PERSONAL INCOME TAXATION REFORMS IN THE 21st CENTURY

Maria Crespo Garrido

Abstract

In the last ten years the fiscal systems of the majority of the OCDE countries have been reformed with a few very similar trends, being the economic reality of the moment the determining one of great importance. So the economic environment in which the countries are developed has marked and it will continue doing it, the guideline to continuing, according to the aims of economic policy previously designed. One of the main problems which the legislator meets is the deslocalitation of the capital and the need to attract it, as consequence of its mobility. In a society where the interest rate differentials are not any inducement, the tax system can be a determinant at the moment of deciding the place and the type of investment

KEY WORDS: Fiscal reform, tax flat, personal income tax, corporate income tax, mobility of the cardinal factor, international transactions.

1. CHARACTERISTICS OF REFORM MODELS IN TAXATION SYSTEMS IN THE SETTING OF THE O.C.D.E. (Organization for Economic Cooperation and Development)[1]

Most economists agree that it is necessary to consider the relationship that exists between the economic environment and tax reform trends[2], and it is certainly true that the

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[1] This article is the result of the Complementary Action of the Institute of the Women of Spain. SUBVENCIONES DESTINADAS A LA REALIZACIÓN DE ACCIONES COMPLEMENTARIAS A LA INVESTIGACIÓN EN EL ÁMBITO UNIVERSITARIO PARA EL AÑO 2010. RESOLUCIÓN DE 9 DE JULIO DE 2010 DEL INSTITUTO DE LA MUJER B.O.E. 25 DE AGOSTO DE 2010.

[2] Reform trends, related to tax rates, may be summarized as follows:

economic reality, regardless of what it might be, inevitably affects the taxing environment and the alternatives raised by tax reforms, particularly income tax, since taxation is an extraordinary tool in the design of economic policies.

1.1. Economic changes in the 20th Century affect and continue to influence due structure reforms. The most recent changes may be grouped in the following three groups:[3]

a) Improved welfare standards, represented by higher and better medical and healthcare benefits, together with technical progress, have produced an increase in population, which has allowed the use of overall taxes for large sectors of the population, since there is a higher number of individuals that surpass the poverty threshold, and therefore, tax collection is not reduced even though tax rates are lowered because the number of taxpayers has expanded.

b) The second circumstance was described on the Wagnerian forecasting, for whom the progress of civilization inevitably led to the growth of the public sector, the weight of the public sector going from five percent to somewhere between forty and fifty percent in the Western world.

c) Perhaps the most distinctive trend at the end of the 20th Century was globalization, to which taxation is not unrelated. Considered to be basically macroeconomic, it relates to the decision of enterprises to internationally organize their productive chain[4], trying to take advantage of the benefits offered by different countries, such as production costs, deregulation of certain activities, free movement of capitals and market interconnection.

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a) General reductions in marginal tax rates: Germany, Austria, Belgium, Finland, United Kingdom, France, Italy, Luxemburg, Portugal, Ireland, Spain and the Netherlands.

b) Selective reductions aimed at low income groups: Denmark, France, Finland, Italy, Portugal and Belgium.

c) Income tax reductions by specific groups (usually workers in the secondary workforce, their children, and workers with low salaries).

c.1) Increase in deductions for employment and childcare: Belgium, Finland, Germany, Italy, the Netherlands and United Kingdom.

c.2) Elimination of double-scale joint taxation: Ireland and Spain.

c.3) Increase of the minimum exempt threshold: France, Germany, Sweden, Greece and Spain

c.4) Deductions for low income employment: Finland, France, Greece, Ireland and United Kingdom.

Zubiri (2001)

[3] Lagares (2001).

[4] It is important to consider that the concept of globalization is not based in the so-called “multidomestic enterprise”, but, as Krugman (1995) states in the division, in different national spheres, of the total added value chain of a specific enterprise. Therefore, while the multidomestic enterprise is the one that serves different national markets through a complete and closed activity in these markets, and in addition, is independent from them, globalization of the entrepreneurial activity implies a division of work in different national spheres applied to a production process of the enterprise contemplated as unique. This means that globalization demands a transnational enterprise.
Lagares (2001).

The economic realities, indicated above, take the evolution of the taxing system to a very specific course, encouraging reforms such as the following.

1. 2. The reform of the tax system, in general, does not respond to a mere desire for change, but usually is the result of a series of circumstances that call for changes in the existing taxing outlook. Today, the idea that the taxing system should serve economic policies has acquired special relevance, as advised by the Spanish General Taxing Law.

Traditional taxing principles have also suffered important transformations, given that current public finance experts have attempted to establish a tax policy that is ruled by neutrality and the achievement of financial equilibrium, stepping over other principles that were a priority before, such as equity. The former becomes important on taxing of capital returns, since it is determining to avoid income relocation situations; therefore, neutrality and sufficiency are two of the basic principles of current taxing systems. And these two taxing principles rule the reforms analyzed on the following pages.

2. In recent years, there have been multiple tax reforms that have emphasized different objectives. The most recent reforms are fundamentally based on the principles of efficiency, equity and administrative simplicity. Today, however, the main reforms have been aimed to mitigate the negative effects of capital relocation, in an attempt to improve tax neutrality and efficiency.

This paragraph analyzes two theoretical proposals presented in other two studies, in which an attempt is made to modify current income tax, both personal and corporative, by means of different forms of taxation, with the main purpose of avoiding the capital factor relocation caused by taxing reasons.

Today there are different countries with a flat tax in force; they are:

Country	**Tax rate**	**Year of introduction**	**Country**	**Tax rate**	**Year of introduction**
Hong-Kong	16%	1947	Irak	15%	2004
Estonia	26%	1994	Slovakia	19%	2004
Lithuania	33%	1994	Georgia	12%	2005
Latvia	25%	1995	Romania	16%	2005
Russia	13%	2001	Kyrgyzstzan	10%	2006

Serbia	14%	2003	Macedonia	12%	2007
Ukraine	13%	2004	Iceland	35,73%	2007

Source: European Commission

In Spain, from a theoretical point of view, it was suggested within the framework of the 1998 reform, to substitute the income tax with a flat tax with a type of unique rate similar to the Corporate Income Tax, with the purpose of improving the taxing situation of capital returns, in order to maximize the reduction of capital "flight". If it had been possible to tax all returns at the same rate, taxing neutrality would have improved, eliminating the distortions produced by the different taxation of the different returns. However, the Commission for the Personal Income Tax Reform rejected this option, since it improved the taxation of extreme incomes, that is, the very high and the very low, negatively affecting the medium income tax. In addition, when this type of tax is introduced, some aids disappear, such as those related to housing or retirement plans; therefore it becomes necessary to consider the needs of those groups affected, which weigh even more than the positive effect that this kind of tax has on fraud reduction.

These reforms, as well as others not covered in this article, in spite of presenting important differences, are aimed at a more neutral and simple tax, as a priority, always taking into consideration the fair distribution of income.

2.1. The Hall and Rabushka[5] flat tax

A variation of the Spain proposal is the one proposed by Robert Hall and Alvin Rabushka[6] in the United States, through a "flat tax", that consists of the application of a tax that would burden earned incomes (in Spain terminology), along with a tax that would levy the benefits of economic activities, taxing both incomes at the same marginal tax rate[7], although a reduction[8] was established on earned income, as the means to guarantee

[5] Hall and Rabushka (1995)

[6] This analyzed proposal is more than a theoretical formulation, since this flat tax was introduced as a legal proposal in Congress in 1995 by Dick Armey.

[7] The original proposal included a fixed tax of 19%, as the rate that would allow collection thanks to a base expansion.

[8] Personal and family reduction will vary according to personal circumstances; marital status, number of dependents…. In summary, the tax is subjective of the tax burden according to personal and family circumstances.

progressiveness[9] and, in addition, it establishes a minimum exemption so that those that do not exceed it, do not have to contribute.

This theoretical model, proposed several years ago, has recently received special attention with the constitution in January 2005 of the *President´s Advisory Panel on Federal Tax Reform* by the President of the United States, to present proposals for income tax reforms, and which suggested the establishment of a *Simplified Income Tax Plan* and the *Growth and Investment Tax Plan*, that would involve the combination of a dual tax and the Hall and Rabushka flat tax.

The philosophy of this reform implies taxing income only once, and consequently, proposes the elimination of the inheritance and donations tax. This tax would improve equity, simplicity, work incentives and investment, as well as corporate efforts, since the marginal rate would be lower for most taxpayers.

Regarding the taxation of incomes derived from economic activities, both those carried out by natural and legal persons will be taxed, including rental income and copyrights, but the deduction of financial expenses or dividends distributed or any other payments made to shareholders is not allowed, with the subsequent base expansion.

With regards to capital gains taxation, they will be taxed on economic activities, those derived from rental income, plant and land property, and asset increases individually obtained shall not be taxed[10].

2.1.1. The criticism can be summarized as follows:

a. Confusion between consumption and rent. In this tax, the taxable base is constituted by wages, which are confused with consumption and not necessarily both magnitudes have to coincide, particularly if the vital cycle perspective is not considered. This leads Roberts and Sullivan (1996) to argue that taxing could be reduced in economic activities through the continuous purchase of assets.

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[9] Tax on salaries is composed of a narrow base that only includes actual income from wages, salaries and private retirement plans. This base only allows the application of a personal and family reduction that is dependent on the marital status of the taxpayer and the number of dependents under his/her care; on the excess, if any, a single taxing rate is applied thus obtaining the taxable amount. Individuals whose tax base does not exceed the exempt minimum do not pay tax. Contributions to retirements plans that enterprises make in favor of their workers are not taxable, since the workers will pay taxes when, upon retirement, he or she receives the retirement pay. In-kind income received by workers is also not taxable. Deductions for mortgage interest payments derived from the purchase of primary residence, deductions for donations, capital gains tax and movable assets tax disappear.
Durán (2002)

[10] Some authors rate this tax as a value-added tax calculated according to the direct subtraction method, which is obtained from the difference between income generated by sales and the cost of purchases, including investments.

b. Fiscal evasion through location in other territories, based on the principle of territoriality, which allow North American enterprises to evade taxes, allocating positive results to enterprises located abroad, and expenses to those located in-country. That is why Mc Lure (1996) feels that the flat tax would cause distortions by encouraging multi-national corporations to acquire debts in countries where payment of interest is deductible, while financial income would be attributed to countries that have adopted the flat tax, with the subsequent collection consequence for the former[11].
c. Another criticism for this flat tax focuses on the lack of equity, since those individuals whose income comes mainly from dividends, interest and capital gains would pay nothing.
d. Losses of economic efficiency would become evident by maintaining some deductions which would also affect administration.
e. With regards to redistribution, Iyer and others (1996) indicate that there would be a slight increase in the average rate for the lowest incomes, while the rest of taxpayers would benefit from a reduction that would increase with the level of income.
f. As a positive comment, recent studies indicate that this kind of tax would cause an increase in labor supply and would improve economic growth.

Definitely, the most polemic aspects of this reform proposal are based on the possible effects over capital accumulation, labor supply and equitable distribution of income and wealth, as opposed to the undoubted simplicity of this model.

2.2. Consumption Flat Tax Rate: The Kotlikoff[12] Proposal

This fiscal reform proposal recommends the substitution of income tax with a comprehensive consumption tax at a flat rate, taxing all service and good acquisitions. However, at the community level it is not compatible with the harmonized VAT implanted in the European Union without prejudice to the regressive effects caused by an excessive consumption tax, although this proposal deserves consideration in light of a future European indirect tax reform.

This consumption tax, with a flat tax rate, contemplates a reimbursable deduction in order to guarantee progressiveness. This deduction is determined by, and varies according to, personal circumstances: number of children, dependents …

Kotlikoff feels that a consumption tax offers higher incentives for savings than income tax. If, as most economists believe, savings is not an end in itself, but a way to finance future consumption, an income tax, as currently conceived, is taxing that consumption two times: first with the savings and later, when the future consumption is

[11] Durán (2002)
[12] Kottlikoff (1996).

materialized. As current consumption is taxed only once, the decision of whether to consume now or save to consume more in the future, an income tax offers a clear incentive to consume more in the present time, and thus, to save less.[13] With a consumption tax this would not happen, since savings will no longer be taxed.

On the other hand, consumption taxing would cause a redistribution of the tax burden from the youngest generations to the oldest, since the latter have a higher tendency to consume.

The proposed model does not lack criticism, with regards to the lack of equity. Those who reject this alternative argue that this tax would increase the fiscal pressure of the older generations and therefore Kotlikoff suggests the possibility of introducing compensations for this age group.

On the positive side, it is necessary to mention that this taxing method would improve efficiency eliminating current distortions. Rather, equity would be decreased with the reduction of the system's progressiveness with a flat rate. In his defense, Kotlikoff argues that the existence of a reimbursable deduction would even establish the same level of progressiveness than before the reform.

Finally, the redistributive effect of the reform depends on the final impact produced over the price level and the integration of the patrimony of individuals, since the new system would generate an important impact in intergenerational distribution, prejudicing older people and alleviating the fiscal burden of the younger generation.

2.2.1. They can be summarized as follows:

a- Inflationary effect. One of the basic problems that this tax presents upon taxing consumption is the negative effect it can cause on the generalized increase in prices, since it is included in the final price of goods and services, according to the analyses carried out by Weidenbaum (1996).

b- Possible pyramid effect argued by Gale (1998) and Lure (1996) who feel that if business transactions are taxed, distortions are introduced in the behavior of economic agents.

c- Its possible negative effects on equity are criticized, since consumption decreases when income increases, as indicated by the consumption function, and therefore this tax will basically collect over the lowest incomes.

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[13] Based on the consumption function Y = C +S, where Y is income, C consumption and S savings, Kotlikoff argues that an income tax can be considered a method to tax both consumption and savings.

- d- Finally, results on welfare would depend on the index considered; if the reference is the annual rent of families, this minority tax would become regressive. However, if income is considered throughout the vital cycle, the tax regressive quality would be much lower, and finally if a reimbursable deduction is introduced to allow exemption of a consumption level equal to the poverty threshold, this tax could be progressive.
- e- Finally, the establishment of a reimbursable deduction could generate administrative complications, for they would be dependent on the income level of the target group to maintain the collection level.

3. As stated before, the latest tax reforms have questioned the hegemony of income taxes, and the two most relevant proposals are the flat rate tax and the dual tax.

In the case of Spain, this form of taxation was adopted in part by the latest reform of the Income Tax, which became effective on January 1, 2007, especially by the differentiation and reduction of capital gain taxing, with the classification of income in general income and income obtained from savings.

3.1. This model is characterized by taxing labor income in a progressive scale and capital gains and income at a flat rate, just like the minimum rate of the progressive tariff, was established at the end of the 80s decade in Nordic countries and later, with some differences, in Austria, Belgium, the Netherlands and Italy. The initial idea of taxing capital gains through a proportional tax emerged in Denmark, where this tax was established in 1987.

It appeared for the first time in 1980 when Nielsen and Sorensen (1997) suggested the substitution of a global income tax, which covers all incomes at the same progressive taxing rates, with a dual tax that would affect, on one hand, income and capital gains at a proportional flat rate, and on the other hand, labor income and other income at progressive taxing rates.[14]

The following are the most significant characteristics of this model, although there are different types of this model, as described below:

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[14] Austria can be mentioned as an example of a fiscal system in which there is no dual tax, strictly speaking, although a retention system was established for certain incomes, that originate from bank secrecy, with dividends and interest and patrimonial earning derived from significant participations, derived from investments in securities and those derived from real state properties, the ones that receive a differentiated treatment.

Another difference, presented by France, where it was decided to establish a differentiated treatment for the following incomes: employed labor income, income earned by economic, agricultural and entrepreneurial activities, returns on investments; dividends, interest, wages, real state rentals, without prejudice of later integrating them to the tax base.

a. Income is classified in two kinds: labor income or "earned"[15] and capital gains or "not earned".
b. A minimum personal exemption is established for labor income and is subjected to a progressive tax.
c. Capital gains are subject to a fixed rate equal to the minimum of the progressive labor income scale, which in turn coincides with the tax rate of corporate incomes, in order to avoid discrimination between individual and corporate incomes.
d. Incomes derived from economic or entrepreneurial activities are considered mixed incomes; labor and capital

The dual model has been adapted through two alternative systems:
I. Finland and Sweden divide it in two taxing bases, labor and capital. While labor income is taxed at a progressive rate, capital gains pay taxes on a proportional rate. Revenues of different nature cannot compensate each other, and in addition, the capital base establishes limits to the compensation of capital reductions with the other incomes, although it is indirectly allowed to compensate negative bases with positive labor incomes through a deduction in the labor compensation quota.
II. Norway establishes a general taxing base which includes all incomes, independent of their nature, and a personal taxing base integrated only by labor compensation. The former is taxed at a single proportional rate, and over the latter a first base tranche is established that pays taxes at a zero rate, so the personal base is configured as a surcharge applied only to high labor incomes. Joint taxation allows negative capital gains to compensate with labor positive incomes and that the minimum tax exemption is common even though labor revenues are subjected to additional progressive rates. The application of deductible expenditures is allowed as well as different reductions that benefit all in the same way, while the personal taxing base does not allow the application of any reduction.

There are many differences among the countries that applied this model; therefore, the most significant characteristics of dual taxes applied in the Nordic countries are summarized below:

	SWEDEN	FINLAND	THE NETHERLANDS	NORWAY
Year of introduction	1991	1993	2001	1992
Territoriality	State and municipal	State and municipal	State	State, municipal and provincial

[15] "Earned" incomes include salary remuneration, cash and in-kind compensations, pensions, and Social Security benefits, and capital gains include: interests, dividends, rentals and capital gains.

Taxed incomes	Earned incomes and capital gains	Earned incomes and capital gain	Personal, dividends and capital gains	General income and personal income
Tax rate earned incomes	Minimum 20% state maximum 25% municipal rate: 31% 3 tranches	Minimum: 14% maximum: 37% municipal: 19% 6 tranches	Minimum: 32,35% maximum: 52% 4 tranches	28% total 10,35% state 6,45% provincial 11,20% municipal
Tax capital gains	30%	29%	30%	Minimum: 13,5%, maximum 19,5% 3 tranches
I.S. rate	28%	29%	Progressive 30-35%	28%

Source: International Bureau of Fiscal Documentation: European Tax Handbook (2001)

3.2. This alternative is not free of criticism; the reasons for rejecting the dual tax are summarized below:

a. Lack of neutrality: Since there is not a unique taxing model for capital gains in the European Union, the adequacy would be slower than anticipated. This is one of the most discussed issues, however, recent studies reveal that dual taxing substantially reduces incentives to be chosen between capital income generating assets and transforming labor into capital.
b. Lack of unity regarding equity issues will likely take the Danish government to abandon this system in 1994, adopting a tax over dividends.
c. The strongest criticism is probably centered on the vertical inequity caused by the tax on labor compensation, as stated by Sorensen (1997) if it is accepted to concentrate capital gains in high income levels.

4. In light of the previously mentioned results it can be stated that there is not a unique taxing model for incomes obtained from savings. Rather, there are very different solutions, even, dissenting. There have been theoretical attempts to carry out the so called “fundamental fiscal reform”, in the United States, substituting a personal consumption tax for current income taxes. On the other hand, the dual tax, as such, only exists in a couple of countries –Norway and Finland- with a close approximation to Sweden. And the most recent reforms appear to accentuate this heterogeneity, at least for the moment.

Regarding neutrality in the treatment of the different savings results, it does not have to be absolute. It is obvious that there are differences regarding taxing of these products and there is nothing against them, as long as they are not so important as to originate distortions. That is, if they do not significantly alter the assignation of resources generated by the market. It is recommended not to eliminate them altogether, particularly when their entire correctness can lead to serious problems in other areas such as equity. However, let's not forget that as long as the mobility of capitals increases, distortions in income taxing can cause relocating problems.

The interest shown in the substitution of classic direct taxes with a flan tax is higher in countries like the United States where there is no harmonized VAT such as the European tax since the new corporate tax should coexist only with indirect t taxes at moderate rates on existing sales at the state level. In the European Union countries, this tax should be combined with the current harmonized VAT which makes it necessary to consider the level of fiscal pressure that should be maintained on indirect taxing, with the regressive problems it presents.

Due to the benefits of a consumption tax with regards to capital accumulation, and the problems of establishing this kina of taxes, particularly in European Union setting, the recommendation is made to give a favorable treatment to capital gains, in order to avoid relocation problems, but keeping the current taxing structure.

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