas no personal deductions apply. For the equal treatment of wages and capital income in a lifetime perspective, the above-mentioned avalanche effects, in other words the multi-burdening of savings, have to be avoided. Two different methods could be applied, which in their impacts on capital income taxation are equivalent but would heavily influence the periodical distribution of the tax revenue. In case of the *interest adjustment method* a standard market interest rate must be subtracted from all capital income. If the *saving adjustment method* is applied, the saving itself has to be tax-free while the latter earnings in the payment period must be taxed. Consequently the saving adjustment procedure shifts the taxable base into the future, so that the fiscal administration at least for a longer chain of periods would be threatened by large tax revenue losses.

However, the Easy Tax provides pragmatic solutions: in case of all sources of capital income (interest, profits, rents, etc.) a basic rate of return – for instance the interest rate for a two years government bond – remains as remuneration for the abnegation of consumption tax-free. Consequently only capital incomes above this basic rate of return (also called protective interest rate) are taxed whereas a steady tax base on capital income remains. The protective interest rate avoids the avalanche effects, and in the dynamical perspective the equal treatment of wages and capital income is assured. The calculation of profits follows a modified cash-flow method, which defines the profit as (cash) surplus of earnings to business expenses. The modifications are related to the expenses for depreciations and the discount for the protective interest rate.

In case of retirement income (all forms of pensions) the saving adjustment method is preferable in which the premiums and contributions to old-age protection are tax-free. Interest and saving adjustment are the measures for a dynamical design of the annual taxation which necessary remains the basic tax period due to pragmatic reasons. Both methods assure that all components of lifetime income are taxed once and only once, independent from their sources. At the same time the equal burden on the whole lifetime income and the intertemporal neutrality for the consumption decision is guaranteed, which abolishes the discrimination of saving as consequence of the traditional income tax systems.

A consumption orientated enterprise taxation following the interest adjustment method is often objected to leave profits tax exempt; consequently the firm sector would be widely untaxed. In view of the return on equity within the firm sample for the assessment simulation such

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<sup>31</sup> A short description is to be found in *Petersen (2002)*; for more detail see *Petersen/Rose (forthcoming)*.



presumptions are totally unrealistic.<sup>32</sup> For sole traders and partnerships the deduction of the protective interest rate (interest adjustment) amounts to a reduction of the profits between 2 % (SST) and 15 % (LPS); for corporations the reduction is between 6 % (SC) and 17 % (LC). If the firm sample would be taken as representative for the German firm sector, the deduction of the with 5 % adopted protective interest rate would reduce the taxable base in case of the Easy Tax by 7.4 % if the weighting is done with the respective fractions of firm types in the whole sample. The interest adjustment connected with the elimination of the avalanche effects is therefore much less costly than all the loopholes and tax concessions within the existing income and corporation tax systems, which have led to a strong erosion of the tax bases.<sup>33</sup>

Regarding the enterprise taxation, the Easy Tax draft law also establishes the above-mentioned neutrality of the legal status for small and medium sized enterprises. Chart 3 above demonstrates that the marginal tax rate of the Easy Tax is equal for all legal forms, where the S-corporations are marked with S (SCS, MCS, and LCS) and the public companies with P. In case of the small corporations in chart 4 it becomes obvious that the average burden for the SCS is substantially reduced compared to their treatment as public companies (SCP). Furthermore in the annual perspective the average tax burden for all SME is strongly decreased so that the overall enterprise tax burden is shifted in the direction of the large public companies, which also would pay less profit tax than under the old regime.<sup>34</sup> Additionally the deductible protective interest rate secures neutrality for investment and financing as well as inflationary neutrality. The latter prevents from any taxation of pure inflationary windfall profits. Obviously, the Easy Tax is still a pragmatic approach, which enables the practical implementation but also corresponds to the theoretical demands of a second-best tax.

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<sup>32</sup> For the sample of 130,412 model firms the return on equity is between 314 % for the average SST, 40 % for the LST, 48 % for the SPS, 38 % for the MPS, 33 % for the LPS, 84 % for the SC, 68 % for the MC and 29 % for the LC; obviously this high rates of return are the result due to behavioural adaptations to the German income and corporation tax law, which favours a comparatively low input of equity capital. For more details see *Petersen/Fischer/Flach* (forthcoming).

<sup>33</sup> The "Heidelberger Steuerkreis" also recommends to replace the current German firms tax by a surcharge for the local communities on the Easy Tax yield. If the firms tax revenue at an average effective tax rate of currently 385 % should be substitute by such a surcharge, the necessary surcharge rate on business enterprises would be 29 %. If the tax base would be extended to self-employed and employees, the surcharge rate could be reduced to below 10 %. Such local surcharge would comprehend all local citizen and firms and could also be connected with a local surcharge rate autonomy. For more details see *Rose* (2002, pp. 29).

<sup>34</sup> The assessment simulation does not hold the tax revenue constant. This can only be done by an approach using microsimulation models, see e.g. *Anton/Brehe/Petersen* (2002). Because of the lack of micro data on the firms level in Germany, up to now such simulations cannot be realised.

#### IV. Summary

In an efficient, integrated and consumption orientated tax and transfer system PAYGO financing has to be reduced to the basic security elements (social aid, minimum pensions, basic health care), which are financing the necessary redistribution to prevent society from unacceptable poverty. Consequently capital shortage is avoided, which is one essential prerequisite for future growth. In the final stage upgrade insurance above the basic provisions has to be assured within the private insurance scheme. Because then basic security in all existing branches of social insurance would be tax financed, social security contributions can be substantially reduced and non-distortable indirect taxes be increased. Consequently ancillary wage costs are strongly reduced, which sets incentives for higher employment and additional investment.

Tax optimisation is a rational behaviour of well-informed individuals within the private sector, having also in mind the equivalence in between tax burdens and the efficient supply of public goods and services. In the sphere of private enterprises it is not an illegal behaviour, because capital owners, shareholders as well as the management have no national obligation but to secure the future existence of their equity capital (and the connected jobs for their employees). Pleas of politicians to remind the entrepreneurs for their national obligations are reminiscences of nationalism, which today should have been overcome at least in open societies, which are seriously profiting by their international relations and cooperation.

Politicians should not complain about the alleged costs of globalisation, but have to face the challenge of systems competition to take the full advantages from a global free trade and mobility of production factors. This challenge has to be put into practice by a fundamental tax and transfer reform, which improve the advantage of location of their countries in a sustainable manner. Politicians also have to become aware that tax and social security systems competition is a positive and necessary element of a fair global cooperation, thus limiting state activities to an efficient level and preventing from always possible developments in the direction of the Leviathan (more or less totalitarian tax state<sup>35</sup>) with permanent rising tax burdens and ever increasing numbers of transfer recipients being on a drip of the state. The countries, which are falling back, will temporarily loose but also be given incentives for future reforms.

The notion reform should be limited to really fundamental changes; the many centennial reforms of the past have overwhelmingly stand for curing symptoms instead of sustainable therapy. The Easy Tax proposed by the "Heidelberger Steuerkreis" is such a fundamental reform. The integration of the PIT and the CIT would guarantee an equal treatment of wage and capital income in a lifetime perspective and make ad hoc interventions and political manipulations into income taxation far more difficult. The Easy Tax Proposal would guarantee neutrality of legal status, investment, financing, profit distribution and inflation as well.<sup>36</sup> Therefore, this proposal considers the most important elements of modern tax theory. At the same time this proposal gives evidence that modern theory can be implemented in realistic tax drafts. In some European countries discussions for an implementation are already flourishing<sup>37</sup> and even in Germany the number of supporters is steadily increasing. If the Easy Tax as core element of a fundamental tax and transfer reform would be implemented, the signals could be set for another German economic miracle.

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<sup>35</sup> See *Schumpeter* (1918).

<sup>36</sup> See *Petersen/Rose* (forthcoming).

<sup>37</sup> In a region of Bosnia and Hercegovina (Brcko County) a slightly modified Easy Tax has been implemented in 2003 in cooperation in between members of the "Heidelberger Steuerkreis", the German "Gesellschaft für Technische Zusammenarbeit GmbH (GTZ)" and the local government.

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