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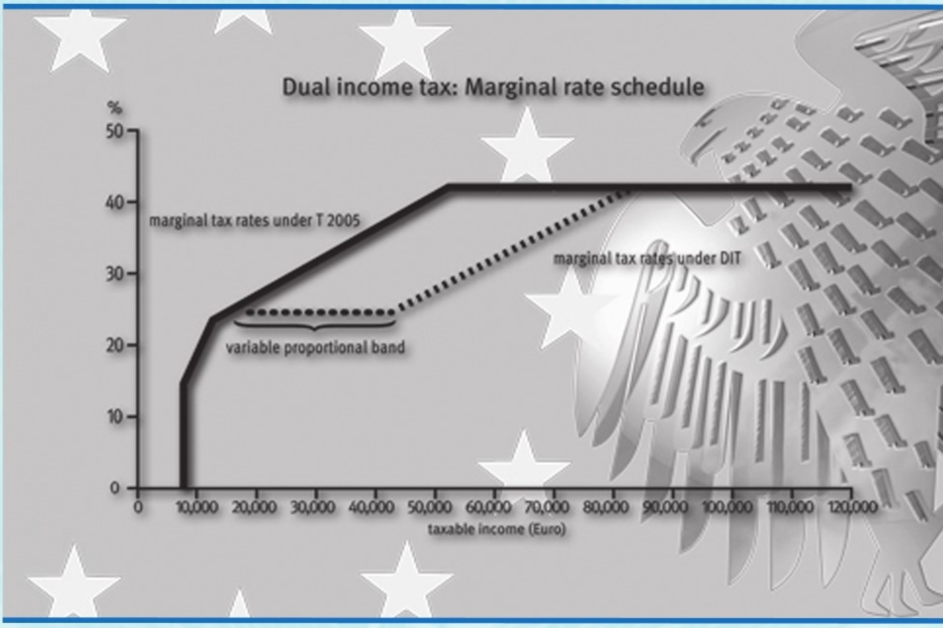

A Proposal for Reforming Corporate and Personal Income Tax in Germany

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Series Editor
Prof. Dr. Dr. h.c. mult. Wolfgang Franz

Authors
Prof. Dr. Wolfgang Wiegard
Prof. Dr. Dr. h.c. Bert Rürup
German Council of Economic Experts
[Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung]
Statistisches Bundesamt
65180 Wiesbaden
Germany

Prof. Dr. Ulrich Schreiber
Prof. Dr. Christoph Spengel
Centre of European Economic Research
[Zentrum für Europäische Wirtschaftsforschung GmbH (ZEW)]
L 7, 1
68161 Mannheim
Germany

Prof. Dr. Wolfgang Schön
Max Planck Institute for Intellectual Property, Competition an Tax Law
[Max-Planck-Institut für geistiges Eigentum, Wettbewerbs- und Steuerrecht]
Marstallplatz 1
80539 München
Germany

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Preface

1. In its Annual Report 2003/2004, the German Council of Economic Experts launched a dual income tax as an option for a fundamental tax reform in Germany. In February 2005, the Federal Minister of Finance, Hans Eichel, and the Federal Minister of Economics and Labour, Wolfgang Clement, appointed the Council to prepare a detailed report on the economic effects of a business tax reform, with special emphasis on a dual income tax. With regard to the latter, conceptual problems of tax law and of tax administration were to be addressed as well as possible transitional problems when implementing a dual income tax.

2. The commissioned report was completed in April 2006 as a joint project of the German Council of Economic Experts (SVR), the Max Planck Institute for Intellectual Property, Competition and Tax Law (MPI), Munich, and the Centre for European Economic Research (ZEW), Mannheim. Responsibility for preparation of this study and primary work on this project were lying with
– Wolfgang Wiegard for the German Council of Economic Experts,
– Wolfgang Schön for the Max Planck Institute,
– Ulrich Schreiber and Christoph Spengel for the Centre for European Economic Research.

In the course of work many persons helped to prepare this report. An especially important role was played by Ulli Konrad (MPI) who contributed to the project by designing and formulating the draft for a new income tax law, by preparing drafts of parts of this report and by translating sections of the Norwegian tax committee's report (2003) from Norwegian into German. In addition, we are extremely grateful to Martin Finkenzeller, Michael Grünewald, Michael Overesch and Timo Reister (all ZEW) for their excellent help in the quantitative parts of this project.

3. We have had comments from and discussions with the following persons and institutions:
– German Federal Ministry of Finance,
– Friedrich Brusch and Matthias Schenk (Hessian Ministry of Finance),
– Dr. Jürgen Haun and Professor Michael Schaden (Ernst & Young AG),
– Professor Peter Birch Sørensen, University of Copenhagen,
– Professor Frederik Zimmer, University of Oslo,
– American Chamber of Commerce,
– Heads of Tax Departments of DAX-30 companies.
We express our gratitude for their valuable advice and encouragement.

4. The German Federal Ministry of Finance provided calculations of the expected tax revenue effects of introducing a dual income tax. Donia Maria Radulescu, ifo institute, Munich, and Michael Stimmelmayr, Centre for Economic Studies, University of Munich, estimated the effects of reforming capital income taxes on key macro-economic variables, such as GDP, employment and welfare, using their dynamic numerical equilibrium model ifoMOD, developed with the help of Professor Christian Keuschnigg, University of St. Gallen. We gratefully acknowledge their support.

5. As always, the administrative and scientific staff of the German Council of Economic Experts provided competent comments and technical help in preparing the German version of the report. Our special thanks go to Caroline Essig, Dr. Katrin Forster, Wolfgang Glöckler, Birgit Hein, Klaus-Peter Klein, Dr. Stephan Kohns, Uwe Krüger, Dr. Hannes Schellhorn, Volker Schmitt, Hans-Jürgen Schwab and Beate Zanni.

6. This book presents a reduced English version of the original report. The English version does not contain various details of German tax law, the draft for a new tax law necessary to implement a dual income tax in Germany as well as several detailed quantitative analyses on the comparative company tax burdens of a dual income tax as proposed here. Readers who are interested in all of these details are referred to the full German version of the report "Reform der Einkommens- und Unternehmensbesteuerung durch die Duale Einkommensteuer" (Federal Ministry of Finance, 2006; also available at www.sachverstaendigenrat.org).

7. In preparing the English version of the report, Andrew Fenner provided a first draft of the translation and reviewed the final version. This was hard work, and he is due special recognition for his professional expertise. Ulli Konrad (MPI) and Timo Reister (ZEW) were extremely helpful in preparing and editing the English version. With admirable efforts and technical skills, the administrative staff of the German Council of Economic Experts prepared the final manuscript for publication. We express our gratitude to Wolfgang Glöckler, Birgit Hein, Uwe Krüger, Volker Schmitt, Hans-Jürgen Schwab and Sabrina Welter.

8. Finally, we acknowledge the generous financial support from Ernst & Young Foundation, enabling us to conduct the English translation and the publication of this report.

9. It is, of course, to be understood that none of the persons who have helped us is responsible neither for the views expressed in this report nor for any remaining errors and deficiencies.

Wiesbaden, August 2007

Bert Rürup and *Wolfgang Wiegard* (German Council of Economic Experts)

Wolfgang Schön (Max Planck Institute for Intellectual Property, Competition and Tax Law)

Ulrich Schreiber and *Christoph Spengel* (Centre for European Economic Research)

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1 Dual Income Tax: Supporting Arguments and Design – An Overview

1.1 In Support of Dual Income Tax

1.1.1 Objectives and Constraints for Reforming Business Taxes

1. In November 2005, Germany's major political parties, the CDU, CSU and SPD issued a coalition statement, setting out the guidelines for the Federal Government's policy under Chancellor Merkel. On 'reforming business taxes', this statement reads as follows:

> Germany must be able to hold its own in competing internationally on tax into the future. In this legislature period, until 01.01.2008, we will, therefore, continue to develop business tax laws thoroughly, implementing tax rates that are competitive internationally. As well as corporations, these reforms must also include transparent entities, as these account for more than 80% of all German businesses. In particular, we will be guided by the following aims:
> - Making Germany more competitive internationally and viable within Europe
> - Improving neutrality in terms of legal form and financial decisions as far as possible
> - Limiting the room for creative accounting
> - Improving planning certainty for businesses and the public budgets
> - Safeguarding Germany's tax base in the long term.
>
> We will make a basic decision between comprehensive and dual income taxation. In this legislative period, we will reform the taxation of capital gains and private profits on disposals (Coalition agreement, 2005).

2. As is well known and documented in detail,[1] the way Germany taxes business at present fails to achieve these objectives. Germany is not competitive in international tax terms, because our tax rates and effective tax burdens on business profits are amongst the highest in Europe. This encourages businesses to relocate

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[1] See German Council of Economic Experts (2001: section 372 pp.; 2003: section 518 pp.; 2004: section 759 pp.; 2005: section 391 pp.).

production and/or profits to lower-taxed countries abroad. Which means in turn that fewer and fewer groups pay tax in Germany. Our current system of business taxation also distorts matters when businesses decide how to raise finance and what legal form those businesses should take. With corporations, financing investment from internal funds is generally treated more favourably in tax terms than debt and equity finance. With transparent entities, the situation is slightly in favour of debt while the transparency principle means there are no differences in taxation between profits retained and profits taken. If finance is raised equally out of retained earnings, new share issues and debt, the tax system favours partnerships over corporations if the top rate of personal income tax applies, but treats them much worse if the partners are on zero tax rate. None of this makes any sense from an economic point of view. It distorts competition and affects the amount of capital that is employed as well as its efficient allocation between sectors of production. As a consequence, production inefficiencies and income losses will result, and the complexity of the tax system will increase.

Therefore, the reform of business taxes is mainly aimed at making Germany more attractive to international investment and improving the neutrality of the tax system.

Distribution objectives come into play when reforming business taxes as soon as we are dealing with shareholders or partners individually. If we keep partnerships transparent for tax purposes, this is automatically the case, as there is no distinction between the business itself and those involved in it from a tax standpoint.

3. If reforming business taxation is to work, there are other requirements to meet, which can be formulated as constraints on reforms. One essential here is that they have to be compatible with European law. They have to comply with the fundamental freedoms of the EC Treaty, the freedom of establishment and free movement of capital in particular. One of the ‘softer’ constraints here is the need to limit loss of tax revenues, to safeguard Germany’s tax base. This demand can only reasonably be applied to the revenue effects involved with the specific rate and system characteristics of a given set of tax reform proposals. A tax system which satisfies the neutrality objective automatically limits room to maneuver: Because decision-neutral taxation means the way business is taxed has no effect on when businesses come to decide how to finance their investments or decide what legal form their business should take. That is to say, they would take the same decisions, whether they take taxes into account or not. So they need not spend time planning their tax matters in view of avoiding taxation. Now, there is no way of achieving complete neutrality with respect to financing decisions and choice of legal form. There will always be some space to maneuver. When reforming business taxation, it is, therefore, also advisable to demand that space to be limited.

4. *Conflicts of objectives* may arise, especially if a direct progressive income tax rate is considered necessary to achieve distribution objectives. This inevitably undermines the aim of being neutral in terms of finance and legal form. The more external reform constraints have to be taken into consideration and the more stringent they are, the harder it becomes to achieve the aims of reforming the business tax system. For example, limiting loss of tax revenues comes directly into conflict with the aim of making Germany more attractive as a place to do business.

What stands out most about the present proposals to reform tax on business is that these emphasise potential conflicts between the aims of tax policy differently or are based on differing reform constraints. Comparing tax reform strategies should, therefore, be based on the reform elements which make up individual proposals. Reforming tax accounting, for example, is irrelevant when choosing between individual models, and may, therefore, be ignored here because this objective is compatible with all of the existing reform proposals.

5. The vast majority of foreign investment is made by corporations. When multinational groups decide where they should be based and how they should invest, their decisions are not, as a general rule, governed by how their shareholders are subject to personal income taxes. Firstly, the 'marginal' investor who is relevant to decisions by publicly-quoted corporations is often unknown or does not pay tax; secondly, the move away from imputation systems which is apparent internationally has decoupled taxation at corporate and at shareholder level. We may, therefore, assume that it is the rate of corporation tax or, more generally, taxation at corporate level which decides over how attractive individual locations are to international corporations. The assumption here is that the aim should be a *25% rate at corporate level* if the objective is to *make a location more attractive*. This target variable also serves as the basis for most of the tax reforms proposals which are currently under discussion in Germany. This 25% tax rate should include the solidarity surcharge of currently 5.50% and either trade tax or the tax burden on business profits resulting from reorganising local government finances. A higher tax rate could also be used to limit loss of tax revenues, but this would make Germany less attractive as a place to do business.

6. Making Germany more attractive as a business location could be done by reducing the tax rates on corporations. If done in isolation, however, this would merely exacerbate the already existing distortions and tax differences in the field of business tax. These tax differences relate to the taxation of retained and distributed profits on corporations, taxes on interest resulting from assignment of debt compared to taxes on equity capital and, lastly, taxes on profits by transparent entities (sole traders and partnerships) as opposed to corporations. Such differences distort how businesses choose to finance themselves and what legal forms they choose to take and are, therefore, undesirable in principle. They lead to efficiency losses, which are reflected in avoidable losses in production and income. While trying to make Germany more attractive as a place to do business, we must, therefore, at the same time improve the *neutrality properties of business taxes* with respect to financing and investment decisions and the choice of legal form.

7. The objectives of business tax reforms making Germany more attractive as a place to do business and ensuring neutrality of the tax system will be severely limited from the outset as long as *trade tax* remains in place. In a rational business tax system, there is no place for trade tax in the currently existing form. It should be abolished and replaced with a local government surcharge system to income and corporation tax. The reorganisation of local government finances as proposed by the *Stiftung Marktwirtschaft* (2006) is a potential solution here.

Although the shortcomings of trade tax are well known and have been explained often enough, it is highly unlikely local government taxes can be fundamentally reformed by 2008. Revenue from trade tax is soaring and will be higher in 2006 than ever before. For that reason alone, local authorities and their representatives can hardly be expected to agree upon abolishing trade tax and replacing it with a local government surcharge system in the foreseeable future.

However essential reorganising local government finances may be, reforming corporate taxes in 2008 must not be allowed to fail because trade tax is retained. The dual income tax can also be realised even if trade tax remains.

1.1.2 Reform Options: Comprehensive or Dual Income Tax?

1.1.2.1 Comprehensive Income Tax

8. One of the first basic decisions which has to be made when reforming business taxes is whether the tax policy ideal of a comprehensive income tax is to be retained or whether it should be abandoned. Comprehensive income tax means that the total income from all sources together is aggregated, and the resulting taxable income is subject to a single tax schedule.

When it comes to reforming business taxes, comprehensive income tax undeniably has advantages, especially if it is imposed at a *flat rate*, that is, a single marginal tax rate over a basic allowance, and income tax and corporation tax are integrated by using the same marginal tax rate for each.[2] The major advantages of a flat tax with integrated corporation tax as an option for reforming business taxes apply even if a comprehensive income tax is hardly feasible in its pure form.

9. A comprehensive income tax, combined with a *flat rate*, would result in a largely insolvable dilemma if the aims of corporate tax reforms are combined with those of limiting loss of tax revenue. Making the German tax system more competitive internationally calls for a tax rate of 25% (or thereabouts) for corporation tax and for income tax. At the same time, the basic allowance for income tax would have to be set high enough if excessively drastic redistribution effects are to be avoided. Using both – a lower corporate as well as marginal income tax rate and a higher basic allowance – would result in losing considerable tax revenues. If the aim is to avoid losing any more tax revenues than necessary, this cannot be

[2] See Scientific Advisory Committee of the German Federal Ministry of Finance (2004).

combined with making Germany more attractive as a place to do business and achieving a just and equitable distribution without considerably compromising.

10. In what follows below, we will assume that there is no chance of introducing a comprehensive income tax by way of a *flat tax* in Germany within the near future. Retaining a direct progressive income tax system in particular would make it impossible to achieve decision-neutral taxation in business without resorting to the imputation system for corporation and personal income taxes in the first place. But reintroducing the imputation system has no chance of realization at all. If we wish to achieve the objectives of business tax reforms as stated, we must say goodbye to the tax policy ideal of a comprehensive income tax.

1.1.2.2 Interest-Adjusted Income and Profits Tax

11. Interest-adjusted income and profits tax is another tax policy ideal: In addition to making Germany more attractive and achieving a neutrality of finance and legal form, it would also ensure inter-period neutrality in investment and consumption decisions. The constituent elements of this tax concept at corporate level consist of deducting imputed normal return on equity capital from taxable income (*allowance for corporate equity*) and, for individuals, in allowing them to claim relief on interest income and on dividends as well as on capital gains upon the disposal of shares at a standard statutory rate. Any profit shares in excess of that and any other income would then be subject to a *flat tax*. Such a tax system was applied in Croatia between 1994 and 2000; in Belgium the legislators introduced a rule making a standardised return on equity capital tax-exempt for corporations (although no dividends paid) in 2006.

This reform option has not figured in the German tax policy debate despite its attractive neutrality aspects. It is not an option for the business tax reforms in 2008 for a number of reasons. Following recent Belgian developments would be inadvisable, given the massive loss of revenue in terms of corporation tax this would involve.

1.1.2.3 Dual Income Tax Versions

12. If tax policy ideals are unachievable, pragmatic compromises are required. If we drop the idea of a comprehensive income tax, this automatically implies that we must move to a schedular tax, with different kinds of income and earnings being subject to different rates. As a special case of a schedular tax, dual income taxation distinguishes between two kinds of income, each with its own tax rates. As the different kinds of income to be separately taxed can be defined differently, there are a number of possible options for a dual income tax. In fact, most of the tax reform proposals being discussed at present are different embodiments of a dual income tax – even if that is not necessarily how the supporters of each proposal actually see them.