

# Income Tax in the Global Arena

*Income tax has been one of Germany's most heated topics of debate for a long time. Increasingly, reference is made to the impact of the forces of globalization and tax competition. In his article,*

**STEFFEN GANGHOF** of the **MAX PLANCK INSTITUTE FOR THE STUDY OF SOCIETIES** in Cologne examines the background to the discussion and describes two different reform models.

**W**hat impact does the process of globalization have on income tax? How is this impact connected with tax policy conflicts? These and similar questions have occupied experts for some time now. In the course of discussions on income tax, meaning taxation levied on both individuals (personal income tax) and incorporated companies (corporation income tax), two now clearly delineated models for reform have emerged. These models are essentially the polarizing forces at the heart of the conflict.

► The *flat-tax* model: All types of income will be taxed at a low flat rate, for instance 25 percent.

► The *dual income tax* model: Only income from capital will be taxed at a uniform low rate. Earned income will be subject to a progressive rate schedule, with a higher top tax rate.

The most obvious pressure exerted by tax competition is for reform measures relating to corporate income taxation. By the mid-eighties, the corporate tax rates (on retained earnings) of industrialized nations had reached a relatively high level, averaging around 50 percent. At the

same time, these countries encouraged capital expenditure by offering tax incentives, such as the accelerated depreciation of assets. This made the tax base more conducive to investment, but at the same time, narrower and less systematic.

By the mid-eighties, this system of taxation had proved to be unviable in the international competitive arena. High corporate income tax rates had a dual effect: foreign investors, particularly profitable companies, had less incentive to invest directly, and international companies saw great advantage in shifting taxable profit into countries with low taxation rates. The tax reforms in Great Britain (1984) and the US (1986) launched the race to lower corporate income taxes – a race that is still going on today. The average tax rate has since fallen by more than a third; in 2003, it was approximately 32 percent (Figure 1).

There is little sign that this downward spiral is set to abate. Austria is a prime example: In the late eighties and early nineties, business taxation (corporate income tax plus trade tax) had been slashed within the space of a couple of years, from over 60 per-

cent down to 34 percent. Since this rate was one of the lowest in Europe for many years, and therefore stable, the Austrian government recently announced a new reduction to 25 percent, partly in response to the relatively low corporate income tax in the new EU member states.

## THE DOWNTREND HAS MANY CAUSES

Enabling companies to improve their competitive edge by offering a favorable tax environment is, of course, not the only reason for this downtrend. Many governments had other reasons for cutting tax rates and, in turn, broadening the measurement base upon which their taxes are levied. The generous investment incentives, granted in combination with higher rates of taxation, left an indelible stamp on the structure of investments, thereby distorting market processes. The intention was to rectify these distortions. That tax competition does indeed constitute a key driving force behind tax rate reductions is evidenced by the following: Although the variation in tax rates in the advanced industrial nations has not lessened during this



downtrend – before the wave of reforms, rates ranged between 62 and 42 percent, compared to today's band of between 33 and 13 percent – the position of individual countries within the tax rate distribution has increasingly reflected the size of the country (Figure 1). The economic theory of asymmetrical tax competition predicted exactly this. It is easier to lower tax rates in a small country because the country's own tax base is relatively small in comparison to the tax base it can import through having a lower tax rate. To put it another way, if a large country raises the tax rate unilaterally, it will cost that country less than it will cost a small country because, per capita, the increase will drive less capital out of the large country.

This rule has held fast not only for the advanced industrialized nations, but also for the 74 countries included in the Corporate Tax Survey con-

ducted by the accounting firm KPMG based on uniform criteria (Figure 2). Whereas larger countries such as India and the US have relatively high levels of corporate income taxation of around 40 percent, the tax rates of many small countries range between 10 and 20 percent. The new EU member state Estonia levies no tax at all on companies' retained earnings.

The problem for governments in the race for lower tax rates, at least up until now, is not so much the fact that revenue from corporate income tax has fallen dramatically – most governments have been able to close the gap by scaling down or abolishing investment incentives and tax relief. The real dilemma is the indirect impact lower corporate tax rates have on personal income tax. If the corporate income tax rate is way below the top tax rate levied on personal income, not only can this

cause undesirable distortions in terms of economic decisions, it can also lead tax payers to use the appropriate form of incorporated company to shield part of their income from capital from the higher and progressive taxation of personal income. To put it dramatically, increasingly lower corporate income tax rates can create a loophole through which part of the revenue from capital income subject to a progressive rate schedule can slip.

With respect to domestic taxation, it would be ideal if the top income tax rate were to harmonize with the corporate income tax rate. It is precisely this that long constituted a central principle of tax policy in Germany and several other countries. Aligning both (top) tax rates was deemed necessary in the effort to approach the ideal of a "comprehensive" income tax. Under this ideal, all income should be uniformly

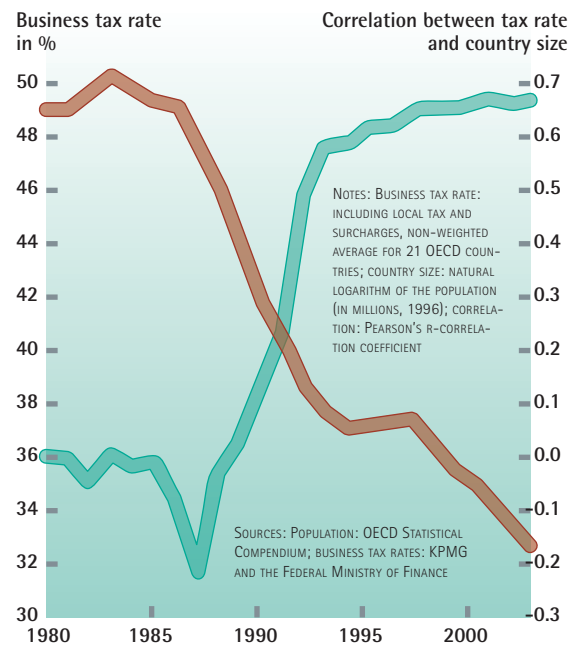


Fig. 1: Development of business tax rates (corporate income tax plus trade tax) and the correlation between these rates and country size (natural logarithm of the population) from 1980 to 2003 (21 OECD countries).

taxed. Certain types of income should not be given tax preference and, accordingly, the (retained) earnings of incorporated companies should not be taxed at rates lower than those applicable to, say, the earnings of partnerships, bank interest or earned income.

Tax competition has rendered the implementation of uniform (top) tax rates for corporations and individuals impracticable for most countries or, at minimum, made it much more expensive. If top tax rates on personal income were brought down to the level acceptable for corporate income, tax competition would “spill over” into the realms of taxation of less mobile income types. This problem is particularly relevant to wages and salaries, which are much more significant than capital income for the tax base of a welfare state. In most countries, a sharp reduction in the top tax rate would lead to either a large tax shortfall or less progressive taxation – or both.

This is most evident in the special case of Estonia. If the top income tax rate were also lowered to zero, the approximately 8.5 percent of the gross domestic product (GDP) resulting from income tax revenues would cease to exist altogether. This corresponds roughly to a quarter of Estonia’s total revenue from taxes and social security contributions. The problem is less hypothetical for countries such as Ireland and Denmark.

**LITTLE ROOM TO MANEUVER**

Ireland has pursued a proactive strategy of offering tax incentives to foreign investors for decades, and has lowered its corporate tax rate to 12.5 percent. If the top income tax rate were also set at this level, it would be impossible to maintain the revenue from personal and corporate income taxation (in recent years, 13 to 14 percent of GDP). Ireland’s top income tax rate has therefore been lowered considerably over the last two decades, but still stands at 42 percent.

There is even less room to maneuver in a country such as Denmark, where tax revenue of almost 30 percent is more than double that of Ireland. Here, too, policy makers saw the necessity of setting the corporate tax rate at 30 percent, without being able to so much as consider a corresponding cut in the top income tax rate. Even if the tax base were to be radically revised and streamlined and all tax progression abolished, lowering the top tax rate (currently 59 percent) on earned income to 30 percent without affecting revenue would be impossible. Seen in this light, it is no wonder that the top tax rates on personal income in the advanced industrial nations are not oriented toward the size of the country. Instead, there is a statistically significant correlation between

the level of direct taxation on earned income (personal income tax and social security contributions as a percent of GDP) and the top tax brackets (Figure 3). This correlation is based on two different mechanisms.

In countries such as Denmark, where the main burden placed on earned income is in the form of income tax, the higher level of tax levied on wages and salaries generally results in a higher top tax rate. In countries where social security contributions play a significant role, such as the continental welfare states of Germany and the Netherlands, less tax is levied through tax on earned income and more through higher social security contributions. Lower top tax rates were more easily achievable in these countries because revenue from income tax is comparatively low. At the same time, however, a large part of the tax burden stems from the higher social security contributions paid on wages and salaries. These contributions are levied on the first euro upwards, but are frequently no longer paid above a certain level of contribution. Seen as a tax, social security contributions are therefore designed to be proportionate and to some extent regressive. This is probably the reason why, in most countries where contributions play an important role in financing social security, the taxation of earned income through the medium of income tax is designed to be comparatively progressive, resulting in higher top taxation rates.

**LOGIC AT THE INTERSECTION OF OPPOSING FORCES**

The ideal of comprehensive income tax has thus turned into a kind of tug of war, with two opposing forces pulling in opposite directions. To a great extent, corporate tax rates are governed by the economic logic of

international tax competition. By contrast, the (top) tax rates on personal income are generally much more strongly oriented toward a domestic, rather politically defined logic pursuant to which the central focus is placed on the historically evolved level of security found in a welfare state, and thus also on the level of the tax and social security contributions burden accruing from wages.

Sophisticated forms of comprehensive income taxation do not have much of a chance when these opposing forces meet. Aligning corporate income tax and the top income tax rates is a more viable option in large countries where taxation and social security contributions run at low levels. In the US, for example, both of these component rates averaged around 39 percent in 2003, taking into account the varying tax rates of the individual states. In contrast, leveling out these rates in small countries with high levels of taxation and social security contributions is generally out of the question. In Denmark, the gap is 29 percentage points, 28 in Sweden, an imminent 25 in Austria, 24 in Finland, 22.5 in Belgium and 17.5 in the Netherlands. This is also one of the reasons why these and other countries have given up on the ideal of a comprehensive income tax. Many of them have modeled their tax structures on the dual income tax model that was developed in the Scandinavian countries.

This model acknowledges the fact that the taxation of capital income and earned income is subject to different requirements and constraints, and thus attempts to draw as systematic a dividing line as possible between the two areas of income tax. All capital income is taxed at a low proportional tax rate corresponding to the corporate income tax rate. In this way, at least as far as

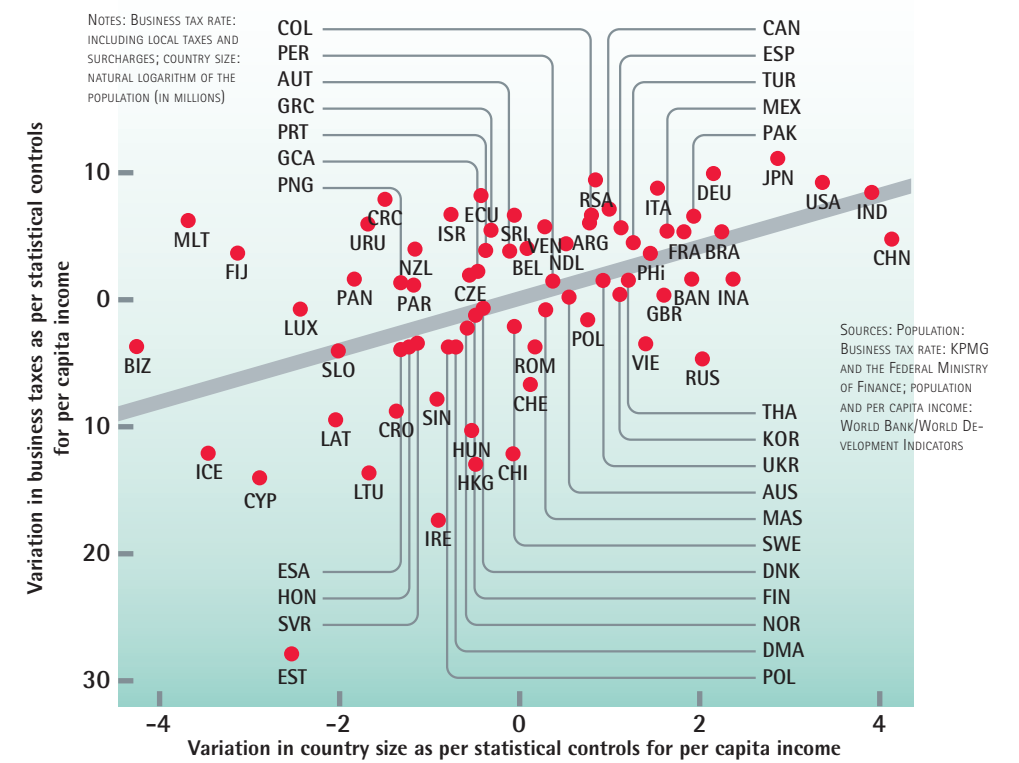


Fig. 2: Partial correlation between country size and corporate tax rate, 2003.

the taxing of capital income is concerned, the ideal of having uniform taxation is upheld, with the primary aim of preventing inefficient measures from interfering in decentralized market processes. Contrary to this, earned income is taxed progressively, with a higher top tax rate. This makes it easier for governments to pursue their goals of distribution and domestic policy, but it leads to new administrative problems in distinguishing earned income from capital income, as in the case of partnerships, for instance.

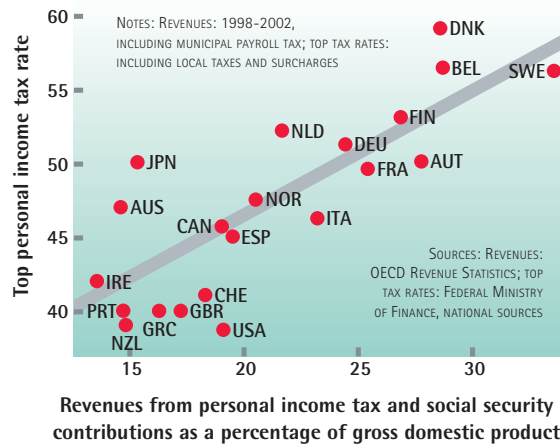
However, the structure of income tax is, of course, not merely the result of variables such as the size of the country and the overall tax ratio. These factors are incentive structures, and still have to be translated into collectively binding decisions by political actors. Statistical analyses show that this process is influenced primarily by two variables: the government’s ideological focus at the national or state level, on the

one hand, and on the other hand, the extent of the institutional division of power in political systems, meaning the extent to which governments are forced to take account of the preferences of other actors, such as opposition parties, constitutional courts or sub-national governments.

**PARTIES LOOK FOR VOTERS IN THE MIDDLE**

As far as fixing corporate income tax rates is concerned, political and institutional factors have come to be of secondary importance. The incentives stemming from tax competition have become so powerful that the stances taken by right and left wing parties are clearly starting to coincide. It is therefore relatively insignificant which party is in power and how much it depends on compromises with others. Left wing parties, as in Scandinavia and Germany, even found it easier to slash the corporate tax rate, as they have altogether ceased pursuing the ideal of a

Fig. 3: Correlation between revenues from personal income tax and social security contributions and top income tax rates, 2003.



comprehensive income tax with leveled top tax rates.

In setting marginal tax rates for progressive personal income tax, political and institutional variables have taken on greater significance. This is due not least to the fact that the amount of the tax and social security burden can be changed in political terms, at least in the medium term. Conservative and liberal parties in some countries therefore pursue the lowering and leveling of progressive income taxation as part of their overall strategy to keep the public sector in its place. Nevertheless, the impact of changes in government on the level and the structure of income tax in western industrialized nations is often limited. This is due to the fact that politics in most of these countries has a strong centripetal tendency. The function of governing is exercised more in coalitions made up of several parties whose policies are directed toward the middle of the voter spectrum (the “median” voter). This is why, for instance, middle-right wing coalitions in countries such as the Netherlands and Austria have decided to leave the top tax rate at 50 percent or higher, and to accept a large gap in relation to the corporate income tax rate.

Differences in party policies come more to the fore when governments are made up of only one party, have an absolute majority in parliament, and do not have to contend with strong vetoing actors. Left wing, single-party governments in Spain and Greece, for example, have kept comparatively high income tax rates, while their right wing equivalents in Great Britain and New Zealand have significantly lowered top tax rates. New Zealand is also a country that, despite tax competition and its small size, has held fast to the ideal of a comprehensive income tax for many years. In the face of public opposition, the government slashed the top income tax rate from 66 percent to 33 percent within a short space of time in order to align it with a competitive corporate income tax rate. However, in New Zealand, too, it was not possible to maintain this over the long term. In 2000, a center-left coalition government raised the top tax rate to 39 percent, and it is only a question of time before the corporate tax rate is lowered again.

The findings of the international comparison show that the controversial discussion about the future of income tax in Germany is nothing unusual. As in many other countries, the main issue is the basic decision between one of the two paths of reform described in the opening paragraphs of this article.

► The *flat tax* model: If policymakers hold fast to the ideal of a comprehensive income tax, they must be prepared to significantly lower the income tax progression or to substantially reduce revenues from income tax, either by cutting spending or by further shifting the tax burden to social security contributions and consumption taxes. Ultimately, they will have to revert to a flat tax, which will mean that taxpayers will all pay the same low

marginal tax rate corresponding to the corporate income tax rate.

► *Dual income tax*: If the government opts for a form of dual income tax, it can react more flexibly to tax competition. In return, however, it must be prepared to accept and overcome the practical administrative difficulties incurred when earned income is taxed separately from income from capital.

By international comparison, what has emerged as unusual are the institutional conditions under which Germany’s politicians must make this decision. After all, Germany is among the political systems with the greatest institutional division of power. A systematic income tax reform against the backdrop of Germany’s intricate federal system will have to garner broad majority support in the lower house (*Bundestag*) and upper house (*Bundesrat*), which is no easy feat. This is further compounded by the fact that, in Germany, there are tight constitutional restrictions on tax policy that are interpreted and championed by a powerful constitutional court.

Thus, it is difficult to predict which way Germany will go in designing its income tax structure as globalization progresses. But one thing is certain: it will be a rocky road.



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