PRESSURES ON EU TAX SYSTEMS AND OPTIONS FOR REFORM

Professor Peter Birch Sörensen
University of Copenhagen

Presentation at the conference
”Wanted: The Tax System of the Future”
hosted by the German Ministry of Finance
and the Social Science Research Center Berlin
May 24, 2007

OUTLINE

- Background: International tax competition

- Alternative options for company tax reform:
  - Comprehensive Business Income Tax
  - Allowance for Corporate Equity

- An option for reform of the personal capital income tax: The Dual Income Tax

COMPANY TAX REFORM

BACKGROUND: INTERNATIONAL TAX COMPETITION

Pressures from the market place:

- Growing capital mobility
- Growing opportunities for international profit shifting

Pressures from the EU (European Court of Justice)

- E.g.: CFC rules difficult to uphold within the EU

Consequence: Strong downward pressure on statutory corporate tax rates

How long can corporate tax revenues be maintained? (Evidence of income shifting from non-corporate sector)

OBSTACLES TO EU TAX COORDINATION

The current uncoordinated company tax systems create tax barriers to cross-broder business activity, but

Most EU Member States prefer tax competition to tax coordination

Harmonisation of (parts of) company tax systems would create aggregate gains, but some Member States would lose (Example: Tax base harmonisation would raise EU income by 0.1%, but German income would fall by 0.3%)

Very difficult to reach agreement on tax coordination under the current unanimity rule (Enhanced Cooperation as yet untried)

HOW CAN THE INDIVIDUAL COUNTRY DEAL WITH THE CAPITAL FLIGHT PROBLEM?

National policy goals:

- Create favourable domestic investment climate
- Protect corporate tax revenue
- Reduce/eliminate the tax bias against equity finance

Two alternative options for business tax reform:

- The Comprehensive Business Income Tax
- The Allowance for Corporate Equity

THE COMPREHENSIVE BUSINESS INCOME TAX (CBIT)

Proposal: Abolish interest deductibility and cut the statutory business income tax rate

Advantages:

- Eliminates the tax preference for debt
- Reduces the incentive for international profit shifting (no incentive for thin capitalisation; reduced incentive for transfer pricing)

Potential further advantage:

- Reduces the tax burden on highly profitable mobile firms (often the most innovative and dynamic ones)

Disadvantage:

- Increases the cost of debt finance

THE ALLOWANCE FOR CORPORATE EQUITY (ACE)

Proposal: Allow deduction for a ’normal’ return on equity from the business income tax base

Advantages:

- Eliminates the tax preference for debt
- Eliminates the incentive for international profit shifting through thin capitalisation
- Offsets the distortion from accelerated depreciation

Potential disadvantages (if the statutory tax rate is raised):

- Increases the incentive for profit shifting through transfer pricing
- Increases the tax burden on highly profitable mobile firms

THE THEORETICAL CASE FOR THE ACE

- In an open economy with free capital mobility, the burden of a tax on the normal return to capital is shifted to workers (capital flees the country so labour productivity falls and workers earn lower wages)

- If workers paid the tax directly, capital would not flee the country, labour productivity and hence pre-tax wages would be higher; workers would be better off!

- Does this mean that capital should not be taxed? No! It only means that taxing the ’normal’ return to capital is inefficient, but above-normal profits should certainly be taxed. This is what the ACE achieves.

DESIGNING AN ACE

- No rationale for raising the statutory corporate tax rate (workers and land owners will be better off even if they have to make up for the lost corporate tax revenue)

- No rationale for granting an allowance to ’old’ equity. The allowance should be granted only to ’new’ equity (this avoids windfall gains and limits the short term revenue loss)

- The ACE has been tested in practice (Croatia, Belgium)

THE ACE VERSUS THE CBIT

Similarities: Both systems eliminate the discrimination between debt and equity; both solve the problem of thin capitalisation

Differences:

- The CBIT reduces the transfer-pricing problem; the ACE does not
- The CBIT reduces the tax burden on highly profitable firms but increases the burden on firms with relatively low returns and firms relying heavily on debt; the ACE (with an unchanged tax rate) reduces the tax burden on all firms, although relatively more so on the less profitable firms. Hence the ACE will unambiguously stimulate domestic investment

ACE VERSUS CBIT: THE TRANSITION ISSUE

- ACE: The revenue loss would occur only gradually, since the allowance would be granted only for *new* investments

- CBIT: The revenue gain would occur only gradually, since the interest deduction for *old* debt would probably have to be 'grandfathered'.

Implication: Only limited scope for cutting the statutory tax rate in the short run under the CBIT; this makes it hard to abolish the interest deduction for new investment

Conclusion: The transition problems speak clearly in favour of the ACE

THE ACE IN THE GERMAN CONTEXT

- Current German situation: Narrow corporate tax base and high tax rate

- The basic argument for the ACE also holds in the German context, but there is a case for reducing other allowances (e.g. for depreciation) and cutting the tax rate

REFORMING THE PERSONAL TAX ON CAPITAL INCOME

ALTERNATIVE BLUEPRINTS FOR THE PERSONAL TAX SYSTEM

- **The comprehensive income tax**: capital income is taxed at the same marginal rate as labor income
- **The expenditure tax**: the normal return to capital is exempt from tax
- **The dual income tax** as a compromise: capital income is taxed at a low flat rate below the top marginal tax rate on labour income

THE CASE FOR THE DUAL INCOME TAX

- Accounting for capital mobility
- Improving tax neutrality
- Accounting for inflation
- Reducing the scope for tax avoidance
- Reducing discrimination against saving

ILLUSTRATING THE INFLATION ARGUMENT FOR THE DUAL INCOME TAX

Assumptions:

- Nominal interest rate = 4%
- Inflation rate = 2%
- Tax rate on nominal capital income = 50%

Effective tax rate on **real** interest income:

$$\frac{0.5 \bullet 4}{4-2} = \frac{2}{2} = 100\ \%$$

COMPONENTS OF THE CAPITAL INCOME TAX BASE UNDER A PURE DUAL INCOME TAX

- Interest
- Dividends
- Capital gains
- Rental income
- Royalties
- Imputed returns on owner-occupied housing
- Imputed returns on capital invested in non-corporate firms

Negative capital income deductible only against other income from capital

TAXATION OF INCOME FROM CLOSELY HELD CORPORATIONS UNDER THE DUAL INCOME TAX

The income shifting problem

Active owners of small companies may transform labor income into capital income. In this way they may lower their total tax bill if the sum of the corporation tax and the personal tax on dividends and/or capital gains is lower than the (top) marginal tax rate on labor income

SOLVING THE INCOME SHIFTING PROBLEM

- Make sure that the sum of the corporate tax rate and the capital income tax rate on dividends and capital gains equals the top marginal tax rate on labour income; then there is no gain from income-shifting

SUMMARY

- The international mobility of capital and tax bases forces the individual country to keep the corporate tax rate low
- The CBIT achieves a low statutory tax rate by broadening the tax base through abolition of interest deductibility, but increases the effective tax burden on some firms
- The ACE reduces the effective tax rate by allowing a deduction for the normal return on equity
- Both the ACE and the CBIT achieve neutrality between debt and equity, but transition problems speak in favour of the ACE
- The need to account for international capital mobility and the desirability of greater tax neutrality provide a case for a low flat tax rate on all capital income (dual income tax)