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.

What impact does the process of globalization have on income tax? How do the forces connected with tax policy conflicts affect these and similar questions? 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).

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taxed. Certain types of income would 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 inter-
est 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 be “spilled 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 6% of the gross domestic product (GDP) resulting from income tax revenues would cease to exist altogether. This corre-
sponds roughly to the rate of Estonia’s total revenue from taxes and so-
cial security contributions. The prob-
lem 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%. 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 mane-
ueur in a country such as Denmark, where tax revenue of almost 30 percent is more than double that of Ire-
land. Here, too, policy makers saw the necessity of setting the corpor-
ate 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 progressions abolished, lowering the top tax rate (currently 59 percent) on earned income to 30 percent without affecting revenue would be impossible. In this light, it is no wonder that the top tax rates on personal income in the advanced industrial nations are now oriented toward the size of the country. Instead, there is a statisti-
cally significant correlation between the level of direct taxation on earned income (personal income tax and social security contributions as a proportion of GDP) and the top tax brackets (Figure 3). This correlation is based on two different mecha-
nisms.

In countries such as Denmark, where the main burden placed on earned income is in the form of in-
come tax, the higher level of tax levied on wages and salaries gener-
ally results in a higher top tax rate. In countries where social security contribu-
tions play a significant role, such as the continental welfare states of Germany and the Nether-
lands, 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 bur-
deren stems from the higher social se-
curity contributions paid on wages and salaries. These contributions are levied on the first euro upwards, but are frequently Margaret paid above a certain level of contribution. Seen as a tax, social security contribu-
tions are therefore designed to be proportionate and to some extent re-
gressive. This is probably the reason why, in most countries where contri-
butions play an important role in fi-
nancing social security, the taxation of earned income through the medi-
um of income tax is designed to be comparatively progressive, resulting in higher top taxation rates.

LOGIC AT THE INTERSECTION OF OPPressing FORces

The ideal of comprehensive income tax has thus turned into a kind of tug of war between different interest groups 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 per-
sonal income are generally much more strongly influenced by a dom-
estic, rather politically defined logic pursuant to which the central focus is placed on the historically evolved level of public finances in each state, and thus also on the level of the tax and social security contributions burden accruing from wages.

Sophisticated forms of compre-
nsive income taxation do not have much of a chance when these oppos-
ing forces meet. Aligning a top 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 taxa-
tion and social security contribu-
tions is generally out of the ques-
tion. In Denmark, the gap is 29 percentage points, 28 in Sweden, an im-
minent 25 in Austria, 24 in Fin-
land, 22.5 in Belgium and 17.5 in the Nether-
lands. This is also one of the reasons why these and other coun-
tries have given up on the ideal of a comprehensive income tax. Many of them have modeled their tax struc-
tures on the dual income tax model that was developed in the Scandina-
avian countries.

This model acknowledges the fact that the taxation of capital income and earned income is subject to dif-
ferent requirements and constraints, and thus attempts to draw as sys-
tematic a dividing line as possible between the two areas of income tax. All capital gains are treated as income at a low proportional tax rate corre-
sponding to the corporate income tax rate. In this way, at least as far as the taxing of capital income is con-
cerned, the ideal of having uniform income taxation is upheld, with the primary aim of preventing inefficient mea-
sures from interfering in decentral-
ized wage and market processes. Contrary to this, earned income is taxed progres-
ively, 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 dis-
tinguishing the domestic income from capital income, as in the case of partnerships, for instance.

However, the structure of income tax is, of course, not merely the re-
sult of variables such as the size of the country and the overall tax rate. These factors are incentive struc-
tures, and still have to be translated into collectively binding decisions by political actors. Statistical analy-
ses show that this process is influ-
enced primarily by two variables: the government’s ideological focus on the national or state level, on the one hand, and on the other hand, the extent of the institutional power of political systems, meaning the extent to which governments are forced to take account of the prefer-
ences of other actors, such as oppo-
sition 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 incen-
tives stemming from tax competition have become so powerful that the stances taken by right and left wing parties are clearly starting to coin-
cide. It is therefore relatively in-
significant which party is in power and how much it depends on com-
promises with others. Left wing par-
ties, as in Scandinavia and Germany, even found it easier to slash the cor-
porate tax rate, as they have alto-
gether ceased pursuing the ideal of a
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.

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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