Modern Income Taxation and International Tax Competition: The Answer to Globalization Pressures

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Abstract. The paper deals with the recent growth retardations in France and Germany and with the more efficient tax strategies being pursued in other EU and non-EU countries. The persistency of traditional income taxation is named as one possible reason for the growth differentials in the different countries. The avalanche effects of traditional income taxation and the cumulative impacts of multiple capital income taxation (by income, corporation, firm, property, capital gains, inheritance taxes, and specific property taxes) are re-valued and the arbitrary company taxation in Germany is taken as a typical example. The "Easy Tax Bill" of the "Heidelberger Steuerkreis" and a transitory allowance on corporate equity tax is presented, which would bring a fundamental simplification for company taxation, especially favouring the SME, as well as almost complete neutrality for the business sector, thus inducing higher capital formation, but particularly more investment within the affected countries.

Keywords: Allowance on corporate equity (ACE), Growth retardation, Income taxation, Avalanche effects of capital income taxation, Multiple taxation of capital, Interest adjustment, Saving adjustment, Protective interest rate, Flat-rate, Easy tax.

JEL codes: H21, H25, H32, O43

1. 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 pressure on national tax and transfer schemes to reduce costs by abolishing existing inefficiencies. Although there is not much fear of a "race to the bottom"[2] at least

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[2] 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).

some large groups within the societies favoured by the old systems inevitably will become losers, loudly complaining in public about unjustified social dismantling. Globalization pressures, recessions, and accelerating structural problems have also forced several European and extra-European countries to reform their direct tax systems, especially the taxation of capital income and companies.[3] 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: personal income tax, corporate tax, property tax, 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 also exist, which burden specific kinds of real and financial assets, for example, 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.[4]

Taking the growth performance of different countries into consideration, obviously Germany has been seriously lagging behind for at least ten years, and recently France, as the second core country of the EU, has also been confronted with stronger growth retardation.[5] 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, partly dependent on fundamental economic reforms which have been applied since the mid 1980s, especially in Denmark, Finland, Ireland, the Netherlands, Sweden, and the UK. In countries such as Austria, Luxembourg, and Switzerland, relatively stable economic framework conditions have worked successfully, 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 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), have

[3] 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).

[4] See Petersen (2003a, 2006).

[5] Since 1995 the growth performance in France has been much better than in Germany; see *OECD* (2003): *Economic Outlook* 73, Annex Table 1.

led to a growth stimulation.[6] In the same period, these countries and the UK have substantially reduced transfers and implemented measures against the poverty trap phenomenon, which enforced the reintegration of the unemployed into official labour markets.[7] The more efficient taxation of capital income and companies has 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.

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 the critical scepticism of German and French politicians, 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 and at least partly Australia and New Zealand, have often be blamed as tax shelters due to their reserved and often comparatively low tax burdens on capital income and business profits. Obviously these countries have profited by enormous capital inflows, while the high-tax countries are increasingly confronted with capital outflows. 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 banks than as competitors for productive investment.[8] However, the detour of capital to EU external or internal tax shelters increases capital costs.

The most effective way to avoid additional transaction costs would be to reform the tax and transfer systems in the high-tax countries at least to narrow the gap between low and high-tax countries.[9] A total harmonization in the direction of the lowest existing tax rates connected with the 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.[10]

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[6] For details see Bach, Seidel, Teichmann (2000).

[7] This is especially true for the Netherlands which has developed the most efficient integration of direct taxation and social security contributions; see Petersen (2004a).

[8] Malta, as an EU accession country in 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.

[9] For an international comparison of tax pressures see Lafay, Périvier (2003).

[10] 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 argument becomes invalid if differences between risk sharing (insurance) and redistribution are taken into consideration, which are totally neglected by Sinn; see Petersen (2003, pp. 212).

2. Problems of Traditional Income and Profit Taxation

2.1. 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 corporate 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 citizens. In a world of almost legally unlimited mobility – or, in other words, in a globalized 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.[11]

Obviously mobility is dependant on individual endowment of 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.[12] 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) amortization to the former owners.[13] Therefore, the actual behavioural adaptations of citizens are determined by tax and transfer policy patterns of the past and their expectations of the future burden developments. If their individual projections will make them believe in further burden increases, then even immobile citizens will reconsider the location advantages (in the form of personal and public infrastructure) and disadvantages (in the form of factual or at least presumed future burden increases).

Lafay (2003) correctly points out the problem that the absence of tax revolts in France as well as in Germany does not mean that the electorates are completely inactive. On the contrary, for decades they have been active in the informal sector and increasingly voting with their feet, and this has accelerated by the increasing globalization as consequence of the changes after 1989. Already at the end of the 1970s and the beginning 1980s, growing shadow economies have been observed, with a permanent increase up to now.[14] Increased voting with their feet is an

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[11] See *ibid.* and Petersen (2004b).

[12] The 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 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).

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

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

expression of the 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 highly skilled persons as tax havens or shelters, which they often denote as immoral political strategies. Such tax shelters, with an obviously more attractive environment for capital income and investment, are often asked to make any necessary adjustments for a harmonization on the level of their inefficient regulations, neglecting the fact that, because of the avalanche effects[15] described below, their own capital income taxation by the existing traditional income and corporation taxes is highly questionable and immoral itself. The hope for increased national and global capital formation partly to overcome problems within the PAYGO pension systems with higher tax burdens on capital income is a contradiction in terms.

2.2. 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 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 results 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 with a strategy of tax optimization. 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 characterized 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 for almost everybody; beyond that, property is not created by overnights miracles, but is heavily earned by the work of one's own hands and personally saved for by abnegation of consumption. It is no wonder that double and multi-burdening today are evaluated quite differently, and

[15] See Petersen (2003a) and Petersen and Rose (2004).

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 income 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. Nevertheless, in many countries, the corporate tax rates have been seriously decreased and source taxes on interest income have been introduced with flat rates formerly only typical for tax havens. Dual income tax systems, as in Scandinavia, or even triple box systems with different tax schedules, as in the Netherlands, have been implemented which favour profits from equity capital, 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 a performance measure.

At least, with regard to corporate taxation, in Germany the tax burden for legal entities has been drastically reduced twice (by the 1998 tax reform and the 2008 reform of corporate taxation), especially if the scheduled tax rates are taken into consideration. While in the mid 1990s the average corporation and business tax burden (including the solidarity surcharge) was often above 70 per cent, the reforms of 1998 have reduced that burden to about 43.5 percent.[16] But even this substantial tax cut did not yield the expected expansive impacts on growth and labour markets, and the negative outcome is not only caused by the necessary, but also largely delayed, social and labour market reforms. In 2008, the corporate tax burden was further reduced to 30.8 percent; but it is too early to determine the possible effects because in both reforms the tax base has been broadened so that the changes in the effective marginal and average tax rates are ambiguous.[17]

2.3. Avalanche Effects

On account of historical reasons within the German income and corporate 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 diagnosis that the income and corporate tax base was heavily eroded, and the switch to a more comprehensive tax base would yield additional revenue which would allow for a substantial decrease of the marginal tax rates. This argument, obviously in

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[16] See Bundesministerium der Finanzen (2003).

[17] See, http://www.bundesfinanzministerium.de/nn_86/DE/Presse/Reden_20und_20Interviews/050.html, 13.05.2008.

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.[18] If such concessions are abolished, the tax burden on such income parts remains 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 invest at least partly in their companies with the intent of withdrawing the invested amounts and the connected interest or profit for old age. Therefore, at least in case of long-term investment and old-age provision, the ability to pay argument seems not to be appropriate.[19] 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 argument.

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 income. 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 income (or profits, dividends, rent, etc.) on that capital are taxed again. Capital itself and capital income is consequently burdened several-fold.[20] Chart 1 demonstrates this so-called avalanche effect of capital income taxation in a simple example.

An income tax rate of 25 percent (e.g., flat-rate) is assumed; an entrepreneur (or employee) is saving 1,000€ and invests that amount profitably at an interest rate of 5 percent for forty 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 for his 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 percent only 750€ can be invested for that forty-year period.

Due to the tax reduced investment amount, the interest payment for the first year is not any longer 50.00€ but only 37.50€. In spite of that original 25 percent tax, the gross interest payment of 37.50€ is taxed again at the 25 percent flat-rate mentioned above. Consequently his saving account is only growing by 28.13€. The effective tax burden, including that already paid, is then, after the first year, 43.7 percent. In all the following thirty-nine 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€. Compared to the 6,040€ in the situation without

[18] 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).
[19] See Petersen (2003a).
[20] See for more details Petersen and Rose *(2004)*.

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

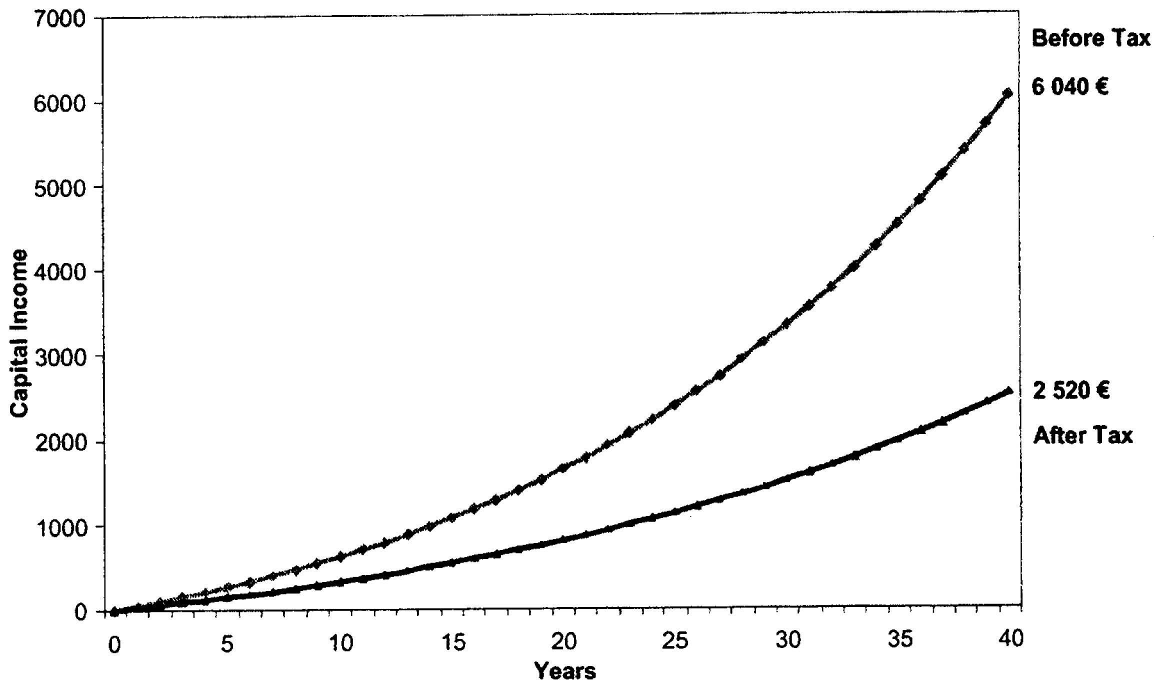
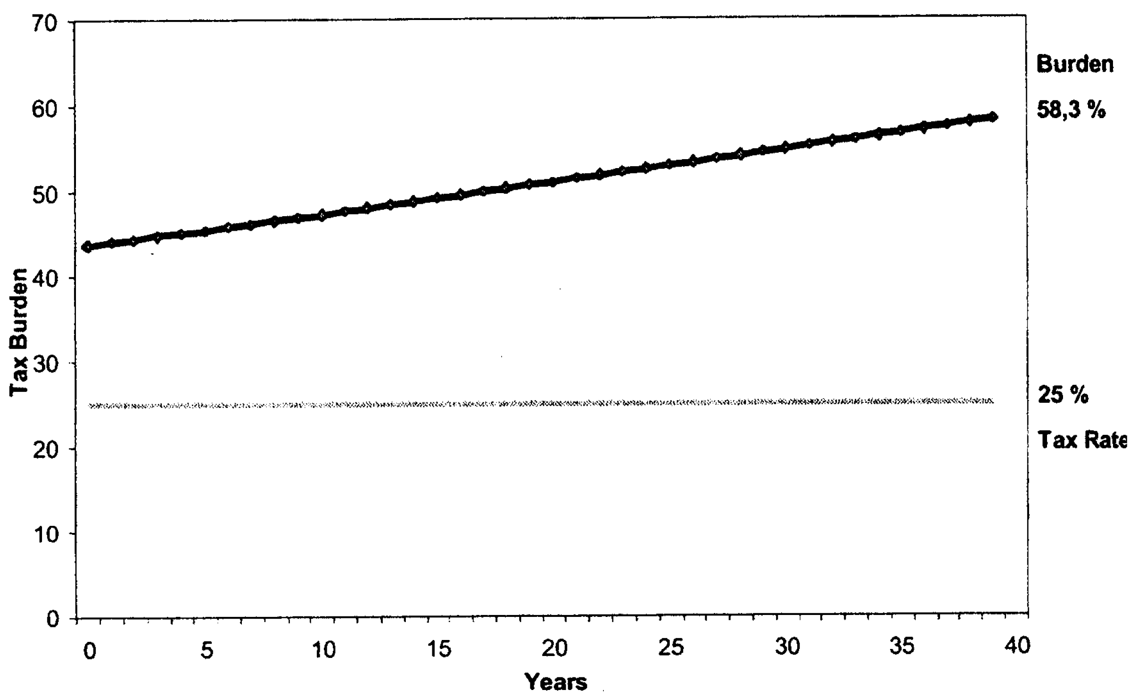


Chart 2: Lifetime Burden on Interest Income of a Traditional Income Tax (Flat-rate 25 %)



any income tax, the effective lifetime tax on the interest income is 58.3 percent (see chart 2), which is more than twice as much as the annual 25 percent flat rate.

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 past 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 forty-year investment period, then, the accumulated burden is 80.8 percent higher than in the simple example – and this burden is not the end of it. Compared to the situation before the tax reform, at least for such investments, the decrease of marginal rates has played no role. On the contrary, an enormous increase in tax burden has taken place. Depending on the relevance of such investment, at least a certain restraint with regard to long-term investments might be a likely consequence.

2.4. Cumulative Effects

The above described avalanche effects are even more intense if, beside an income and corporate tax, an additional property tax is levied on the personal property or equity capital. For 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. On an 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 the 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 percent, a property tax rate of 1 percent on total wealth would correspond to an income tax rate of 20 percent on interest payments and profits. For lower effective interest rates, this burden would be even higher. As the capital income tax, also the property tax would be connected to the above-mentioned avalanche effects. While, on a annual perspective, the property tax burden of a 1 percent rate on investment returns would be 20 percent, from a lifetime perspective (over forty years of investment) this burden would increase to 38.6 percent.

Capital gains taxes[21] and inheritance taxes create additional burdens, which from a lifetime perspective again show elements of the avalanche effects.[22] If, in addition to the above-mentioned flat rate of 25 percent, a 1 percent property tax on total property were levied, the annual tax on capital income would increase by 20 percentage points. The avalanche effect would then produce a lifetime burden of both taxes, which would clearly be above 70 percent. In case of an additionally levied capital gains tax and the burden of inheritance taxes, the total lifetime burden of all income and property taxes often would reach more than 90 percent.[23]

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 very dangerous advice, because the long-term burden of capital income taxation would be heavily increased, even if the annual tax rates were decreased strongly. The avalanche effects over-compensate short-term tax-rate cuts as the investment period lengthens. 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 (for example, 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.

2.5. Arbitrary Taxation of Companies

For the assessment simulation of the tax burden on the firm sector, a data file from 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).[24] Sole traders and partnerships are subject to the personal income tax

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[21] Capital gains are often taxed within the income and corporate tax systems (as in Germany) or by specific capital gains taxes (as in the UK and the United States).

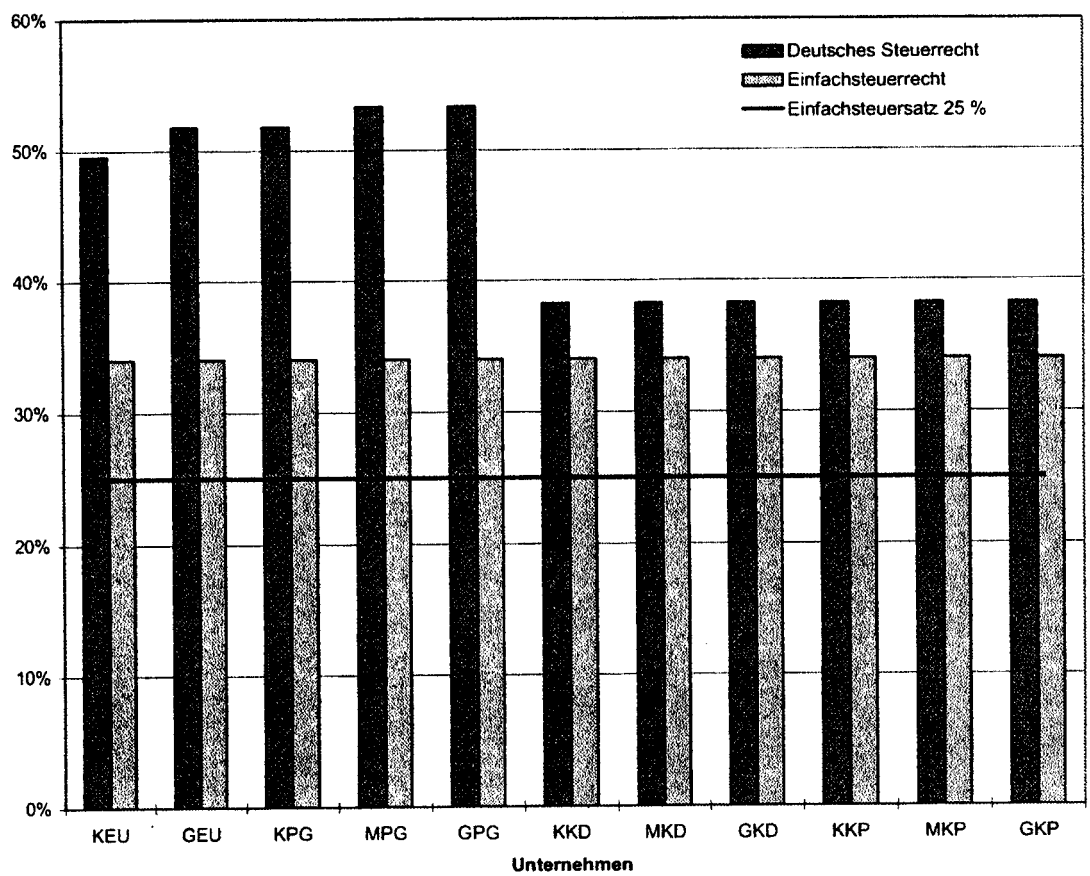
[22] Not to forget the specific property taxes such as the land taxes, motor vehicle taxes, etc.

[23] See, e.g., Petersen (2003a).

[24] For the details of that data file see, Petersen, Fischer, and Flach (2005).

(PIT), corporations to the corporate income tax (CIT), whilst both also have to bear the firms' tax levied at the local level. Within the assessment simulation, simple interrelations between the income, corporate and firms' taxes have to be taken into consideration. The comparison is done on the basis of the 2004 tax law, assuming that the last steps of the current tax reform process will have been implemented.[25] 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 business tax rate is applied. For the sake of simplicity, it is assumed that profits are not distributed but retained in the firms.[26]

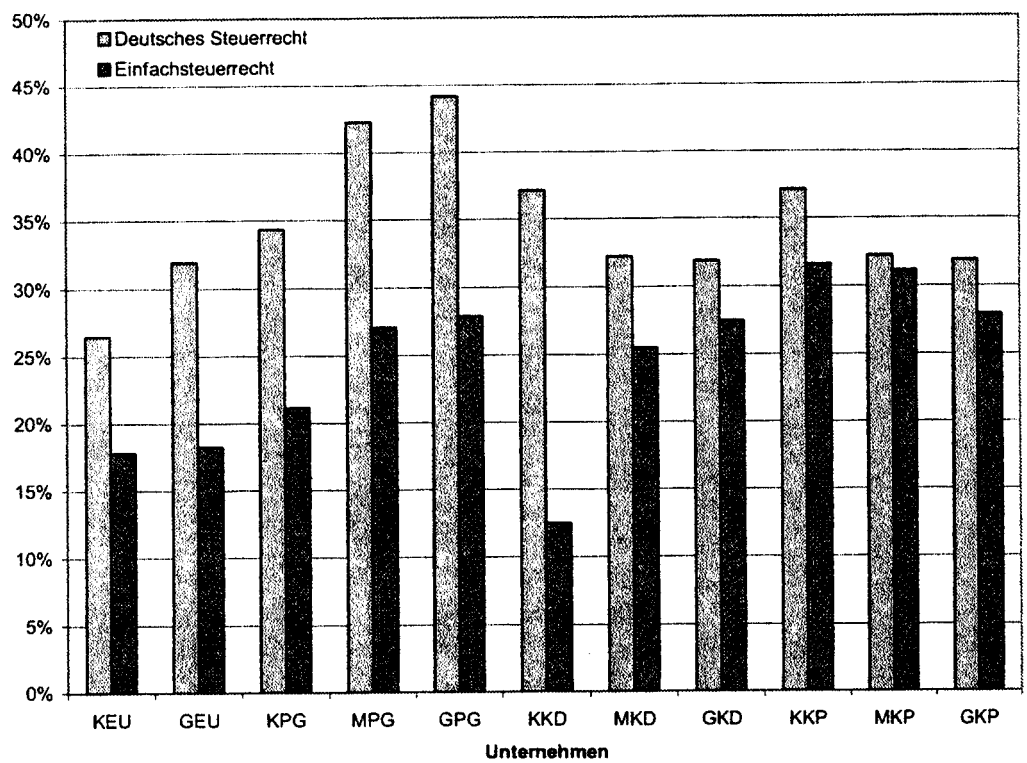
Chart 3: Marginal Tax Burden of the Model Enterprises



[25] For details on the German tax reform process see Petersen (2000) and Petersen and Bork (2000).

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).[27] While the profits in case of sole traders and partnerships are taxed under the PIT and business taxes 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.[28] 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 corporations increases but still remains more or less below the levels for partnerships.[29] Therefore the 2004 tax law discriminates against firms on the basis of their different legal status and between the corporations which distribute a large part of their profits.

Chart 4: Average Tax Burden of the Model Enterprises



[26] Since 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 *ibid.*
[27] The light-grey columns represent the corresponding marginal rates for the easy tax system, which will be discussed below.
[28] All tax rates also reflect the solidarity surcharge.
[29] For more details see Petersen, Fischer and Flach (2005).

Chart 4 displays the average tax rates for the different business 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, and this leads to the higher average tax burden. Even within the same firm size, extreme discriminations occurs because of the different legal status which are especially turned against small and medium corporations.

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 corporate 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). Thus the SME – which have been the backbone of the German economy – are impaired in net investment. Therefore, new jobs are not created in Germany in a sufficient dimension. However, a fundamental reform of capital income taxation is a necessary prerequisite for additional growth dynamics and is also inescapable to promote increasing capital formation to overcome future demographic problems.

3. The Last Resort: Easy Tax

Almost all of the proposals currently being discussed 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 a reintroduction of the property tax abolished in 1997 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 behavioral adaptations. Therefore, it is not astonishing that the mobility of capital and persons is further increased. If such political patterns were to 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 (such as 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.[30] While for wages the traditional direct progressive tax schedules (with strongly increasing marginal rates) are applied, for capital gains usually a much lower flat-rate has been adopted, or as in

[30] For details see Bach, Seidel and Teichmann (2000).

Austria and Luxembourg, a withholding tax on interest income with a comparatively low flat-rate has been introduced. The outcome is that at least middle and higher-wage income are taxed marginally with rates which are often much higher than for individual capital income or profits. Therefore, equal amounts of income, from different sources, are often treated unequally so that the fairness of treatment is hurt. Obviously the efficiency target (growth enhancement, capital formation, and job creation) is dominating fairness.

Such a breach of equality would, at least in Germany, raise serious constitutional problems. Thus, alternative patterns have to be developed. Because of the close relations between tax and transfer schemes, an integrated approach is necessary to develop a long-term reform perspective. If, for instance, the pension system were reformed by expanding capital funding and at least partly substituting the PAYGO system, a harmonization with the tax system (treatment of contributions as well as pension payments) would be inevitable. A simplification of tax and transfer law is needed to improve the information available to, and the knowledge by, 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), whatever the 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 tax rate. Compared to the current situation in Germany, that would mean a lower marginal rate 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.[31]

Therefore, the "Heidelberger Steuerkreis" has developed an "Easy Tax Proposal",[32] which, on the one hand, integrates income and corporate tax into one law and, on the other hand, secures as equal a 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.[33] If a lifetime perspective for undistorted preferences is striven for, an integrated income and corporate tax system has to be developed, which 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. The taxable income comes from three sources: income from wages, income from self-employment, and retirement income. The expenses for vocational education are to be subtracted. The profits from

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[31] See Petersen, Fischer and Flach (2005).

[32] 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.

[33] A short description is to be found in Petersen (2002); for more detail see Petersen and Rose (2004).

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 U.S. corporate tax; the profits of the S-corporations, named as "pass-through" companies in the Easy Tax draft law, are distributed to the shareholders and taxed as their other personal income.

Integration of profits, as far as possible, into the personal income tax by way of a "pass-through" company has the important feature that small and medium firms are taxed equally, independent of their legal structure (neutrality of the legal structure). Large corporations (public companies) are taxed at the highest marginal rate of income tax, where no personal deductions apply.

For the equal treatment of wages and capital income over a lifetime, the above-mentioned avalanche effects, in other words, the multi-burdening on savings, have to be avoided. Two different methods could be applied which, in their impacts on capital income taxation, would be equivalent but would heavily influence the periodical distribution of tax revenue. In case of the *interest adjustment method,* a standard market interest rate would have to be subtracted from all capital income. If the *saving adjustment method* were applied, the saving itself would have to be tax-free while the latter earnings in the payment period would have to be taxed. Consequently, the saving adjustment procedure would shift the taxable base into the future, so that fiscal administration, at least for a longer chain of periods, would be threatened by large tax revenue losses.

However, the Easy Tax would provide pragmatic solutions. In the case of all sources of capital income (interest, profits, rents, etc.) a basic rate of return – for instance, the interest rate for a two-year government bond – would remain tax-free as remuneration for the abnegation of consumption. Consequently only capital income above this basic rate of return (also called protective interest rate) would be taxed, whereas a steady tax base on capital income would remain. The protective interest rate would avoid the avalanche effects, and in the dynamic perspective the equal treatment of wages and capital income would be assured. The calculation of profits would follow a modified cash-flow method which would define profit as the (cash) surplus of earnings to business expenses. The modifications would be related to expenses for depreciation and the discount for the protective interest rate.

In the case of retirement income (all forms of pensions), the saving adjustment method would be preferable in which the premiums and contributions to old-age protection would be tax-free. Interest and saving adjustment would be the measures for a dynamic design of the annual taxation which necessarily would remain the basic tax period for pragmatic reasons. Both methods assure that all components of lifetime income regardless of their sources are taxed once and only once. At the same time, the equal burden on the whole lifetime income and the intertemporal neutrality for the consumption decision would be guaranteed, which would abolish the discrimination against saving which is a consequence of the traditional income tax system.

A consumption-orientated enterprise taxation following the interest adjustment method is often objected to for leaving profits tax exempt; consequently the firm sector would be widely untaxed. In view of the return on equity within the firm sample for assessment simulation, such presumptions are totally unrealistic.[34] For sole traders and partnerships, the deduction of the protective interest rate (interest adjustment) amounts to a reduction of the profits between 2 percent (SST) and 15 percent (LPS); for corporations the reduction is between 6 percent (SC) and 17 percent (LC). If the firm sample would be taken as representative for the German business sector, the deduction of the interest income by 5 percent would reduce the taxable base in case of the Easy Tax by 7.4 percent if the weighting were done with the respective fractions of firm types in the whole sample. The interest adjustment, connected with the elimination of the avalanche effects, would therefore be much less costly than all the loopholes and tax concessions within the existing income and corporate tax system, which has led to a strong erosion of the tax base.[35]

Regarding enterprise taxation, the Easy Tax draft law would also establish the above-mentioned neutrality of the legal status for small and medium-sized enterprises. Chart 3 demonstrates that the marginal tax rate of the Easy Tax would be 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 would be substantially reduced compared to their treatment as public companies (SCP). Furthermore, on an annual perspective, the average tax burden for all SME would be greatly decreased so that the overall enterprise tax burden would be shifted in the direction of the large public companies which also would pay less profit tax than under the old regime.[36] In addition, the deductible protective interest rate would secure neutrality for investment and financing, as well as inflationary neutrality. The latter would prevent any taxation of purely inflationary windfall profits. Obviously, the Easy Tax would

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[34] 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 these high rates of return are the result of behavioural adaptations to the German income and corporate tax law which favours a comparatively low input of equity capital. For more details, see Petersen, Fischer and Flach (2005).

[35] The "Heidelberger Steuerkreis" also recommends replacing the current German business tax with a surcharge for local communities on the Easy Tax yield. If the business tax revenue at an average effective tax rate of currently 385% should be substituted 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 a local surcharge would include all local citizens and firms and could also be connected to local surcharge rate autonomy. For more details, see Rose (2002, pp. 29).

[36] 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.

still be a pragmatic approach which would enable the practical implementation but also correspond to the theoretical demands of a second-best tax.

4. 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 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 a private insurance scheme, because then basic security in all existing branches of social insurance would be tax-financed, social security contributions could be substantially reduced, and non-distortable indirect taxes be increased. Consequently ancillary wage costs would be greatly reduced, which would set incentives for higher employment and additional investment.

Tax optimization is the 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 from their international relations and cooperation.

Politicians should not complain about the alleged costs of globalization, but they have to face the challenge of systems' competition to take full advantages of global free trade and mobility of production factors. This challenge has to be put into practice with a fundamental tax and transfer reform which would 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 fair global cooperation, thus limiting state activities to an efficient level and preventing possible developments in the direction of a totalitarian tax state[37] with permanently rising tax burdens and ever-increasing numbers of recipients relying on state support. Countries, which are falling back, will temporarily lose but also be given incentives for future reforms.

The notion of reform should be limited to really 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 such a fundamental reform. The integration of the PIT and the CIT would guarantee an equal treatment of wage and capital income over a lifetime and make ad hoc

[37] See Schumpeter (1918).

intervention 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.[38] Therefore, this proposal considers the most important elements of modern tax theory. At the same time, this proposal gives evidence that modern tax theory can be implemented in realistic tax drafts. In some European countries discussion for an implementation are already under way[39] 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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[38] See Petersen and Rose (2004).

[39] In a region of Bosnia and Hercegovina (Brcko County) a slightly modified Easy Tax was implemented in 2003 in cooperation with members of the "Heidelberger Steuerkreis", the German "Gesellschaft für Technische Zusammenarbeit GmbH (GTZ)," and the local government. A similar draft law is currently being discussed in Liechtenstein.

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