

Viewpoints



Globalization, Capital Flight, and Capital Income Taxation: A European Perspective

by Hans-Georg Petersen

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The collapse of the Iron Curtain and the free mobility of persons and capital have strengthened international competition. Recently, this has also increased the pressures on national tax and transfer schemes to reduce costs by abolishing inefficiencies. Although there is not much fear of a race to the bottom,¹ large groups within the societies favored by the old systems will inevitably become losers, loudly complaining in public about unjustified social dismantling. Globalization 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 businesses.²

Sole proprietors, partnerships, and other legal entities — and capital income from capital investment, renting and leasing, and other entrepreneurial activities — are or have been burdened by a whole basket of taxes, which are or were more or less closely related to capital ownership or connected income. Income tax (for natural persons), corporate tax (for corporations), property tax, business tax (or similar taxes), capital gains tax, and inheritance tax are all levied on earnings or capital stock itself. In addition to those general taxes on capital income and property, there are other taxes that burden specific kinds of real and financial assets: land tax; second habitation tax; motor vehicle tax; stock exchange tax; insurance tax; and so forth. By simple transformations, these taxes are related to capital income, so the

¹See, for example, Sinn (2002 and 2003). These fears are overwhelmingly unsubstantiated, because much of the income redistribution is not directed to the real poor but to middle- and higher-income earners, which do not require public assistance. For more details, see Petersen (1989 and 2003).

²Capital income includes all types of income from real and financial assets. Following the traditional income definitions of most of the existing income tax laws, capital income includes profits from agriculture and forestry, trade and self-employment, financial assets, rents and leasing, and capital gains. In a modern and simple income tax system, principally only two main income sources exist: capital income and employees' wages. For more details, see Rose (2002) and Petersen/Rose (2003).

total burden on capital income can be easily determined.³

Compared to the growth of other countries, Germany is seriously lagging behind. Recently, France, as the second core country of the European Union, has also experienced stronger growth retardation.⁴ Other EU countries — such as Austria, Belgium, Denmark, Finland, Greece, Italy, Ireland, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom — have been much more successful. This is partly dependent on fundamental economic reforms applied since the mid-1980s, especially in Denmark, Finland, Ireland, the Netherlands, Sweden, and the United Kingdom. In other countries, like Austria, Luxembourg, and Switzerland, relatively stable economic framework conditions have been successful. 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 tax and transfer systems have stimulated growth. This is often closely connected with tax privileges for foreign direct investment (for example, in Ireland and the Netherlands) or, at least, with more favorable taxation of capital income (in Austria, Denmark, Finland, Luxembourg, the Netherlands, and Sweden).⁵ In the same period, these countries and the United Kingdom have substantially reduced the transfers and implemented measures against the poverty trap phenomenon, which allowed the reintegration of the unemployed into official labor markets.⁶ More efficient taxation of capital income and businesses has improved capital formation and the assumption of risk, the most important prerequisites for a stable and increasing pattern of private investment.

The dual character of 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 been met with skepticism by German and French politicians, prejudiced by their thinking in patterns of traditional income taxation. Non-EU countries with a similar favorable taxation of capital income, such as Switzerland, Liechtenstein,

Singapore, Hong Kong, countries in the Caribbean, and, at least partly Australia and New Zealand, are often called tax havens because of their reserved and often comparatively low taxes on capital income and business profits. Those countries have profited by enormous capital inflows, while the high-tax countries have been increasingly confronted with capital outflows. But even within the European Union, besides Ireland and the Netherlands, regions like Jersey, Guernsey, and Gibraltar have set similar tax incentives without being blamed by the high-tax countries within the European Union. Perhaps this is because they play a role as more of a collecting bank than as competitor for productive investment.⁷ However, the detour of capital to EU external or internal tax shelters increases capital costs.

The most effective way to avoid more transaction costs is to reform the tax and transfer systems in the high-tax countries, at least to narrow the gap between low- and high-tax countries.⁸ A total harmonization in the direction of the lowest existing tax rates connected with the inevitable dismantling of the social security system is not necessary, because high-tax countries in the European Union are the large countries with big internal markets and good infrastructures. This allows a higher level of taxation than in the small tax havens, because of their advantages in scale and scope.⁹

I. Problems of Traditional Income and Profit Taxation

A. Basic Principles

Mobility of people and of capital is the basic component of human rights. Consequently, the tax basis of wage and capital income taxation (both linked to traditional income and corporate taxes) are mobile as well. While high tax burdens push potential taxpayers away, high transfer payments attract potential transfer recipients. Because the

³See Anton/Petersen (forthcoming).

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

⁵For details, see Bach/Seidel/Teichmann (2000).

⁶This is especially true in the Netherlands, which has developed the most efficient integration of direct taxation and social security contributions. See Petersen (forthcoming).

⁷Malta, as an EU accession country in 2004, is often named as a most favorable tax shelter. But in the accession negotiations, Malta has not been obliged to change its tax policy patterns. Therefore, inside the European Union, Malta might become a much stronger competitor than Switzerland and Liechtenstein.

⁸For an international comparison of tax pressures, see Lafay/Périvier (2003).

⁹As mentioned above, fears of inevitable downgrading in the social security system due to the globalization process are expressed by Sinn (1997, 2002, and 2003). This argument becomes invalid if differences between risk sharing (insurance) and redistribution are taken into consideration, which are totally neglected by Sinn. See Petersen (2003, p. 212).

residence principle (unlimited tax liability) and the world income principle serve as cornerstones of direct taxation and — at least partly — for social protection, tax burdens and transfer generosity at residence determine the behavioral adaptations of citizens. In a world of (almost) legally unlimited mobility or, in other words, in a globalized world, the result is local, regional, and international competition of tax and transfer systems, setting pressures on efficient regulation and limiting the always-threatening Leviathan¹⁰ (a more or less totalitarian tax state¹¹).

Obviously, mobility is dependent on the individual endowment of human, monetary, and real capital. Because of the free movement of capital, monetary capital has undoubtedly the highest mobility, even if individuals are not mobile.¹² People with a lot of capital income are highly mobile, while employees who have lower qualifications and are mainly dependent on their wages have comparatively low mobility. Real estate and buildings are immobile by definition. In case of tax increases or transfer reductions, the mobile owners can sell real estate, but the additional burden is then shifted by lower prices as a consequence of tax (and transfer) amortization to the former owners.¹³ Therefore, the actual behavioral adaptations of citizens are determined by tax and transfer policy patterns of the past and their expectations for future developments. If individuals believe there will be increasing tax burdens, even immobile citizens will reconsider the advantages (in the form of personal and public infrastructure) and disadvantages (in the form of factual or presumed future burden increases) of their location.

Lafay (2003) correctly pointed to the problem. The absence of tax revolts in France and Germany does not mean that the public is inactive. On the contrary, for decades they have been active in the informal sector and increasingly are voting with their feet, accelerated by the increasing globalization as a consequence of the post-1989 changes. From the late 1970s to the early 1980s, shadow economies grew, and they have continued to

grow.¹⁴ Increased voting with the feet is an expression of the inefficiencies in the tax and transfer systems, especially in high-tax countries. It leads, in the short and mid-term, to the expatriation of capital and, in the long run, to the migration of individuals, especially the wealthy. Despite the previously mentioned adaptations in the tax and transfer policy patterns, politicians usually blame countries with immigration of capital and high-skilled persons and call them tax havens or shelters, which they often denote as immoral political strategies. Tax havens, with a more attractive environment for capital income and investment, are often asked to make adjustments for harmonization. The high-tax countries neglect the fact that because of the avalanche effect¹⁵ (in other words, the multiburdening of savings) described below, their own capital income taxation is highly questionable and immoral in itself. The hope for increased national and global capital formation, partly due to overcoming problems within the pay-as-you-go (PAYGO) pension systems at higher tax burdens on capital income, is a contradiction in terms.

B. Consequences of Traditional Tax and Transfer Schemes

The tax and transfer schemes in Germany and France include several regulations that create enormous inefficiencies and behavioral adaptations connected with tax avoidance and tax evasion. On one hand, the complexity of these regulations discourages taxpayers and impairs compliance. On the other hand, it overstrains fiscal administration. As a result, an increasing number of tax assessments are false, therefore inducing arbitrariness, impairing equity, and creating taxpayer indifference. This results in harmful consequences for tax mentality and morality, and promotes tax evasion and transfer fraud.

The lifetime avalanche effect and the cumulative burdens of multiple capital income taxation (by income, corporate, firm, property, capital gains, and, potentially, inheritance taxes) cause behavioral adaptations. Capital, large enterprises (especially multinational corporations), and wealthy people leave high-tax countries under a strategy of tax optimization.

The burden on capital income has been justified for generations by the extra security that is connected with property and funded income, and by

¹⁰*Id.* and Petersen (1998).

¹¹See Schumpeter (1918).

¹²The shift of monetary capital and connected interest payments into foreign countries implies a breach of the world income principle and is classified as tax evasion. The very limited control possibilities for fiscal administrations and the lack of awareness and illusions on the side of the taxpayers limit the factual and moral costs of that illegal behavior for the uninformed electorate with regard to taxation. See Lafay (2003, p. 10).

¹³For details, see Petersen (1993, pp. 309 and 324).

¹⁴See Feige (1979 and 1984), Petersen (1981, 1982, and 1984), and Schneider (2000).

¹⁵See Petersen (2003a) and Petersen/Rose (forthcoming).

the fact that capital income, at least in specific literature, was characterized as unearned. These justifications were overwhelmingly accepted as long as real property and financial assets were heavily concentrated on a happy rich few. Now different forms of capital income and property are a typical income source for a majority of taxpayers. This property was not created by overnight miracles; it was earned by heavy work and was personally saved for by forgoing consumption. There is no wonder that double- and multi-tax burdens today are evaluated quite differently and have led to an enormous spectrum of behavioral adaptations, from tax avoidance to tax evasion. Also, capital risks are often comparable to labor market risks, so the additional security of capital ownership is also very limited.

The negative effect of high tax burdens on interest payments and profits have led many countries to overcome old ideological positions, which at least today still motivate many politicians to demand additional property taxes and surcharges on capital income. Despite that lip service, in many countries the corporate tax rates have significantly decreased and source taxes on interest payments have been introduced with flat rates, formerly only typical for the tax havens. Dual income tax systems, like in Scandinavia, and even triple box systems with different tax schedules, like in the Netherlands, have been implemented. These systems favor interest payments, dividends, and profits from real and financial assets, compared to the marginal tax rates applied already to lower and middle wage earners. Connected to social and labor market reforms, these measures have been comparatively successful, especially if unemployment figures are taken as a performance measure.

For corporate taxation in Germany, the tax burden for legal entities was drastically reduced, especially if scheduled tax rates are taken into consideration. In the mid-1990s, the average corporate and business tax burden, including the solidarity surcharge, was often above 70 percent. However, the reforms in 2000 reduced that burden to about 43.5 percent.¹⁶ But even this tax cut has not yielded the expected expansive effects on growth and labor markets. This negative outcome is caused by necessary, but very delayed, social and labor market reforms.

C. Avalanche Effects

For historical reasons, many tax concessions and loopholes existed in the German income and corporate tax system. They were overwhelmingly used to reduce the effects of high marginal tax rates on some kinds of profits and capital gains. For individual savings, comparatively generous saving exemptions left a considerable amount of financial assets untaxed. Especially favored were — and are — different expenses for the old-age provision. Many tax theorists determined that the income and corporate tax base was heavily eroded and the switch to a more comprehensive tax base would yield more revenue, which would allow for a substantial decrease of the marginal tax rates. This argument, in accordance with the mainstream theories of efficient taxation, overlooked that many of the existing concessions have functioned like loopholes and mitigated the long-term burdens on capital income connected with traditional income taxation. If those concessions are abolished, the tax burden on that income remains an additional one, even if the newly applied marginal rates are less than the rates levied before on other kinds of (nonfavored) capital income.

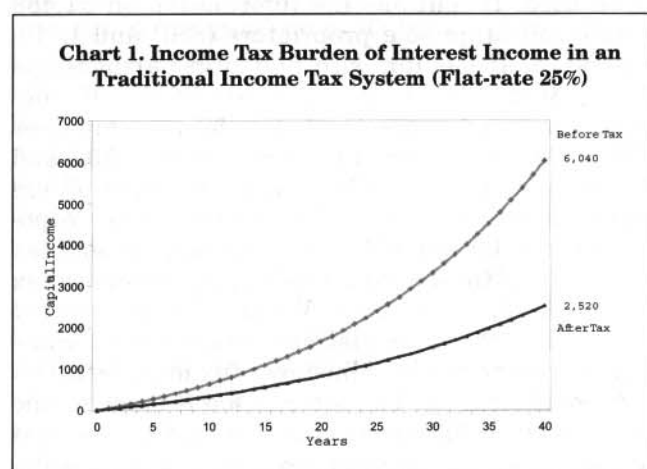
Also, many of the abolished concessions were connected to long-term investment perspectives. Many entrepreneurs invest in their companies with the intention of withdrawing the invested amounts and the connected interest or profit for old age. Therefore, in the case of long-term investment and the old-age provision, the periodically orientated ability to pay argumentation does not seem to be appropriate.¹⁷ Instead, the accumulated burden over the whole investment period or active life span is of utmost relevance for those investment decisions. A simple example should shed some light on this argument.

Precautionary measures in private companies or insurance schemes are principally connected with capital formation and capital income. If a traditional income tax system is applied, this system depends exclusively on annual incomes. The background 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, and so forth) on that capital are taxed again. Capital and capital income are consequently burdened several

¹⁶See Bundesministerium der Finanzen (2003).

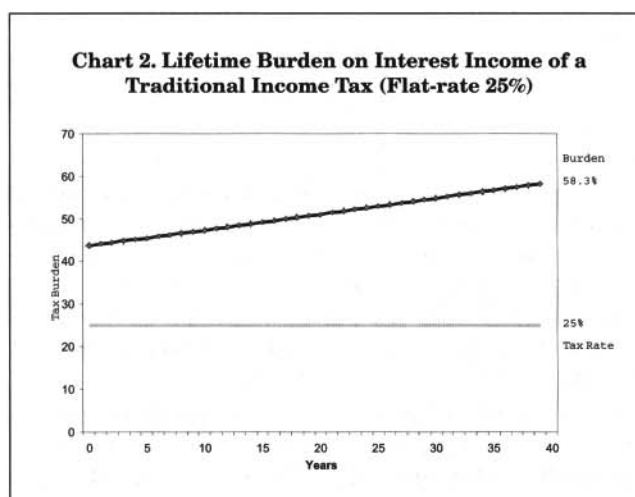
¹⁷See Petersen (2003a).

times.¹⁸ Chart 1 demonstrates the avalanche effect of capital income taxation in a simple example.



An income tax rate of 25 percent — that is, a flat tax rate — is assumed. An entrepreneur or employee saves €1,000 and invests that amount at an interest rate of 5 percent for 40 years in his company or on the capital market. Without any taxation, his interest earnings would grow to €6,040 (see Chart 1) and be available for his consumption in his old age. In the case of a traditional income tax, savings are accumulated from taxed income, so that at the assumed wage tax rate of 25 percent, only €750 can be invested for that 40-year period.

Because of the tax-reduced investment amount, the interest payment for the first year is no longer €50, but only €37.50. Despite the original 25 percent burden, the gross interest payment of €37.50 is taxed again by the 25 percent flat tax rate mentioned above. Consequently, the savings only grow by €28.13. The effective tax burden, including the original paid amount, is 43.7 percent after the first year. During the following 39 years, income tax must be paid on annual interest income. The disposable amount for old-age consumption is reduced to €2,520. Compared to the €6,040 in the situation without any income tax, the effective lifetime tax burden on the interest income is 58.3 percent (see Chart 2) — more than twice as much as the annual 25 percent flat rate.



In most traditional income tax systems, small savings amounts are protected by special savings allowances or other tax privileges. However, much higher income tax rates are applied for savings above the exemptions and the avalanche effects are even more severe. For the German tax burden on corporate profits, as estimated by the *Bundesministerium der Finanzen*, the above-mentioned average rate is about 43.5 percent. For a 40-year investment period, the accumulated burden is 80.8 percent, much higher than in the simple example. This burden is not the end of the flagpole. Compared to the situation before tax reform for those investments, the decrease of marginal rates has played no role. On the contrary, the tax burden has increased enormously. Some restraint on long-term investments is a likely consequence of this.

D. Cumulative Effects

The avalanche effects are even more acute if, on top of an income and corporate tax, an additional property tax is levied on personal property or equity capital. For reasons of simplicity, we neglect all the possible exemptions and deductions and argue with only flat tax rates on capital income or property (beyond the basic low- or no-tax savings amounts). Definitions of different kinds of property are also not taken into consideration. For 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 is 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 the flat rate on capital income ($C \cdot r$). In the case of identical tax revenue ($T_p = T_c$) it follows for the two tax rates:

$$t_p = t_c \cdot r$$

¹⁸For more details, see Petersen/Rose (forthcoming).

and

$$t_c = t_p/r.$$

If we assume an interest rate of 5 percent, a property tax rate of 1 percent on total wealth corresponds to an income tax rate of 20 percent on interest payments and profits. This tax burden is even higher for lower effective interest rates. Like the capital income tax, avalanche effects also affect the property tax. For annual taxes, the property tax burden of a 1 percent rate on investment returns is 20 percent. Over 40 years of investment this burden increases to 38.6 percent.

Capital gains taxes¹⁹ and inheritance taxes create additional burdens, which, over a lifetime, again show elements of the avalanche effect.²⁰ If a 1 percent property tax on total property is levied in addition to the flat tax rate of 25 percent, the annual burden on capital income is increased by 20 percentage points. The avalanche effect then produces a lifetime tax burden of over 70 percent. Including the additional capital gains tax and inheritance taxes, the total lifetime burden of all income and property taxes often reaches more than 90 percent.²¹

In many contemporary tax systems, capital income would be overburdened if the many tax loopholes were abolished. The frequently discussed proposal to broaden the tax base is very dangerous advice, because the long-term burden of capital income taxation is heavily increased even if the annual tax rates are cut. The avalanche effect overcompensates short-term tax rate cuts the longer the investment period. It is no wonder that in countries with an extreme long-term burden on capital income, saving and capital formation are increasingly impaired. If comparatively high saving ratios still exist in countries like Germany, this is due to the fears of the working generations that the social pension system, in view of demographic developments, has a gloomy outlook, and a sufficient level of retirement income can only be secured by personal capital formation. While capital formation, at least in the short run, might be satisfactory, long-term investment is avoided and the number of jobs is decreasing, creating an ever-increasing number of unemployed people.

¹⁹Capital gains are often taxed within the income and corporate tax systems, like in Germany, or by specific capital gains taxes, like in the United Kingdom and the United States.

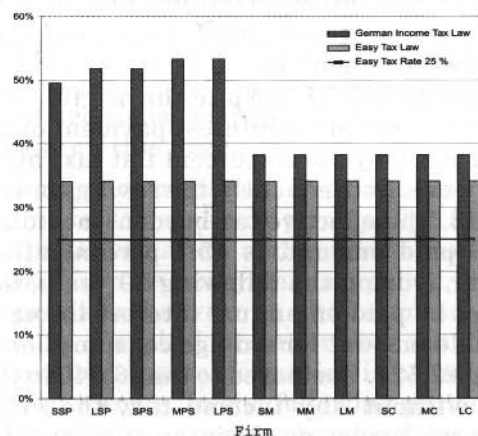
²⁰Not to forget the specific property taxes like the land taxes, motor vehicle taxes, and the like.

²¹See, for example, Anton/Petersen (forthcoming) and Petersen (2003a).

E. Arbitrary Company Taxation

For the assessment simulation of the tax burden on the business sector, a data file of the German Institute for Economic Research (DIW Berlin) has been used. It contains the information on 51,458 small and large sole proprietors (SSP and LSP), 28,450 small, medium-size, and large partnerships (SPS, MPS, and LPS), and 50,504 small, medium-size, and large limited liability companies (SM, MM, and LM) and corporations (SC, MC, and LC).²² Sole proprietorships and partnerships are burdened by the personal income tax (PIT). Corporations are burdened by the corporate income tax (CIT). All of these also must bear the business tax levied on the local level. Within the assessment simulation, the interrelations between the income tax, corporate tax, and business tax must be taken into consideration. The comparison is made on the basis of the 2005 tax law, assuming that the last steps of the tax reform process will be implemented.²³ 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 business types and the average local business tax rate is applied. For simplicity, it is assumed that profits are not distributed but are retained in the companies.²⁴

Chart 3. Marginal Tax Burden of the Model Enterprises



²²For the pros and cons of that data file, see Petersen/Fischer/Flach (2003).

²³For details on the German tax reform process, see Petersen (2000) and Petersen/Bork (2000).

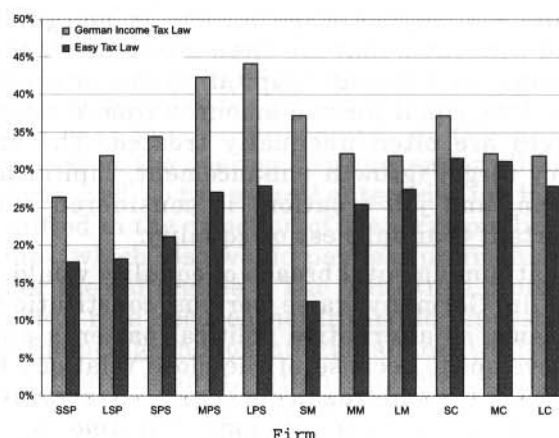
²⁴Because half of the dividends are treated as income within the PIT, the marginal and average tax burden of corporations also depends on the ratio of distributed profits to total profits. See previous note.

Chart 3 represents the marginal annual tax burden of the different average business types as defined above for the 2005 tax law (dark-gray columns).²⁵ While the profits for sole proprietorships and partnerships are taxed by the PIT and business tax at marginal rates of about 50 percent and more, the profits of corporations are burdened with marginal rates of the CIT and business tax of less than 40 percent.²⁶ Therefore, the average marginal burden on SSPs, SPSs, and MPSs is much higher than that on corporations for retained profits. With fully distributed profits, the marginal burden for the corporate tax increases, but still remains more or less below the levels for partnerships.²⁷ Therefore, the 2005 tax law discriminates between business based on their different legal structure and between those corporations, which are distributing a remarkable part of their profits.

Chart 4 displays the average tax rates for the different business types being considered. If the average tax burden on sole proprietorships is compared to that of small corporations, it becomes clear that, despite lower marginal tax rates, small corporations have a higher average tax rate. This result comes partly from the lower profits of small corporations compared to small sole proprietorships and partly from the fact that corporations are taxed on the business level by the CIT. Consequently, the individual deductions of the PIT system do not apply, which leads to a higher average tax burden. Even within the same business size, discrimination occurs because of different legal status, especially in small and medium-size corporations.

If all of the problems of the traditional PIT and CIT are summarized, despite the long-term, almost constant macroeconomic tax ratio and a middle position within typical OECD tax burden rankings, the burden of ancillary wage costs and profit taxation has reached or exceeded a critical level. This is especially true because the business tax burden is more unequally distributed than before. The burdens have shifted from highly mobile large multinational corporations, which use all tax saving instruments, to the much more immobile small and medium-size enterprises (SMEs). SMEs, which have been the backbone of the German economy, are not doing enough net invest-

Chart 4. Average Tax Burden of the Model Enterprises



ment to create a sufficient number of new jobs in Germany. A fundamental reform of capital income taxation is a necessary prerequisite for additional growth dynamics, which is also required to promote increasing capital formation to overcome future demographic problems.

The Last Resort: Easy Tax

Almost all of the proposals to reform the PIT and CIT systems in Germany fail to address the problems of capital income taxation, despite the enormous long-term burdens on capital income. Especially in Germany, some political groups are still discussing the reintroduction of the 1997 abolished property tax or at least an increase in the inheritance tax rates. Political illusions and shady promises that the wealthy will be more severely taxed are clear signals for behavioral adaptations. Therefore, it is not surprising that the mobility of capital and people has increased. If these political patterns become dominant, the German outlook is particularly gloomy. However, a sustainable relief from growth retardation and increasing employment figures is possible only if these problems are really tackled.

As mentioned, many countries (like the Netherlands and Scandinavian countries) have introduced a so-called dual income tax system, which taxes wages and capital incomes with different tax schedules.²⁸ For wages, the traditional progressive tax schedules (with increasing marginal rates) are applied. For capital income, usually a much lower flat rate has been adopted or, as in

²⁵The light-gray columns represent the corresponding marginal rates for the Easy Tax system, which will be discussed below.

²⁶All tax rates also reflect the solidarity surcharge.

²⁷For more detail, see Petersen/Fischer/Flach (forthcoming).

²⁸For details, see Bach/Seidel/Teichmann (2000).

Austria and Luxembourg, a withholding tax on interest payments with a comparatively low flat rate has been introduced. The result has been that middle and higher wage income is marginally taxed with rates that are often much higher than the rates on individual capital income or profits. Therefore, equal income amounts from different sources are often unequally treated. The efficiency target (growth enhancement, capital formation, and job creation) is considered more important than fairness or equality.

That fundamental breach of equality would, at least in Germany, raise serious constitutional problems, so alternative political patterns must be developed. Because of the close relations between the tax and transfer schemes, an integrated approach is necessary for long-term reform. For example, if the pension system is reformed by expanding capital funding and partly substituting the PAYGO system, a harmonization within the tax system (similar treatment of contributions and pension payments) is inevitable. Tax and transfer law simplification is necessary to improve the information and knowledge of the electorate, which will lead to more efficient control over political actions.

At the core, the aims of tax reform for the household sector are equal treatment of lifetime income (from wages and capital), independent of the source, and equal treatment of future and current consumption. Within the enterprise sector, neutrality is the most important target, so that at the end of the reform process all enterprises would have an equal marginal burden. Compared to the German situation, that would mean a lower marginal burden for sole proprietorships, partnerships, and small corporations (S corporations) and a major decrease in the average tax burden for SMEs.²⁹

The Heidelberger Steuerkreis has developed an "easy tax proposal" (the Easy Tax)³⁰ that, on one hand, integrates income and corporate taxes into one law and, on the other hand, secures equal treatment of wages and capital income as far as possible. The conflict between efficiency and justice is reduced to an absolute minimum. Here, only the basic elements for capital income treatment are presented.³¹ If the above-implied life-

time perspective for undistorted preferences is attempted, an integrated income and corporate tax system must be developed that applies the same tax criteria for wages and capital income.

The Easy Tax has two specific forms of tax collection: personal income tax and profit tax. Taxable income comprises three sources: wages, self-employment income, and retirement income. Expenses for vocational education are subtracted. The profits of S 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 U.S. corporate tax. Profits of S corporations, considered pass-through companies in the Easy Tax draft law, are considered distributed to shareholders and are taxed as personal income.

The integration of profits into personal income tax through passthrough companies has an important feature in that small and medium-size businesses are taxed independently of their legal construction (neutrality of legal construction). Big corporations (public companies) are taxed at the highest marginal rate of the income tax, and no personal deductions apply. For the equal treatment of wages and capital income over the course of a lifetime, the above-mentioned avalanche effect must be avoided. Two different methods could be applied. Their effects on capital income taxation are equal, but they would influence the periodic distribution of tax revenue. In the interest adjustment method, a standard market interest rate is subtracted from all capital income. If the savings adjustment method is applied, savings are tax-free, while earnings in a payment period must be taxed. Consequently, the savings adjustment method shifts the taxable base into the future, so that fiscal administration, at least for longer time periods, would be threatened by large tax revenue losses.

The Easy Tax provides pragmatic solutions. For all sources of capital income (interest, profits, rents, and so forth), a basic rate of return — for instance, the interest rate for a two-year government bond — remains tax-free as remuneration for the abnegation of consumption. Consequently, only capital incomes above this basic rate of return (also called the protective interest rate) are taxed, whereas a steady tax base on capital income remains. The protective interest rate avoids the avalanche effect and, in the lifetime perspective, the equal treatment of wages and capital in-

²⁹See Petersen/Fischer/Flach (forthcoming).

³⁰The 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 can be found at <http://www.einfachsteuer.de>.

³¹A short description can be found in Petersen (2002); for more detail, see Petersen/Rose (forthcoming).

come is assured. The calculation of profits follows a modified cash flow method, which defines profits as a cash surplus of earnings to business expenses. The modifications are related to the expenses for depreciation and the discount for the protective interest rate.

For all forms of retirement income, the savings adjustment method, in which the premiums and contributions to old-age protection are tax-free, is preferable. Interest and savings adjustments are the measures for a dynamic design of annual taxation, which remains the basic tax period for practical reasons. Both methods ensure that all components of lifetime income are taxed only once, independent of their sources. At the same time, the equal burden on the types of lifetime income and the equal treatment of future and current consumption is guaranteed, which abolishes discrimination on saving as a consequence of the traditional income tax systems.

Consumption-oriented enterprise taxation following the interest adjustment method is often criticized for leaving profits tax-exempt. Consequently, the business sector would be widely untaxed. In view of the return on equity within the business sample for the assessment simulation, those presumptions are unrealistic.³² For sole proprietorships and partnerships, the deduction of the protective interest rate (interest adjustment) amounts to a reduction of profits between 2 percent (for SSPs) and 15 percent (for LPSs). For corporations, the reduction is between 6 percent (for SCs) and 17 percent (for LCs). If the business sample is representative for the German business sector, the deduction of the 5 percent adopted protective interest rate would reduce the taxable base of the Easy Tax by 7.4 percent if the weighting is done with the respective fractions of business types in the whole sample. The interest adjustment connected with the elimination of the avalanche effect is, therefore, much less costly than all the loopholes and tax concessions within the existing income and corporate tax systems, which have led to an erosion of the tax base.³³

For enterprise taxation, the Easy Tax draft law also establishes the above-mentioned neutrality of the legal status for small and medium-size

enterprises. Chart 3 demonstrates that the marginal tax rate of the Easy Tax is equal for all legal forms. S corporations are marked with S (SCS, MCS, and LCS) and public companies with P. For small corporations, in Chart 4 it is obvious that the average burden for SCSs is substantially reduced compared to their treatment as public companies (SCPs). Furthermore, in the annual perspective, the average tax burden for all SMEs is decreased, so 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.³⁴ The deductible protective interest rate secures neutrality for investment and financing, and for inflationary neutrality. The latter prevents any taxation of purely inflationary windfall profits. The Easy Tax is a pragmatic approach, enabling practical implementation, but it also corresponds to the theoretical demands of a second-best tax.

III. Summary

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

Tax optimization is rational behavior of well-informed individuals within the private sector,

³²For the sample of 130,412 model firms, the return on equity is between 314 percent for the average SSP, 40 percent for the LSP, 48 percent for the SPS, 38 percent for the MPS, 33 percent for the LPS, 84 percent for the SC, 68 percent for the MC, and 29 percent for the LC. These high rates of return result because of behavioral adaptations to the German income and corporate tax law, which favors a comparatively low input of equity capital. For more details, see Petersen/Fischer/Flach (forthcoming).

³³The Heidelberger Steuerkreis also recommends replacing the German business tax with a surcharge for the local communities of the Easy Tax yield. If the business tax revenue at an average effective tax rate of currently 385 percent should be substituted with that surcharge, the necessary surcharge rate on business enterprises would be 29 percent. If the tax base is extended to the self-employed and employees, the surcharge rate could be reduced to below 10 percent. That local surcharge would include all local citizens and businesses and could be determined by the local jurisdiction. For more details, see Rose (2002, p. 29).

³⁴The assessment simulation does not hold tax revenue constant. This can only be done with an approach using microsimulation models. See, for example, Anton/Brehe/Petersen (2002). Because of the lack of micro-data on the business level in Germany, those simulations cannot be done.

considering the equivalence in tax burdens and the efficient supply of public goods and services. Regarding private enterprise, it is not illegal, because capital owners, shareholders, and the management have no national obligation except to secure the future existence of their equity capital — and the connected jobs for their employees. Politicians' pleas to remind entrepreneurs of their national obligations are reminiscent of nationalism, which today should be overcome in open societies that profit from international relationships and cooperation.

Politicians should not complain about the alleged costs of globalization, but instead face the challenge of systems competition to take advantage of global free trade and the mobility of production factors. This challenge must be put into practice by a fundamental tax and transfer reform, which would improve the advantage of location of their countries in a sustainable manner. Politicians must also become aware that tax and social security systems competition is a positive and necessary element of fair global cooperation. They should limit state activities to an efficient level and prevent possible developments in the direction of the Leviathan with permanently rising tax burdens and ever-increasing numbers of transfer recipients being on the drip of the state. The countries that are falling back will temporarily lose, but they will also be given incentives for future reforms.

Reform should be limited to significant fundamental changes. The many reforms of the past have overwhelmingly stood for curing symptoms instead of sustainable therapy. The Easy Tax proposed by the Heidelberger Steuerkreis is a fundamental reform. The integration of the PIT and the CIT would guarantee equal treatment of wage and capital income in a lifetime perspective and make ad hoc interventions and political manipulations of income taxation far more difficult. The Easy Tax would guarantee the neutrality of legal status, investment, financing, profit distribution, and inflation.³⁵ The proposal includes the most important elements of modern tax theory. At the same time, it shows that modern theory can be implemented in realistic tax drafts. In some European countries, discussions for implementation are already occurring. Even in Germany, the number of supporters is steadily increasing. If the Easy Tax, as a core element of a fundamental tax and transfer reform, is implemented, another German economic miracle could happen. ♦

³⁵See Petersen/Rose (forthcoming).

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