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Business and Investment Tax Options: A European View.

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Abstract

The paper summarizes the arguments in favour of a shift from comprehensive to dual income taxation as a desirable business and investment tax option. The attractivity of comprehensive income taxation is reduced in a world with integrated capital and commodity markets and mobile business. Dual income taxation is shown to offer a serious theoretical and practical alternative, which should be considered as a stepping stone toward business tax coordination in the EU.

Keywords: income tax reform, dual income tax, business taxation

JEL: H2, H24, H25

1. Introduction

Globalization in commodity and capital markets as well as the completion and enlargement of the European internal market forced national governments to adjust their business tax regimes since the mid eighties. The most visible reform steps are the significant reductions in statutory corporate income tax rates, the introduction of dual income tax systems, and the revision of bilateral double taxation treaties.

While the European Commission denied the necessity of harmonizing business taxation in the early 1990s when the Ruding Report[1] identified tax distortions in the internal market and recommended the introduction of a harmonized European corporation tax in three reform steps, the official view was changed in the following years, when the EU agreed on the Code of Conduct[2] for Business Taxation to fight unfair tax practices,

* For critical and helpful remarks I owe thanks to Dirk Schindler (University of Konstanz).

[1] European Commission (1992),

[2] European Commission (1998)

when the EU initiated the Bolkestein Report[3] calling for consolidated balances of multinational companies, or when the EU passed the Savings Tax Directive in 2003. This development reveals that the member states recognize the necessity for European business tax coordination, but they still are very reluctant and unwilling to shift competences in business taxation to the EU and prefer to rely on national reforms to cope with the economic and fiscal repercussions of the changing economic environment.

The objective of the paper is to characterize the recent business tax reforms in Europe within an adequate open economy framework and to draw some general conclusions on viable business tax reform options for EU and non EU countries.

The paper is organized as follows. We discuss the pros and cons of comprehensive, Schanz/Haig/Simons-type income taxation as the traditional guideline for business taxation in section 2. Problems of a comprehensive income tax reform in an open economy are addresses in section 3. Section 4 reviews the characteristic features of the dual income tax concept. The dual income tax reforms in the Nordic countries are surveyed in section 5, related income tax reforms in other EU member countries in section 6. Section 7 sketches the EU business reform agenda of Cnossen (2004) which uses dual income taxation as a crucial stepping stone. Section 8 concludes.

2. The Pros for and Cons against Business Taxation within Comprehensive Income Taxation

The Schanz/Haig/Simons (SHS) type comprehensive income tax has been the fundamental principle of income taxation in the developed world for almost a century.

2.1 Attractive Features of SHS Taxation

Tax equity and tax neutrality have been the crucial desiderata in tax policy design in democratic societies. Advocates of SHS taxation have agreed that comprehensive income is a socially acceptable indicator of a citizen's *ability to pay.* Comprehensive income determines the ability to spend on consumer goods during a year without forcing a tax payer to reduce the amount of assets held at the beginning of that year. Business income

[3] European Commission (2001),

is one element of the comprehensive income tax base and consists of business income flows as well as accruals in business wealth.

With comprehensive annual income as the socially agreed tax base SHS taxation ensures *horizontal equity*. Citizens with equal comprehensive income before tax are liable to the same amount of income tax and therefore end up equally well off with the same level of net comprehensive income after tax. The comprehensive income tax also allows for suitably graduated annual tax payments to ensure *vertical equity* in line with socially agreed after-tax distribution patterns.

Horizontal and vertical equity prevail if different types of comprehensive income are taxed separately at source given that these prepaid income taxes are credited against the annual comprehensive income tax liability. This is true for withholding taxes on labour or capital income, but it is also true for income taxes paid at source in foreign countries, as long as the *full credit method* is applied.

An economically important feature of comprehensive income taxation is the symmetric treatment of different components of income which makes the tax system immune against *assignment problems* of income to specific income categories. For returns from business activities in a closely held company it is of no relevance if the owner receives them as managerial labour income, as capital income, or as capital gains. Any partition of total profits between different categories leaves comprehensive income and the income tax burden unchanged and the tax authority does not have to check the economically correct assignment of different sources of business income to a taxpayer.

Moreover the marginal tax rate on any income component of comprehensive income is the same which implies a *tax neutrality* property. A given optimal income portfolio, characterized by the same rate of return for all income generating activities, will not be changed under a comprehensive income tax, as the net rate of return after tax is the same as well.

Finally, taxing business income at the company level is in line with the SHS standard if the corporate income tax is credited against the comprehensive personal income tax. However, partial crediting or even double taxation of dividends need not be

regarded as violations of comprehensive income taxation as long as the corporation tax is levied as a separate benefit tax or as a user fee companies have to pay for doing business.

2.2 Problems of SHS Taxation

Objections against the SHS standard address the fundamental concept as well as the practical implementation of comprehensive income taxation.

A first objection argues that horizontal equity breaks down if interpersonal equity is regarded as a lifetime rather than a one-period phenomenon. Citizens who earn an equal present value of comprehensive income over the life cycle (and whose ability to pay therefore is equal) face a different income tax burden in present value terms, if consumption smoothing through saving generates a different pattern of interest income which is taxable under a comprehensive income tax. This discrimination is a clear *violation of horizontal equity* in a life-cycle perspective which can be avoided under a consumption-based income tax which exempts the normal rate of interest, as advocated already by Irving Fisher and Nicholas Kaldor[4].

A second violation of horizontal equity occurs because lifecycle saving through human capital accumulation is treated differently under a comprehensive income tax from life cycle saving through financial capital accumulation. Financial assets must be purchased out of net earned income. *Human capital formation* requires investment in time to participate in educational programmes. As potential labour income is not taxed under a comprehensive income tax, the total amount of potential gross earnings can be invested in human capital formation. The preferential treatment of human capital savers in comparison to financial asset savers who are equally well off in present value comprehensive income terms is another violation of horizontal equity which can again be avoided under a consumption-based income tax. This tax can be implemented as a cash-flow tax which exempts income which is invested in capital formation and taxes it only when it is used for consumption.

[4] Kaldor's expenditure tax concept for India and Sri Lanka failed and was rapidly repealed in the 1950s, but the idea has been alive and found prominent supporters under the heading of cash-flow taxation (Meade Committee, 1978) or the X-base tax (Bradford 1986, 1989). A full-fledged consumption-based income tax was introduced in Croatia in 1994 (Rose/Wiswesser, 1998), but repealed 2001.

A third objection is directed against the neutrality property of taxing all factor returns at the same marginal tax rate. The objection is based on the fundamental lesson of *second-best theory*. If the comprehensive income tax is distorting, then the social welfare loss associated with the revenue requirement may be reduced if the unique SHS income tax wedge on comprehensive income is replaced by an income tax system which allows for different tax wedges on the components of comprehensive income. From an optimal income tax perspective the application of the same tax rate on returns from different factors under a comprehensive income tax regime is an additional restriction, which generally raises the social costs of public funds.

A forth objection against SHS taxation is the incentive for income splitting among related persons, in particular family members, to reduce the burden of a progressive income tax schedule.[5] Business income splitting is not only attractive under individual income tax regimes[6], when it pays to allocate capital income to the spouse with the lower income tax rate, it also allows to reduce the tax burden under household income tax regimes, if business income can be shifted to other separately taxed units (e.g., children under the German spouse splitting system). *Strategic income splitting* erodes vertical equity targets and violates horizontal equity.

The proper calculation of capital income under a comprehensive income tax is a serious problem, as any market-induced increase in business or private wealth within a year has to be assessed as comprehensive income. Income accounting can only rely on proper market values if assets are sold. When the owner keeps the assets imputed prices have to be used and this assessment is subject to evaluation biases as well as strategic pricing. This imputation problem has been solved technically by the *realization principle*, which implies that capital gains remain untaxed until the assets are sold. The realization principle has been adopted in many national tax codes throughout the world and it erodes

[5] Tax engineering by shifting assets among family members is an important operating field for consulting industry. Tax policy recognized the importance of this tax engineering strategy by specific anti-avoidance measures, e.g. the mandatory inclusion of certain categories of capital income of the spouse or minor children to the taxable income of the main income earner, or the introduction of the Kiddie Tax in the US in 1986 and in Canada in 2000. The US Kiddie Tax implies that from 2006 a child's investment income is taxed at the parent's highest marginal tax rate in the US, if the child is under 18 and the child's annual investment income exceeds $1700.

[6] For an international overview on the tax treatment of family members see Genser and Reutter (2007).

comprehensive income taxation in all these countries by deferring the taxation of capital gains[7].

Another problem of comprehensive income taxation is the nonseparation of nominal and real returns on interest bearing assets. Interest income is regarded as taxable capital income under SHS standard, although the component of interest income which compensates for inflation to keep the value of wealth constant in real terms must not be taxed as comprehensive income. Only the real interest component increases wealth and thus is taxable capital income. Separating the two components requires the imputation of an economically correct inflation rate. Most tax codes do not allow for inflation adjustment of nominal values, since interest income is not the only field for such a correction. Technically this deviation from the SHS standard is called *nominal-value principle* and it implies that the valuation for tax purposes has to use nominal prices, even if they refer to different periods and constant prices would be the economically correct valuation devise.

Besides these systematic deviations from the SHS standard, further regulations have become standard elements of tax codes although they contradict to the principle of comprehensive income taxation. Most of these regulations are *tax preferences* which erode comprehensive income, e.g., the deferral of the taxation of old age pension claims until pensions are paid out[8], the exemption of capital returns in pension funds or in life insurance companies, the exemption of capital gains in owner-occupied housing, etc. There are, however, other deficiencies of income tax regimes which contradict to the pure SHS standard and lead to overtaxation, e.g., double taxation through constrained tax credits, restrictions to business loss offsets, limitations to depreciation of assets, etc.

[7] The realization principle is also applied to business profits of subsidiaries which are withheld and reinvested rather than distributed to the parent company..

[8] It is interesting to note that tax deferral of pension claims is not regarded as a violation of the SHS standard and the ability to pay principle in the view of experts in tax law, and the discussion of a consistent treatment of old-age benefits in Germany have led the Constitutional Court to define a „correspondence principle“, stating that old age savings income should be taxed only once over the lifecycle. This view ignores the problem of tax burden differentials in present value terms and does not recognize the conflict with the SHS principle.

3. Income Tax Reform in an Open Economy

Keeping the attractive properties of SHS taxation in a world with international business activities and eliminating its most pressing deficiencies would require taxing global comprehensive income on a residence basis at the individual level and exempting the normal return to capital. Such a residence-based, comprehensive lifetime income tax regime would be equitable and nondistortionary, if individuals do not change the country of residence in response to this tax regime, if the tax authority is able to identify the correct normal rate of return, and if worldwide comprehensive annual income could be imputed to each taxpayer in the residence country.

Problems associated with these requirements make Auerbach, Devereux, and Simpson (2008) identify two major strands of business tax reform in open economies: defining appropriate tax bases for international business income taxation and defining whether the residence or the source country should be entitled to tax this income.

Income tax regimes throughout the world tax business income in the source country. This is true for foreign subsidiaries which are regarded as business companies of the source country but also for permanent establishments of foreign firms in line with the OECD model tax convention. The residence country then may either exempt income from foreign affiliates or establishments in line with the source principle, or it may grant a tax credit in line with the residence principle. Whereas most EU member states, in particular in continental Europe implemented the exemption method, the UK and IR, like most Anglo-Saxon countries and JP implemented the credit method. There is, however, a substantial erosion of the residence principle, since the affiliate's business income is taxable in the residence country only after it is repatriated. Moreover, most double taxation treaties constrain tax credits and generate excess credits if the source tax rate exceeds the residence tax rate. Therefore the tax burden under the credit method turns out similar to that of the source method. This erosion of comprehensive income taxation is reinforced by strategic international tax competition of source countries to attract mobile capital or taxable profits.

Sorensen (2007) distinguishes two strands of tax reform proposals which seek to mitigate the capital flight problem incentive due to source based taxation of international business income:

(i) Source-based corporate income taxes which tax the full return to equity, i.e., profits minus interest paid on business debt, but exempt the normal rate of return on equity. This can be done either by an Allowance for Corporate Equity or by cash-flow taxation.

(ii) Comprehensive Business Income Taxes, which tax the full return to capital, viz., equity and debt, by making interest payments on business debt nondeductable from the tax base.

Both reform scenarios enhance efficiency by eliminating the preferential treatment of debt financing, but they are also supposed to reduce strategic tax competition. For the comprehensive business income tax the latter effect is expected as a consequence of lower tax rates on the broadened tax base.

Whereas cash-flow taxation (Bradford, 2003) and the Comprehensive Business Income Tax (U.S. Treasury, 1992) are theoretical concepts which found little political support and an Allowance for Corporate Equity regime was introduced in Croatia in 1994 but repealed again after six years (Rose and Wisswesser, 1998; Keen and King, 2002), dual income taxes have been introduced in many European countries, which can be shown to mitigate some of the crucial problems of business and capital taxation in an open economy setting.

4. The Characteristic Features of a Dual Income Tax

The dual income tax[9] is a schedular tax regime which defines capital and labour income as different tax bases. The *tax-base split* offers an additional degree of freedom for tax policy, which can potentially be used to overcome some of the deficiencies of comprehensive income taxation listed in section 2.

4.1 The Dual Income Tax Concept

The tax-base split into capital and labour income is required for income from different economic activities, e.g., doing business, self employment, leasing land, etc. Capital income includes dividends, interest income, rents, but also rental values as well as capital gains of real capital and property. Labour income consists of wages and salaries, non-

[9] See also Boadway (2004), Cnossen (1999), Eggert and Genser (2005), Sørensen (1998, 2005b).

monetary fringe benefits, pension payments, and social security transfers. The allocation is straightforward for these traditional income classes. Business income earned by business owners working in their own firm (proprietorships, partnerships, or self employed), however, is compound income stemming from capital, which the owner has invested in his own firm, as well as from labour. This business income therefore has to be split into a capital and a labour component.

Capital income is taxed at a flat rate, whereas labour income, on the other hand, is subject to progressive tax rates. Costs of earning capital and labour income are tax deductible from both tax bases, the *principle of net returns* is carried over from comprehensive income taxation. Since the capital income tax is flat and uniform across all individuals, it can be collected as a final withholding tax at source. Final withholding taxation does not only reduce tax collection costs, it also contributes to overcoming strategic or negligent capital income tax evasion through non filing.[10] The tax rate on labour income in the lowest income bracket is set equal to the tax rate on capital income, which excludes tax arbitrage incentives for small scale earners of labour and capital income.

Personal allowances are deductible from labour income and thereby induce an element of indirect progressivity already in the first labour income bracket. There is no general recommendation in dual income tax proposals if the personal allowances should be extended to capital income earners without labour income.

For negative capital income which cannot be offset against positive capital income from other sources the dual income tax offers an offset option against the labour income tax liability of the same year. Excess credits can be carried forward or backward and offset against future or past tax liabilities

The dual income tax is compatible with various forms of corporate and personal capital integration. Separate taxation at both levels re-establishes classical double taxation, partial or full imputation implies that the corporate income tax becomes a prepayment of the personal income tax on capital. Under full imputation, dual income tax

[10] There is evidence from European countries which introduced a withholding tax on capital income that tax revenue from capital income increased rather than fell indicating that the broader aggregate tax base overcompensated the lower flat rate on capital income.

administration can be simplified by choosing the corporation tax rate equal to the flat rate on capital. The corporation tax credit then exactly covers the capital income tax liability and no further capital income tax collection is necessary.

4.2 Why Is a Dual Income Tax Attractive?

The dual income tax is attractive because the regime mitigates several problems of the comprehensive income tax, addressed in section 2.1. Taxing capital and labour income at different rates allows paying attention to optimal taxation requirements, as the tax rates can be adjusted to the welfare costs of tax distortions (see Nielsen and Sørensen, 1997; Sørensen, 2005b; Dietz and Keuschnigg, 2007).

The capital-labour split of business income can be used to pay attention to pure profits. The Nordic countries calculate capital income of non-incorporated firms and closely-held companies as the normal perfect market return on business capital. The residual "labour income" then also includes income from pure profits or excess returns on capital, which are taxed according to the progressive labour tax schedule.

The dual income tax is a well defined variant of a schedular income tax system. It stimulates saving by mitigating the double taxation of interest and dividend income from capital investment. Moreover dual income taxation intends to create a *level playing field* for capital investment by taxing normal returns from capital at the same flat tax rate. The dual income tax recognizes that the scope for progressive capital income taxation is limited.

Taxing capital income under a final withholding tax at a flat and low rate significantly reduces tax compliance and collections costs, because there is no requirement of filing regular capital income from interest and dividends.[11] Moreover, flat capital income taxes will generally reduce the tax rate differential between domestic taxes and source taxes in foreign countries, thereby limiting the incentives for capital flight. In particular, under low capital income tax rates there will be a significantly lower probability that after-tax returns on real wealth turn negative under inflation.

[11] .Cost saving would be considerable in Germany, where interest and dividend income is subject to a withholding tax, but income below a standard savings allowance is exempt, whereas capital income in excess of the savings allowance must be taxed at the personal income tax rate.

The welfare gain from avoided tax engineering costs and reduced compliance and control costs under a dual income tax must, however, be traded off for a loss in redistributive power by taxing capital income at a flat rate.

Another advantage which has hardly gained little attention is the elimination of the incentive for capital income splitting among family members.[12] This incentive is high in countries with individual income taxation, which is the case in the majority of European countries (see Genser and Reutter, 2007). Apart from shifting capital income to lower taxed spouses another widely used avoidance strategy is shifting capital income to children. The latter strategy also works in countries with household taxation.

Finally, under a dual income tax flexible adjustment of the tax rate on capital income to changing economic conditions is facilitated within a country as well as multilaterally, e.g., in the EU, since labour income taxation may remain unchanged.

5. Implementation of the Dual Income Tax in the Nordic Countries

The Nordic countries implemented dual income tax systems in the early nineties (see e.g., Sørensen, 1998; Cnossen, 1999; Lindhe et al., 2004; Reutter and Genser, 2007). The common features and differences in these tax systems are characterized in table 1. Capital income is taxed at a flat rate which is equal or close to the corporation tax rate and close to the labour tax rate in the first income bracket. Labour income is taxed progressively. Indirect progression enters in the first bracket due to personal exemptions, in the next brackets graduated marginal tax rates are applied to higher labour income levels.[13]

A common problem in schedular systems is the misdeclaration of income in order to shift a higher share of income to the low tax schedule. In the Nordic countries use a transparent income splitting model to distinguish business income from labour and capital in practice. Active owners, who are working in their firms as managers or primary workers are forced to split their business income into a labour and a capital component.

[12] There is, however, awareness of the problems of defining an adequate tax base for comprehensive income taxation in line with ability-to-pay, see, e.g.,. Kaplow (1996), Donoghue and Sutherland (1999), or European Commission 2006.

[13] The gap between the tax load on labour and capital income is even higher, as net labour income is further reduced by mandatory social security contributions.

Basically, capital income is defined as the imputed return on the stock of business assets and the difference between business income and imputed returns is classified as labor income. The calculation of the imputed rate of return is defined in national tax codes and differs between the Nordic countries. Income splitting is mandatory for sole proprietorships and partnerships, but also for companies with active owners, who own a substantial share of their business (e.g., two thirds) and work in their firm for a minimum number of hours per year.

The Nordic countries allow for loss offsets if capital income is negative. Norway, Finland and Sweden allowed for full integration of corporate and personal taxation of capital income in their introductory dual income tax reform but switched back to double taxation with reduced tax rates at the personal level in subsequent tax reforms (SE 1994, FI 2005, NO 2006), Denmark already gave up full integration in the parliamentary discussion on the tax reform act and introduced a reduced personal income tax (PIT) regime in 1987. Norway and Sweden supplement their dual income tax by a net wealth tax, Finland abolished this net wealth tax in the tax reform of 2005.

The taxable unit in all Nordic countries is the individual. Individual income of Norwegian tax payers also includes income of children.

Insert Table 1 here

Norway

The Norwegian tax reform of 1992 introduced a pure dual income tax. The splitting of income into a labour and a capital component has been mandatory for proprietorships, self-employed businesses, and for active shareholders in closely held companies. Capital income in these businesses is determined by multiplying the value of capital assets by a normal rate of return on capital. This rate of return is the same for all businesses and it is fixed annually by the Ministry of Finance. It is calculated as an average interest rate on certain government bonds plus a risk premium. Labour income is defined as the residual difference of business profits minus imputed capital income and therefore comprises not

only a compensation of labour supplied by the owner but also capital income in excess of the normal rate of return. As a matter of fact, the residual income component is called earned income rather than labour income to reflect this compound character of the residual income component. Political pressure of business lobbies against the rigidity of progressive earned income taxation have led to special tax preferences, viz. a ceiling for earned income above which excess profits are taxed as capital income, or a salary reduction for work intensive businesses which entitle entrepreneurs to deduct a certain percentage of the firms wage bill from the earned income tax base. While the Norwegian dual income tax worked very well, there was evidence on a steadily declining number of closely held companies with mandatory income splitting. These companies were able to avoid income splitting by inviting "passive" shareholders to join their companies in order to stay below the critical quota of active shareholding. This erosion of dual income taxation was solved in the tax reform of 2006 by introducing a shareholder income tax, which is levied as a separate tax on individual capital income from shares in excess of the normal rate of return. The double tax burden of excess company profits is about the same as the top rate of labour income which eliminated the incentive to transform labour income in capital income. Consequently mandatory income splitting of active shareholders was abolished (see Sørensen 2005a). The shareholder income tax is also levied on dividends from foreign shares, but there is no discrimination as foreign shareholders are entitled to a normal rate of return allowance and therefore are only charged on excess returns. Moreover dividends below the rate-of-return allowance give rise to a carry-forward of unused allowances. The shareholder income tax can be shown to be equivalent to a cash flow tax, which is neutral between capital returns from dividends and capital gains (Sorensen, 2005a, 2007).

Finland

As in Norway, full imputation of the corporate income tax required no further taxation of dividends at the personal level up to 2004. Income splitting is mandatory for companies not listed at the Helsinki stock exchange. Dividends exceeding the normal rate of return (fixes at 9,585%) are taxed at the progressive labour tax rate. In 2005 tax rates were slightly reduced, the imputation system was replaced by a reduced PIT rate system, and

the normal rate of return was reduced to 9%. The corporate income tax (CIT) rate was reduced from 29% to 26%, the withholding tax on dividends and interest from 29% to 28%. Double taxation of dividends is mitigated by taxing only 70% of net dividend income at the personal level. Capital income from nonlisted companies is exempt at the personal level up to a ceiling of € 90,000. Reintroducing double taxation of dividends was further mitigated by the abolition of the Finnish net wealth tax.

Sweden

Sweden introduced a true dual income tax in 1991 but deviated from this system only a few years later. Already in 1995 a classical system of corporate income taxation with double taxation of dividends was reintroduced, although mitigated by a reduced income tax rate of 30%. The reduced rate is applied to all capital income at the personal level, i.e., to dividends, interest income and capital gains. Income splitting for proprietorships and closely held companies is based on a normal rate of interest, which is calculated by adding a risk premium of 5% to the interest rate on ten-years government bonds. Business income exceeding the normal rate of return is taxed at the progressive labour tax rate. Dividends below the imputed rate of return are exempt from capital income taxation at the personal level and only bear the corporate income tax burden of 28%. The system includes further complexities, as capital gains of active shareholders are partly taxed at the progressive rate, while passive shareholders are subject to the proportional capital tax.

Denmark

Denmark was the first country to implement a dual income tax as early as 1987, but the government's dual income tax proposal was modified in the parliamentary process and dividend income was never taxed at a single flat rate. Moreover, dividend income is double taxed at the corporate and the personal level, although at a reduced rate. From 1994 dividends are subject to a 28% withholding tax, which is final for dividend income below the threshold and which is credited against the higher tax rate of 43% for dividend income above the threshold. The Danish income tax code distinguishes personal income, capital income and income from shares. But only income from shares is taxed at the

reduced rates, whereas personal and capital income, in particular interest income, is taxed according to the progressive schedule. A separate schedule is applied to capital gains.

6. Implementation of Schedular Income Tax Systems in Other European Countries

Except for the Nordic countries (including Norway), none of the other EU members has introduced a fully fledged DIT, but half of them have implemented major steps from a comprehensive income tax towards a DIT.[14]

There is a final withholding tax on capital income in Austria, Belgium, Germany, Italy, Portugal, Lithuania, Poland and the Czech Republic,[15] whereas all these countries apply a progressive tax scale on labour income (table 2). Estonia does not to tax capital income at the personal level and charges a flat tax rate on earned income. Preferential treatment of capital income is also found in the Netherlands and in Greece, where the latter furthermore differentiates tax rates of dividend and interest income. France introduced a final withholding tax only for personal interest income (table 3).

Although schedular capital taxation in these countries constitutes an important step towards DIT there are still important differences to the Nordic DIT. None of the other EU countries splits business profits into capital and labour income for closely held corporations or non-incorporated firms, but taxes all business income as comprehensive income. And none of the countries offers a CIT credit equal to the personal capital income tax, which is characteristic for a pure DIT. Most of them double tax dividends, except for Greece and Estonia, which exempt dividends. Double taxation is, however, mitigated by a reduced personal income tax rate, or by a reduced dividend base (Czech Republic, France).

Whereas the Nordic countries still provide some loss offset rules in case of negative capital income, such offsets are granted only in Greece and in a limited form in France. In contrast to a pure DIT Lithuania, the Netherlands, France, and Estonia provide a basic allowance also for capital income, whilst Austria and Belgium offer a filing option. In these two countries, low income tax payers can opt for taxing capital and

[14] See, e.g., Genser and Reutter (2007).
[15] In some countries, however, the tax rate on capital gains can differ from the tax rate on interest income and dividends, e.g., in Belgium and Portugal.

labour income comprehensively at the progressive (labour) schedule. Finally, the corporate income tax rate coincides with the personal income tax rate on capital in Austria, Lithuania, Poland, Greece, and Estonia but differs in the other countries.

Germany enacted a major business tax reform in two steps in 2008 and 2009[16]. The corporate income tax rate was reduced to 15% (from 25%) but companies are still liable to the local business tax constituting a total tax burden of 29.83% on company profits (instead of 38.65%). From 2009, personal capital and labour income will be taxed at separate schedules. For labour income, the progressive income tax schedule is maintained but capital income (interest, dividends, capital gains) is taxed at a flat withholding rate of 25%. Business profits of nonincorporated firms are subject to the progressive income tax schedule and the local business tax, but two new measures ensured a substantial income tax relief. A local business tax credit eliminates double taxation to a large extent, and non-incorporated firms can opt for a flat rate of 28.25% on business profits which are retained and reinvested. Both preferences generate a business tax burden which largely equals that of a company. If these retained earnings are withdrawn by the owners rather than reinvested, they are be treated like dividends and taxed at the flat rate of 25%.

The Netherlands implemented a business tax reform in 2001 which subjects dividend and interest income to a presumptive income tax at the personal level (Cnossen and Bovenberg, 2001). The presumptive personal income tax is levied at a rate of 30% on capital income, which is calculated by applying an imputed return of 4% on the average net value of assets in the tax period. The imputed personal income tax is equivalent to a 1.2% wealth tax on net assets and covers capital income of asset holders from dividends, interest and royalties. Personal allowances cause an indirect progression at the personal level of this “Box 3” type investment. Dividends, interest and capital gains from substantial shareholding are classified as “Box 2” type investment income and are taxed at a flat personal income tax rate of 25%. These flat rates remained unchanged when the Netherlands reduced the CIT rate to 29,6% in 2006.

[16] See Homburg (2007). For a discussion of a reform proposal of the Concil of Economic Experts which was closer to a DIT see Spengel and Wiegard (2004).

Greece is the only EU15 country which exempts dividends at the personal level.[17] Thus, dividends are taxed at the corporate income tax rate of 29% in 2006. For a long time this rate was 35% and only slightly lower than the top personal income tax rate of 40%. The tax relief is more pronounced for interest income, which is subject to a final withholding tax (10% on bonds and bank deposits and 20% on interest of loans and on interest received from abroad).

France only subjects interest income and capital gains to a final withholding tax of 16%, whereas there is no withholding tax on dividends. Similar to the most recent Nordic tax reforms, dividend income is subject to the progressive tariff on earned income but also qualifies for an exemption of 50% of their amount. As a matter of fact dividend income earners are entitled to the basic allowance of personal income tax. Another specific feature of capital taxation in France is the net-wealth tax.

The final withholding tax regime in Slovakia is a flat tax comprehensive income regime, which taxes income from all sources at 19%. As in Greece dividends are exempt at the personal level, but carry the 19% corporate income tax. The only deviation from SHS taxation is that negative capital income cannot be offset against positive earned income.

In Estonia dividend and interest income are exempt at the personal level, reflecting a consumption oriented income tax regime. There is, however, a 23% tax rate on business profits at the company level and on capital gains at the personal level. Only interest income is tax free, all other sources of income bear the standard tax rate of 23%.

Although the countries listed in tables 2 and 3 did not introduce a dual income tax system, there is some convergence in capital income taxation in these countries and toward the Nordic countries. The common features are the low corporate income tax rates, the flat rate on interest and dividend income levied as final withholding taxes, a double taxation of dividends which is largely neutral to the taxation of business profits in nonincorporated firms, and a significant tax reduction on interest income.

[17] Among the EU25 dividend exemption was also adopted in Cyprus, Estonia, Latvia, and since 2005 also in Slovakia.

7. Toward Coordinated Business Taxation in Europe

Globalization and the completion of the European Internal Market have changed the framework for business activities in the EU member countries. Although national tax reforms tried to cope with the new challenges more coordination might be helpful to avoid long term social cost from incentives in international tax engineering and strategic tax competition. Based on experience with recent tax reforms Cnossen (2004)[18] proposes an agenda for a European coordination of business taxation which comprises five sequential steps:

First, all member states should introduce a dual income tax system, which taxes capital income at a single flat rate below the top rate on labour income. The low flat rates on capital income at the personal level should mitigate the distorting effects of double taxation of capital returns to domestic and foreign investors at the corporate and the personal level. *Second*, all member states should introduce a flat withholding tax on interest income at a rate that equals the national corporate income tax rate. This mandatory interest tax should treat interest and dividend income alike and mitigate incentives for debt financing and thin capitalization. *Third*, the EU should recommend an approximation of corporate income tax rates across EU member states, e.g., by introducing a minimum rate, to reduce transfer pricing incentives. *Fourth*, based on the results of the three coordination steps in the member states the EU should propose the introduction of an EU-wide comprehensive business income tax[19] which uses a common tax base in all member countries, in line with the proposal raised in the Bolkestein report. The comprehensive business income tax requires an extension of the dual income tax concept to treat equity financing and debt financing alike, viz. the nondeductibility of interest on business debt from business profits. The broadening of the tax base should allow a reduction of the corporate income tax rate. The common consolidated tax base of multinational companies must be split in appropriate country shares by formula apportionment. The *fifth* and final long-term harmonization step would be a European corporate income tax with a single tax rate set by the Council of the EU.

[18] See also Cnossen (2005) and Genser and Schindler (2007).
[19] See, e.g., Cnossen (1996).

In his evaluation of the five steps Cnossen is cautious and proposes a break after step 3 for a fresh review of the Bolkestein proposals. He is also aware that a European corporation tax requires a reform of the EC Treaty.

Our analysis has shown, however, that the first three steps of the agenda would be economically useful and politically feasible, given the unilateral reforms in EU member states in the last 15 years.

8. Concluding Remarks

Starting out in four Nordic countries schedular income taxation has gained support in many European countries. Although evidence in these countries reveals that it is not an easy task to implement a dual income tax structure, there seems to be little political pressure to return to comprehensive income taxation in these countries. Moreover, many of the new EU member counties did not introduce a traditional SHS tax regime in their tax reforms enacted to adjust to the EU internal market but relied on withholding taxes resembling dual income taxation.

One major advantage of a dual income tax is the nondiscriminating integration of corporate and personal income tax for domestic and foreign investors, which is crucial for an integrated capital market. Dual income taxation allows for final withholding taxes on dividend and interest income, which is not only a cheap way of collecting taxes with respect to compliance and control costs but also curbs tax evasion through improper filing. Taxing dividend and interest income at source is a first step to financial neutrality. Incentives for strategic income splitting between low taxed capital and progressively taxed labour income can be reduced as the recent DIT reform in Norway has shown.

The adoption of dual income tax systems in a pure or partial form generates a new playing field for business tax coordination in the EU. Whereas the proposals of the Ruding Committee in the early nineties on a common European corporate income tax were forcefully rejected by the Commission as well as by national governments, the dual income tax framework ensures room for national tax autonomy in personal taxation, even if corporate income tax rates are aligned. This room can be used for national tax measures which help to improve interpersonal distribution as well as economic efficiency.

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Table 1: The Nordic Dual Income Tax (2006 tax rates in percent)

	Norway	Finland	Sweden	Denmark
First Implementation last DIT reform	1992 2006	1993 2005	1991 1995	1987
Personal income tax rates - on capital income - on earned income	 28 28-54.3	 28 26,5-55[c]	 30 31,6[e]-56,6	 28/43[g] 38,8-48,3
Basic allowance for capital income	Yes	No	No	Yes
Earned income offset of negative capital income	First bracket	Tax credit	Tax credit	First and second bracket
Integration of corporate and personal income tax	Reduced PIT rate normal rate of return allowance	Reduced PIT rate allowance of 90 000 € for dividends from nonlisted firms	Reduced PIT rate[f]	Reduced PIT rate
Corporate income tax rate	28	26	28	28
Withholding PIT - on net dividends - on interest	 0/20,2[a] 28	 0/14,5[d] 28	 30 30	 28 0
PIT on capital gains	28[b]	28	30	28
Net wealth tax	0,9-1,1	No	1,5	No

Notes: [a] 28% on net dividends in excess of normal rate of return
[b] net of retained earnings
[c] for the municipality of Helsinki
[d] 28% on 70% of net dividend income
e local income tax only; additional federal income tax is due for income levels exceeding a threshold of 306000 SEK
[f] since 1994
[g] 28% for dividend income below threshold, 43% else

Source: European Tax Handbook (2006)

Table 2: Final Withholding Taxes on Capital Income (2006 rates in percent)

	Austria	Belgium	Germany[a]	Italy	Portugal	Lithuania	Poland	Czech Republic
Personal income tax rates								
- dividend income	25	25	25	12,5	20	15	19	15
- interest income	25	15	25	12,5/27	20	0/15	19	15
- earned income	38,3-50	26,88-54,25	15-45	23,9-44,9	10,5-42	27	19-40	12-32
Basic allowance for capital income	Filing option	Filing option	Filing option	No	No	Yes	No	No
Offset of negative capital income	No	No	No	No	No	No	No	No
Integration of corporate and personal income tax	Reduced PIT rate	Reduced PIT rate	Reduced PIT rate	Reduced PIT rate	Reduced PIT rate	Reduced PIT rate	Reduced PIT rate	Reduced dividend base
Corporate income tax rate	25	34	15[b]	33	25	15	19	24
Withholding tax on								
- dividends	25	25	25	12,5	20	15	19	15
- interest	25	15	25	12,5/27	20	0/15	19	15
PIT on capital gains	25	33	25	27	10	15	19	12-32
Net wealth tax	No	No	No	No	No	No	No	No

Notes:
[a] tax rates on capital income and corporate income tax rate for 2009
[b] without additional local business tax (14% calculated for a local multiplier of 400%) and solidarity surcharge (0.83%)

Source: European Tax Handbook (2006)

Table 3: Special Tax Regimes on Capital Income (2006 rates in percent)

	Netherlands	Greece	France	Slovakia	Estonia
personal income tax rates - dividend income - interest income - earned income	 30 (Box 3)/25 (Box 2) 30 (Box 3)/25 (Box 2) 34,15-52	 0 10/20 15-40	 6,8-48,1 16 6,8-48,1	 0 19 19	 0 0 23
Basic allowance for capital income	for Box 3	No	Yes	Yes	Yes
Offset of negative capital income	No	Yes	Limited	No	No
Integration of corporate and personal income tax	Reduced personal income tax rate	Dividend exemption	Reduced dividend base	Dividend exemption	Dividend exemption
Corporate income tax rate	29,6	29	33,3	19	23
Withholding tax - dividends - interest	 30 (Box 3)/25 (Box 2) No	 No 10/20	 No 16	 0 19	 No No
PIT on capital gains	30 (Box 3)/25 (Box 2)	0	16	19	23
Net wealth tax	1,2[a]	No	0,55-1,8	No	No
PIT unit	Individual	Individual	Household taxation	Individual	Individual Option for household taxation
Income of children	Included	Included	Included		Taxed separately

Notes: [a] levied as presumptive personal income tax. (Box 3)

Source: European Tax Handbook 2006