THE CASE FOR TAXING CONSUMPTION

by **Joachim Lang**
Professor of Taxation Law and Public Law
Director of the Institute for Taxation Law of the University of Cologne, Albertus-Magnus-Platz 1, D-5000 Cologne 41.
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This article deals with fundamental and topical problems of taxation policy, viewing the subject from both a German and an international perspective. Traditional income tax regimes in developed countries with their progressive tax rates are still based upon the redistributive philosophy which arose in response to the disadvantaged position of workers in early industrialised societies. The author considers that this philosophy is now outdated, for the main problem of the 1990's is how to discourage excessive consumption with its detrimental impact upon the environment and its negative implications for future generations. He advances weighty arguments for confining progressive income tax regimes to that part of income which is appropriated to consumption whilst exempting from them that portion which is used for the formation of capital. Whilst conceding that such a radical scheme cannot be fully implemented at this stage, he urges that these two portions of income be subjected to separate tax regimes. Tax rates could then be so structured as to encourage capital formation. The author's proposals raise matters of obvious importance to a 'savings-poor' country like Australia.

A second part of the article considers how the dual tax regime which the author favours could be put into practice.

Introduction

The present state of taxation gives rise to the question whether tax systems have not been moving in the wrong direction, so that only a fundamental reorientation of taxation policy would be capable of restoring health to these systems. The 'taxing consumption' movement, which is gaining more and more support, must be viewed in this context. Much criticised features of the existing systems, viz high tax rates, complexity and injustice inherent in existing assessment principles, affect particularly the area of income tax, posing in acute form the question whether the existing systems are fundamentally flawed. The proposed alternative of a personal consumption tax would tax only the consumed portion of a person's income as distinct from the portion which is allocated to savings. Is this a superior concept which is likely to dominate and determine future developments? The answer to such a question posed at the end of the 20th century is bound to be significantly different from the answer which would have been given at the end of the 19th century, at the time of the birth of our modern industrial society. At the end of the 20th

century we know that the members of our industrial society tend to consume too much, to the detriment of so-called developing countries and of future generations. We also know that enormous productive capacity will be required if the problem of excessive consumption is to be resolved. Do these considerations not make it appropriate to lessen the tax burden on savings which are the foundation of productivity, and to render consumption more costly by means of taxation?

Philosophy of redistribution

The taxation of consumption is historically the oldest form of taxation. Indirect consumption taxes were levied in ancient times and still form a significant portion of tax revenue in most systems. They are easy to administer and thus enjoy special favour in countries with inefficient revenue administrations. Article 99 of the EEC Treaty expressly postulates the harmonisation of indirect taxes in EEC countries. The greatest progress in this respect has been achieved with the value added tax. Because of its supranational links, value added tax may be regarded as a stable institution within the tax systems of EEC countries, its assessment principles being largely fixed and uniform. What is still to come is the harmonisation of VAT rates.

The focal points of present and future tax policy lie in the taxation of wealth and income. The accretion model income tax, the wealth tax, the estate and gift taxes are based upon the ideological concept of justice proposed by the philosophy of the enlightenment which postulated redistribution of wealth and which freed large numbers of people from the chains of the feudal state and led to their emancipation within the state. Article 13 of the *Declaration des droits de l'homme et du citoyen* (1789) based its assessment of the capacity to pay tax upon a person's wealth (and not upon consumption); the 'general contribution' required by this article was to be 'distributed evenly amongst all citizens taking into account their wealth'.

It took no more than a century for the institution of the progressive income tax to become established side by side with indirect consumption taxes. It owed its place perhaps not so much to the sense of justice of legislatures as to the fact that it proved an easy and abundant source of revenue. The first income tax based upon the taxpayer's total income was introduced in 1799 in order to finance England's war against Napoleon.[1] Similarly, the beginnings of income taxation on German soil were the result of a financial emergency caused by war. In 1806 Karl Freiherr vom Stein advocated a progressive war tax levied upon total income.

1 BEV Sabine, *A History of Income Tax* (London 1966) 26: 'the general tax upon all the leading branches of income' introduced by William Pitt, was a 'war tax' that 'beat Napoleon'.

He recognised this type of tax as 'the most uniform and profitable impost'. It was due to his influence that this tax was introduced in 1808 in Prussia, Lithuania and Koenigsberg.[2]

The legal and ethical justification for the taxation of income was developed in the course of the 19th century in the light of the unfortunate social conditions which had come into being during the period of transition from the feudal agrarian society to the industrial society. The theory of progressive taxation according to capacity to pay, the principle of progression and the capacity to pay principle were developed and elaborated.[3] The fundamental critical analysis advanced by the socialist movement,[4] in particular, contributed to the view that the taxation of consumption was unjust, because of the fact that indirect consumption taxes which were passed on placed in jeopardy minimal requirements to sustain life, and would, in addition, represent a disproportionate burden for the economically weaker groups in the population. On the other hand, the 'general progressive capital tax which represents a percentage of capital which increases as capital increases,[5] was seen as guaranteeing a just and even distribution of the burden of taxation. The unrestrained manner in which the capitalist economy developed led even bourgeois politicians and academics to redefine their positions, so that the concept of a socially oriented tax system, which based taxation upon capacity to pay, was soon no longer limited to the socialist movement, but also became part of the ideological equipment of bourgeois social reformers.[6] In 1891 Johannes von Miqel, Prussian Finance Minister, introduced the modern progressive income tax. The new tax was well received and von Miqel commented: 'This favourable reception is due, in the first instance, to our German sense of justice. One doesn't complain about high taxes merely because they happen to be high, provided that they are being imposed in a way that is just and fair; one does complain, however, when taxes are imposed in a way which is unjust and uneven.'[7]

2 See B Grossfeld, *Die Einkommensteuer, Geschichtliche Grundlage und rechtsvergleichender Ansatz* (Income tax, historical foundations and comparative considerations) (Tuebingen 1981) 29ff; C Heuer, *Karl Freiherr vom Stein als Wegbereiter des deutschen Einkommensteuerrechts (Karl Freiherr vom Stein, pioneer of German income tax law)* (Heidelberg 1988).

3 See D Birk, *Das Leistungsfaehigkeitsprinzip als Masstab der Steuernormen, Ein Beitrag zu den Grundfragen des Verhaeltnisses Steurrecht und Verfassungsrecht* (The capacity to pay principle as the yardstick of the law of taxation, a contribution to fundamental questions involved in the relationship between the law of taxation and constitutional law) (Cologne 1983) 14ff; D Pohmer/G Jurke, *Zur Geschichte und Bedeutung des Leistungsfaehigkeitsprinzips unter besonderer Beruecksichtigung der Beitraege im Finanzarchiv und der Entwicklung der deutschen Einkommensbesteuerung* (Concerning the history and signficance of the capacity to pay principle, considering particularly the contributions to be found in the Finanzarchiv and the development of German income taxation) Finanzarchiv NF, Vol 42 (1984) 445.

4 See B Mesmer, *Steuerreform als Uebergangsmassnahme, Die Rezeption der Forderung nach progressiver Besteuering in den fruehsozialistischen Programmer* (Tax reform as a transitional measure; the reception of the demand for progressive taxation in early socialist programmes) (Bern 1976).

5 The author of this formula is Friedrich Engels, see quotation in B Mesmer, ibid 215. See also the famous polemic pamphlet by Ferdinand Lasalle, *Die indirekte Steuer und die Lage der arbeitenden Klassen* (Indirect taxes and the position of the working classes) (Zuerich 1863).

6 D Birk, above n 3 at 15 (invoking the views of C Frantz and A Wagner).

7 A Pausch, *Johannes von Miqel, Sein Leben und Werk* (Johannes von Miqel, his life and work) (Stuttgart 1964) 33.

Re-orientation of established philosophy

In the industrial societies of the late 20th century, the prevailing mood is an altogether different one. The enormous fiscal profitability of income tax to the state[8] has undermined the general approval of income taxation on grounds of justice. Resistance against high tax burdens, strategies devised for the avoidance of tax, low resistance of politicians to pressures exerted by lobbies and the impact of governmental policies, have all contributed to income tax assessment legislation becoming extremely complicated and have produced inconsistencies in assessment procedures. The result is that the general consensus now favours a reform of income taxation based upon the programme adopted in the United States during Ronald Reagan's presidency: 'Reduce tax rates, reduce complexity, increase fairness.'[9]

Despite failures of many attempts at reform, the popular desire for a truly fundamental reform of the income tax system remains very great. In 1988 the German Legal Congress (Deutscher Juristentag), which very rarely puts matters involving taxation on its agenda, dealt with the question whether German income tax law should be reformed so as to achieve its simplification and the removal of inequalities.[10]

In recent years, industrialised countries have tended to vie with each other in reducing the rates at which corporation taxes are being imposed. This appears to represent a trend to impose less tax upon income which is reinvested, than upon income which is appropriated to consumption. If this interpretation be correct, we are witnessing the re-emergence of a philosophy which had been superseded by the redistribution ethic of the 19th century, and which we find formulated, for example, in *The Leviathan* by Thomas Hobbes: 'What reason is there, that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged, than he that liveth idly getteth little, and spendeth all he gets: Seeing the one hath no more protection from the commonwealth than the other?'[11]

The idea of imposing income tax only upon the consumed portion of a person's income is incompatible with the postulate of the 19th century,

8 In 1987 the four highest-yielding taxes imposed upon income in the Federal Republic of Germany represented 57 percent of total revenue receipts of 481,209 million DM: income tax: 202,752 million DM, corporation tax: 27,302 million DM, church tax: 12,550 million DM, and trade tax: 31,438 million DM. This last named tax is assessed not only on the basis of business profits but also on the basis of business capital and thus has the character of a tax upon imputed profit.

9 See *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985) (published by Prentice Hall).

10 'Proceedings of the 57th German Legal Congress concerning the question: Should it be recommended that the income tax law be reformed so as to simplity it and to remove inequalities?' Session Report N as well as the Opinion by P Kirchhof, (Munich 1988).

11 *Leviathan or the Matter, Forme and Power of a Commonwealth Ecclesiasticall and Civil* (London 1651) Ch XXX.

which assigns to the state the task of redistributing wealth by participating in the continuing process of wealth accumulation, so as to ameliorate or perhaps to prevent altogether any drifting apart of the 'poor' and the 'rich'. It was on this basis that a suggestion made by John Stuart Mill was rejected, viz that the taxation of income from such investments as had themselves been accumulated from taxed income, represented a 'double tax on savings'.[12] According to the philosophy which underlies the existing income tax law (the accretion-model income tax), returns from investment represent new income. A person who saves a great deal and consumes little is regarded as increasing his future capacity to consume by the proceeds of his invested income. The citizen with a small income who consumes all of it, or better, who has no choice but to consume all of it, will fall further and further behind, in terms of his prosperity, the citizen who has sufficient income to form capital, and to engage in a continual process of enhancing his sources of income. In the 19th century the moral behind the story of the carefree cricket and the industrious ant[13] carried no conviction. Those groups of the population which were worthy of protection were industrious ants with no hope of a better future.

The supposedly justice-oriented ideology, upon which the 'accretion-model income tax' is based, has become so thoroughly entrenched in our taxation policy that even the most brilliant proposals and models for the introduction of a general personal expenditure (consumption) tax,[14] have failed to penetrate beyond the anterooms of our taxation policy.[15]

It is, however, undeniable that our ethical ideas in the taxation field are undergoing a transformation. In the writer's opinion, the time has come for interdisciplinary co-operation between economists and those lawyers who have an open mind vis-a-vis economic analyses of the actual effects of taxation and of new economic taxation concepts.[16] The economic

12 JK McNulty, 'The United States' Individual and Corporate Income Tax: Future Reform Possibilities' (1989) 1 Bond LR 52, 56ff.

13 See the famous fable by Jean de la Fontaine: *La cigale et la fourmi.*

14 I Fisher/H Fisher, *Constructive Income Taxation, a Proposal for Reform* (New York/London 1942); N Kaldor, *An Expenditure Tax* (3rd edn London 1965); J E Meade, *The Structure and Reform of Direct Taxation* (London 1978).

15 The US Treasury Department, *Blueprints for Basic Tax Reform* (1978/1984). The failed experiments with expenditure taxes in India in 1957 and in Sri Lanka in 1959 do not yield any useful legislative experiences. In the Federal Republic of Germany, expenditure tax has not as yet been the subject of any official materials concerning taxation reform.

16 Unfortunately lawyers in the Federal Republic of Germany have not as yet shown much interest in new reform concepts such as that of the expenditure tax. My own somewhat sparse observations concerning the expenditure tax in *Die einfache und gerechte Einkommensteuer, Ziele, Chancen und Aufgaben einer Fundamentalreform* (A simple and just income tax, aims, chances and tasks of a fundamental reform) (Cologne 1987), are almost the only thing by any German lawyer concerning this topic. K Tipke and I as editors of the journal *Steuer und Wirtschaft* (Taxation and the Economy) have attempted to stimulate discussion by means of publication of contributions by American lawyers. Of signficance in this context is the German summary by WE Weisflog, published in Stu W 1983, 337, of the article by WD Andrews, 'A Consumption-Type or Cash-Flow Personal Income Tax' (1974) 87 Harvard LR 1113, as well as the contribution by JK McNulty, referred to in n 12 which was also published in Stu W 1989, 120.

arguments for a reform of the taxation system based upon consumption[17] are so well founded that it would be irresponsible to neglect them when designing legislative policy. Two considerations appear to be of particular significance:

1 Amongst the main goals of modern industrial societies are growth and enhancement of prosperity. It would be consistent with these goals not to place too great a tax burden upon that part of income which is used for investment purposes. Those consequences of economic growth which are detrimental to the environment do not yield arguments against economic growth as such; rather, they are reasons why the nature and quality of economic growth should be transformed, a matter which is being debated under the still rather vague formula 'ecological reconstruction of the economy'. Within the framework of such a programme, a rational 'ecological' system of taxation, ie one whose economic consequences have been sufficiently explored, must be made to play its part.

2 In the last analysis, the individual citizen and the potential for consumption possessed by his or her household bears all of the burden of taxation. This makes it seem economically rational to base all fundamental assessment principles directly upon the fact of private consumption. What has not as yet been satisfactorily clarified is the likelihood of capital assets, possessed by different types of persons, developing in divergent ways once capital accumulation has been freed of any tax burden. In our present-day industrial society with its broadly distributed household savings, this matter is not as dramatically significant and problematical as it was in 19th century societies. Nevertheless, the problem must be resolved in a manner which is sufficiently convincing, from a social and ethical point of view, to make it possible to topple the legal traditions of a whole century.

Taxation policy and constitutional values

Consideration of internationally oriented legal reform of taxation must be based upon legal principles which are common to all states with developed taxation systems. It is natural for a lawyer to think first and foremost of the constitutions of democratic states in which the rule of law prevails.

Constitutions tend to impose legal limitations upon the freedom of movement of democratic legislatures. Such limitations may mean that new taxes cannot be freely invented and given any form which the legislature pleases. For example, the introduction of an expenditure tax

17 These arguments have been collected for *Steuer und Wirtschaft* by M Rose, Stu W 1989, 191. See also J A Kay/M A King, *The British Tax System* (4th edn OUP 1986) 90ff; J Mitschke, *Steuer und Transferordnung aus einem Guss, Entwurf einer Neugestaltung der direkten Steuern und Sozialtransfers in der Bundesrepublik Deutschland* (A unified taxation and transfer system, A proposal for the transformation of direct taxes and social transfers in the Federal Republic of Germany) (Baden-Baden 1985); as well as the contributions in the Congress report by JA Pechmann, *What should be taxed: Income or Expenditure?* (The Brookings Institute, Washington 1980).

would have to be preceded by changes to that part of the Constitution which deals with revenue matters.[18] In the Federal Republic of Germany, the Constitutional Court is charged with the responsibility of ensuring that constitutional limitations are observed in practice.

In turn, the extent to which the Constitutional Court is able to control the activities of the legislature is itself limited by the principle of the separation of powers. The Federal Constitutional Court, like the United States Supreme Court, observes the principle of judicial self-restraint vis-a-vis the legislature: the judge must not seek to govern the activities of the legislature. Thus the Constitutional Court concedes to the legislature a great deal of freedom of movement in matters of taxation.[19] It follows that the Constitutional Court is not in a position to force the legislature to enact a tax law which seems to the Court rational and reasonable.

On the other hand, the Constitutional Court has not been content merely to establish a system of threshold controls (Schrankenkontrolle); rather, it has developed a set of basic values and principles which represents a coherent constitutional foundation for a rational tax system. This foundation is a challenge to the science of taxation law to develop systemic principles of taxation which are fit to be used as guides to sensible legislative policy.[20]

This starting point, a search for principles which are consistent with basic constitutional values, unavoidably leads one on to the international plane. Tax law touches basic values which are embedded in the constitutions of all democratic states which subscribe to the rule of law. To encapsulate this in a short formula, these basic values are those of equality, freedom and social solidarity (fraternity) which were formulated 200 years ago in the *Declaration des droits de l'homme et du citoyen*. To this day they represent the political and social compact of societies with developed systems of taxation.

But what are the implications of these values for a consumption-oriented reordering of the taxation system?

Equality: capacity to pay

The internationally held view is that equality means that tax burdens should be imposed according to capacity to pay.[21] Any proposed reform concept must accordingly be able to claim that it is consistent with the

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18 See the contribution by D Birk, *Verfassungrechtliche Grenzen der Konsumbesteuerung* (Constitutional limitations of the taxation of consumption), in: M Rose (ed), *Konsumorientierte Neuordnung des Steuersystems* (Consumption-oriented reform of the tax system) (Berlin 1991).

19 See the observations of the President of the Federal Constitutional Court, R Herzog, in DstZ 1988, 289.

20 The theory of systematic tax principles has been developed by K Tipke. See K Tipke, *Steuerrecht, ein systematischer Grundriss* (The law of taxation, a systematic account) (1st edn Cologne 1973) 18ff; Tipke/Lang, Steuerrecht, *Ein systematischer Grundriss* (The law of taxation, a systematic account) (12th edn Cologne 1989) 24ff. Concerning legislative policy considerations, see J Lang, 'Verantwortung der Rechtswissenschaft fuer das Steuerrecht' (The science of law and its responsibility for our tax system) (Stu W 1989) 201, 206ff.

21 Tipke/Lang, ibid 27ff.

capacity to pay principle. The capacity to pay principle was developed in the 19th century as a weapon in the class struggle, for the purpose of justifying progressive taxation. In this role, the principle has become obsolete. Present-day tax studies indicate that the capacity to pay principle yields no particular useful indications for the appropriate rate of taxation.[22]

The capacity to pay principle has its use as a legal guide. It helps to keep assessment principles free from unwarranted exemptions and immunities. Of particular significance in this context is the method of 'systemic consistency', developed by K Tipke.[23] It needs to be applied in two steps. The first step consists of the discovery of a rule which is legally and economically the most appropriate. The second step involves the incorporation of this appropriate rule in the sphere of its proposed operation, bearing in mind all such other rules as might be inconsistent with it. In the context of the first step, for example, it would not be advisable to seek to implement an accretion-ideal type of comprehensive tax base. Rules based upon the accretion ideal would not be appropriate. The appropriate tax base is the market income,[24] for it is only market incomes which can be ascertained, assessed and taxed in practice. The second step then requires that market income is in fact taxed as far as possible without loopholes and tax exemptions.[25]

The traditional concept of tax justice, developed in the 19th century, assigns primarily to the institution of income tax the task of imposing

22 K Schmidt, *Die Steuerprogression* (Tax progression) (Tuebingen 1960).

23 Above n 20.

24 The opinion of P Kirchhof, above n 10 at 20ff, derives the market income theory from the constitutional freedom of economic activity (Article 12 of the Basic Law). The author relies in particular upon the principle of freedom of acquisition which recognises income differentials as the necessary consequence of the freedom of economic activity. Inherent in the market income concept is the principle of realisation, according to which unrealised and not sufficiently secure and realistically assessable changes in the value of assets are to be excluded. See also D Schneider, 'Verbesserung der Allokation durch Besteuerung unrealisierter Vermoegenswertveraenderungen?' (Should unrealised gains resulting from changes in the value of assets be taxed?) in Finanzarchiv, NF, Vol 44 (1986) 224ff. See also Lang, *Die Bemessungsgrundlage der Einkommensteuer, Rechtssystematische Grundlagen steuerlicher Leistungsfaehigkeit im deutschen Einkommensteuerrecht* (Assessment to income tax; foundations of the capacity to pay in German income tax law, examined from a legal and systematic point of view) (Cologne 1981/88) 18ff, 87ff; 229ff, 235ff; Tipke/Lang, above n 20 at pp 166f, 203f. See also J Lang, *Reformentwurf zu Grundvorshriften des Einkommensteuergesetzes* (Proposals for the reform of basic provisions of the Income Tax Act) (Cologne 1985). In the last-named publication I have attempted to formulate, in the form of proposed legislation, the market income principles as they have been developed in income tax practice.

25 To be removed in particular are those exemptions, limitations, standard deductions and gaps which apply only to particular types of income. When used as the basis for assessment, these create sharply divergent concepts of income and of tax burdens. For example, old age pensions are assessed only to the extent of one quarter, income from private disposal of assets not at all. See also Proceedings of German Legal Congress, above n 10; K Tipke, 'Ueber Steuerverguenstigungen — abbautheoretische Ueberlegungen' (Concerning tax privileges — a theoretical contribution to proposals for their removal) FR 1989 p 186; Raupach, Tipke, Uelner, *Niedergang oder Neuordnung des deutschen Einkommensteuerrechts?* (Decline or reform of German income tax law?) (Cologne 1985); Tipke/Lang, above n 20 at 232ff, 323ff. In my reform proposals (n 24) I have attempted to formulate comprehensively legal rules which would govern market income free from tax privileges.

tax in accordance with capacity to pay.[26] This evaluation of income tax relates not only to progressive tax rates, but also to assessment principles which are based upon the assets accretion theory; it is regarded as an ideal indicator of the capacity to pay tax. With respect, this view is too narrow. The whole of the tax system is dominated by the capacity to pay principle. In principle, three indicators of capacity to pay should be distinguished: the dynamic tax base 'income', the static tax base 'assets' and the dynamic tax base 'consumption'.[27] On the subject of consumption taxes the Federal Constitutional Court has stated that these are taxes which are imposed upon 'economic capacity as it is manifest in the use of income for personal requirements'.

As already stated,[28] in the final analysis the individual citizen and the consumption potential of his or her household is the ultimate bearer of all tax burdens. However, this consideration does not in itself justify a tax upon the consumed portion of income as the sole form of tax. It does, on the other hand, help us understand that the existing income tax system already contains distinct elements of the consumption potential principle. Historically, the intention which underlies the progressive tariff is to burden the individual citizen in accordance with his or her capacity to make sacrifices, which in turn is measured by using the availability of income for private consumption as a yardstick.[29] It seems logical for the existing income tax law to regard a kind of private consumption fund as the appropriate basis for assessment for income tax. Such a view of the matter is implicit in the availability of certain types of expenditure as tax deductions. In principle, the assessment basis for income tax has a dual structure. As a first step it defines market income. Thereupon deductions are made for necessary private expenditure so as to exclude from assessment that portion of income which is not available for the payment of tax.[30] It appears that measuring the capacity to pay tax by consumption is already an established method in the existing income tax law. Thus it seems legitimate to ask whether the taxation of income which is invested is not contrary to the existing system and should be removed, as an assessment element, from any consumption-oriented tariff.

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26 This is the view expressed in many judgments of the Constitutional Court (see, for example, BVerfGE 43/104, 120, 61/319, 343, 66/214, 223. Judge P Kirchhof of the Constitutional Court has proposed that the capacity to pay principle be limited to direct taxes — see Stu W 1985, 324, Steuerberaterkongress-Report 1988, 29, 37). He argues that it could be applied only to 'those taxes which are based upon circumstances which relate to income, assets and needs'.

27 See Tipke/Lang, above n 20 at 160ff; D Birk, *Steuerrecht I, Allgemeines Steuerrecht* (The Law of Taxation I, General Principles) (Muenchen 1988) 43f. 'The capacity of the individual to pay can become manifest in three forms: addition to assets (income), use of assets (expenditure), and state of assets (assets)'.

28 See text at nn 17-18.

29 The legislature is bound to have a broad discretion when determining the extent of progression, for the one and only 'just' type of tariff cannot be determined with any degree of precision; see F Hinterberger, K Mueller, HG Petersen, 'Gerechte' Tariftypen bei and alternativen Opfertheorien und Nutzenfunktionen' (Just types of tariff according to alternative sacrifice theories and utility functions) Finanzarchiv Vol 45 (1987) 45.

30 See Tipke/Lang, above n 20 at 198ff (and literature referred to there).

Freedom of economic activity and social solidarity

According to our economic and constitutional views, taxation is an institution built upon a foundation of freedom. It represents government participation in private property, in private businesses,[31] not the taking of property which already belongs to the state.[32] A state organised upon the basis of individual freedom is not like a beehive from which the beekeeper harvests the whole of the national income, and then returns to the bees only what happens to be indispensable to their survival. Rather, in a state organised upon the basis of personal freedom, the national income is private property from which the community at large has to provide revenue of two types: the price of protection by the state,[33] and the provision of social solidarity which the state expects of the economically productive citizen.[34]

The historical origin of income tax as a war tax demonstrates that the state may have irrefutable, extraordinarily large revenue requirements, justifying high rates of tax which dig deep into private pockets. For this reason no absolute limits can be established to the loss of economic freedom of action, which the individual may have to accept. In an extreme case (eg in the case of a lost war) the price of state protection may be so high that it destroys the economic basis of a person's existence. The much criticised tendency of the state to keep its field of activity expanding endlessly, and thus to impose ever-more unreasonable tax burdens upon the individual, is not seen as diminishing the first-named justification of taxation, the price of state protection.

The present-day debate concerning the justification for taxation[35] is rather concerned with the fundamental problems, hardly capable of being considered in purely legal terms, inherent in the tension which exists

31 In German constitutional literature this aspect of taxation has been elaborated in a useful way particularly by the Judge of the Constitutional Court, P Kirchhof. He has inferred, from the guarantee of private property contained in Article 14 of the Basic Law, an overriding taxation principle of 'freedom of property'. See P Kirchhof, 'Besteuerung und Eigentum' (Taxation and property) VVDStRL39 (1981) 213 Gutachten (opinion) n 10 at 15: 'The decision taken in principle in favour of a private economy and against a State economy makes governmental tax participation in the success of business which serves private advantage a necessary part of an economic order based on private property, given the existing governmental need for revenue.'

32 One representative of this second view, for example, was Friedrich Engels: 'Either private property is sacrosanct and there is no such thing as national property, in which case the state has no right to levy taxes; or the state has the right to levy taxes in which case private property is not sacrosanct, and the national property is superior to private property, and the state is the true proprietor'; *Rheinische Jahrbuecher zur gesellschaftlichen Reform*, Vol 1 (Darmstadt 1845) 61.

33 This accords with the justification for the imposition of tax provided by natural law thinkers from Thomas Hobbes to Adam Smith (see the first maxim of taxation provided by the last-named writer).

34 This is the justification of taxation in the socially oriented state, as it has developed since the *Declaration des droits de l' homme et du citoyen* of 1789. P Kirchhof, Opinion (n 10), pp 14f derives the justification for taxation from the Article of the Basic Law which declares that property implies not only rights but also social obligations (Article 14(2)).

35 In relation to the Federal Republic this theme has been discussed particularly by K Vogel, 'The justification for taxation: a forgotten question' in *The American Journal of Jurisprudence* Vol 33 (1988) 19. See also Tipke/Lang, above n 20 at 178ff.

between freedom of economic action on the one hand, and social solidarity on the other. How much solidarity has the community a right to demand of the free, economically productive citizen? Which tasks should the state perform and which should it refrain from performing? Associated with these questions is the following further question: Which are the limits beyond which the state should not go in redistributing income and assets?

The Basic Law does not make it possible to cast the answers to such questions into a legal mould, for it has not sought to legislate for a particular type of economic structure.[36] In fact, however, there exists a basic political consensus that the economy of the Federal Republic of Germany should be a 'social market economy', ie that it should be based upon the free market approach, but possess, at the same time, a component of social security. This is the concept which has caused the economy in the Federal Republic to blossom; much the same observation can be made about the Japanese economy. The close link between a worker's productivity and his or her sense of economic security, the worker's identification with his or her workplace, is built upon the expectation of being provided with appropriate social security benefits, and it represents a frame of mind or mentality which is an elementary precondition to the Japanese and German economic successes. In both countries the social components are very strong features of the political and economic structure. Whilst the Basic Law of the Federal Republic of Germany contains a commitment to a socially oriented structure of the state[37] without defining it in any way, the Japanese Constitution[38] has formulated with precision the aims of the social aspects of the state.

A discussion of international standards of taxation can hardly be based upon national mentalities and peculiarities: the relationship between the values of freedom and those of social solidarity have developed too differently in different countries. The concept of freedom prevalent in American society, which is based upon the Virginia Bill of Rights (1776) and which, in principle, gives precedence to private welfare over public welfare, is bound to imply different standards of redistribution by means of tax from those prevailing in industrial societies with relatively strongly developed systems of state-controlled social security.

The common denominator in this discussion is not the measure of social solidarity which might happen to be appropriate to particular industrial societies, but the presence of defects in the mechanisms of distribution, the inefficiencies of the state apparatus, the tendency of the state to assume tasks which the private sector would perform more

36 Concerning the 'economic/political neutrality' of the *Basic Law*, see BVerfGE 4, 7, 17f; 7, 337, 400; 14, 19, 23; 30, 292, 315; 50, 290, 337; HJ Papier, 'Grundgesetz und Wirtschaftsordnung' (Basic Law and economic structure) in *Handbuch des Verfassungsrechts* (Handbook of Constitutional Law) (Berlin/New York 1983) 609ff.

37 Article 20(1) of the Basic Law: 'The Federal Republic of Germany is a democratic and social federal state.' See also Article 28(1)(1) of the Basic Law.

38 Article 25: 'All people shall have the right to maintain the minimum standard of wholesome and cultured living. In all spheres of life, the Stage shall use its endeavours for the promotion and extension of social welfare and security, and of public health.'

cheaply (and sometimes even more fairly and justly),[39] the misallocations occurring in the economy through the proliferation of subsidies and as a result of a misconceived system of taxation. Concerning the last-named point, the following may be noted.

The existing system of progressive income taxation has given rise to so much resistance, whether in the area of its application or even in the area of legislative policy, that it has lost any inherent justification which it might once have possessed. Such things as numerous exceptions built into the assessment principles, the evolution of tax avoidance as an art form, excessive cost and effort invested in tax advice and administration, a flood of litigation, syndromes of flight from tax and of tax evasion, deficits in the popular understanding of what is just and lawful, and distortions in contracting processes all characterise the decay of the existing income tax system.[40]

Reform proposals

Thus it can be concluded, even from a legal point of view, that the constraints upon economic freedom of action which result from progressive taxation as it is currently in force, are excessive. These constraints have produced an unacceptable situation in society. By contrast, the loss of economic freedom of action would be greatly reduced if the basis of assessment were the consumed income, for the whole phase of the production of such income would be immune from tax. The taxation of consumption would be appropriate from a market and economic point of view, for the driving motivational forces which give the market economy its impetus would not be interfered with[41] and economic success would be taxed at a point at which it is due to be consumed in any event. Accordingly it appears appropriate to allow the state its share of the economic success of the citizen, at the point at which the citizen consumes, ie where he enjoys the fruits of his economic success. From an ethical point of view, consumption of the fruits of one's endeavours appears as the most plausible time for sharing.[42]

If one were to leave economic processes free from tax, a high (if not to say 'absolute') degree of tax neutrality would be guaranteed. Up to the point where the fruits of economic effort are being consumed, the Edinburgh rule of taxation 'leave them as you find them' will apply.[43]

39 See K Vogel, 'Der Finanz und Steuerstaat' (The finance and tax state) in: Isensee/Kirchhof (eds), *Handbuch des Staatsrechts)* (Handbook of Constitutional Law) Vol I (Heidelberg 1987) 1180.

40 See A Raupach, 'Niedergang des deutschen Einkommenssteuerrechts, Moeglichkeiten der Neubesinnung' (Decline of German income tax law, possibilities of a new beginning) in Raupach/Tipke/Uelner, above n 25 at 15.

41 For a comprehensive collection of the arguments for a consumption-oriented reform of the tax system, see M Rose, Stu W 1989, p 191.

42 Contribution by B Hardorp, *Konsumsteuer und Gesellschaft — Zum erforderlichen steuersystematischen Bewusstseinswandel* (Consumption tax and society — concerning the necessary changes of attitude to our tax system) in: M Rose (ed), *Konsumorientierte Neuordnung des Steuersystems* (Consumption-oriented reform of the tax system) (Berlin 1991).

43 FA Walker, *Political Economy* (2nd edn New York 1887) 491.

The Edinburgh rule is wholly rooted in freedom values; it is not reconcilable with social ideals (Sozialstaatsprinzip).[44] However, the rule does not preclude the existence of a social component if it is applied subject to a time limit and if not all forms of taxation are subjected to it. For example, redistribution based upon social principles can be achieved by imposition of an estate and gift duty.[45]

Neutrality principle

The practice of taxation shows that the current income tax system occasions the most conspicuous infringements of the neutrality principle in the sphere of income taxation. Thus, an urgent need exists to give the neutrality principle priority over the social principle. A person's income has the closest and most comprehensive links with his or her economic activities, so that his or her economic freedom of action is most severely impeded by the imposition of tax upon income.

In the legal sphere, tax neutrality is closely related to the principle of equality, in particular when it appears in the form of competition neutrality[46] and of neutrality of legal form.[47] As already explained, the equality principle requires a systemically consistent implementation of assessment principles, ie the taxation of market income without gaps and tax exemptions.[48] If this condition were fulfilled, many of the reasons which turn taxation into a decisive factor in the making of commercial decisions would have been eliminated.

The principle of neutrality of legal form requires that a particular economic activity be subject to the same tax burden, regardless of the legal form in which it has been carried out. The legal debate has not yet answered the question which preconditions must exist before the requirement of neutrality of legal form is satisfied. The general opinion appears to be that different legal forms justify different forms of taxation.[49]

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44 Tipke/Lang, above n 20 at 50.

45 It was in this vein that J Mitschke suggested a combination of an annual consumption tax with a once-only capital gains tax levied upon the death of the taxpayer — *Steuer und Transferordnung aus einem Guss, Entwurf einer Neugestaltung der direkten Steuern und Sozialtransfers in der Bundesrepublik Deutschland* (The unity of our tax and transfer systems; Proposals for the reform of direct taxes and of social transfers in the Federal Republic of German) (Baden-Baden 1985).

46 This theme is much discussed in the context of the impending reform of the law relating to the taxation of associations. The accumulation of assets by charitable associations (gemeinnuetzige Vereine) is free of tax, which fact gives these associations considerable competitive advantages. See the opinion compiled by the Independent Expert Commission at the request of the Federal Finance Minister concerning the law relating to charitable associations and charitable donations — Federal Ministry of Finance Series, No 40, Bonn 1988.

47 The German Legal Congress in 1924 (Heidelberg — see Proceedings of the 33rd German Legal Congress) and in 1980 (Berlin — see Proceedings of the 53rd German Legal Congress) dealt with this topic, on both occasions without arriving at concrete proposals for a form of taxation which would be neutral in terms of legal form.

48 See above n 25.

49 See eg W Walz, 'Empfiehlt sich eine rechtsformunabhaengige Besteuerung der Unternehmen?' (Is it desirable to impose a tax upon enterprises which is independent of their legal form?) Opinion submitted to the 53rd German Legal Congress (above n 10).

In this context, it is important to make the right distinctions. One has to ask whether different legal forms, because of their differing juristic constructions, result in different economic facts. For example, the loss incurred by an enterprise has a direct impact upon a partner in a partnership, whilst the economic impact of such a loss upon a shareholder of a public company is very different. The position of the shareholder is determined directly by the market value of the shares, and only indirectly by any profits or losses incurred by the company itself. That is why German lawyers tend to be opposed to taxing public companies on the same basis as partnerships. The proposal of a partnership tax for all legal enterprise forms including public companies[50] fails to pay sufficient attention to the economic and legal realities of the public company.[51]

From a legal point of view, neutrality of legal form can only mean that identical economic and legal realities must result in identical tax burdens.[52] Much remains to be done, if this requirement is to be fulfilled. For example, there is no rational reason why the profits of partnerships should be subject to progressive taxation, whilst the profits of public companies should be subject to proportional taxation. The differences in these legal forms do not justify such differential rates of taxation. Moreover, the non-uniform taxation of realised capital gains, the differing tax burdens imposed on business capital, and the existing differences in the recognition of contracts made between shareholders and company, represent annoying imperfections which have their origins solely in the tax laws and have no foundation in economics or private law.[53]

Bearing in mind the requirement of neutrality of legal form, one has to register a protest at the previously noted tendency of states to lower just their company tax rates. Instead, a form of taxation will need to be found which subjects all market income which is subsequently invested, regardless of the legal form used for its derivation, to proportional tax. Progressive tax rates are inappropriate for income which is not made available for purposes of private consumption. Forcing the taxpayer who wishes to achieve an appropriate tax rate or exemption from tax for the formation of capital to form a company, or to satisfy other formal legal conditions which involve considerable bureaucratic transaction costs, means restricting his economic freedom of action without any social-political justification. It follows that the above-mentioned accumulation-model income tax should be made available to all forms of economic activity, including private investment which does not proceed through legally independent organisational forms, eg the letting of real estate, in short, to all non-consumption activity.

50 Report of the Canadian Royal Commission of Taxation Vol 4 (1967) 3ff, Appendix H, pp 661ff; W Engels/W Stuetzel, *Teilhabersteuer, ein Beitrag zur Vermoegenspolitik, zur Verbesserung der Kapitalstruktur und zur Vereinfachung des Steuerrechts* (Participation tax. A contribution concerning wealth policy, the improvement of capital structure, and the simplification of taxation law) (2nd edn Frankfurt 1968).

51 Opinion of the Tax Reform Commission 1971, BMF Series, Issue 17, Bonn 1971, Tz II 100ff; B Knobbe-Keuk, *Bilanz-und Unternehmenssteuerrecht* (Law relating to Company accounts and corporation tax) (6th edn Cologne 1987) 437ff.

52 Concerning this fundamental starting point, see J Lang, '*Reform der Unternehmensbesteuerung*' (Reform of enterprise taxation) Stu W 1989, 3.

53 Ibid.

Objections to exclusive reliance upon consumption tax

Such a broadly conceived income tax levied upon capital formation would make it possible to take a very short step and arrive at the exclusive taxation of consumption: the rate of the tax upon capital formation could simply be reduced to zero.

Such a stroke of the pen by the legislature would be opposed by the redistribution philosophy which developed in the course of the 19th century. The following objections can be raised against the complete exemption of capital formation from tax:

1 As stated earlier, there is as yet no solution to the problem that the step envisaged here would cause asset accumulation to diverge too sharply. The differences between'rich' and 'poor' could become so pronounced that even in those states in which wealth is broadly distributed and in which a degree of social harmony prevails, social tensions could result. In my opinion this problem cannot be satisfactorily resolved by introducing, as a supplement to the annual consumption tax, a capital gains tax levied upon the death of the taxpayer.[54] For the state to allow the citizen to save and accumulate assets to the end of his life and then greatly to diminish the accumulated property, rather like a cat which plays with the mouse before killing it, seems to me morally objectionable. Moreover, a taxpayer who has accumulated large assets is bound to find ways and means of defeating the attempt to deprive him of a large part of his assets by one single act of taxation.

2 Where incomes are very high, the normal measure of capacity to pay which is used to determine tax rates may prove insufficient to produce a tax which will be considered 'socially just and fair'. Where, for example, a successful entrepreneur, film or sports star has succeeded in attracting an annual income of DM 15 million of which he spends DM 3 million, then a consumption tax based upon a figure of DM 3 million will not sufficiently exhaust the capacity to pay of the person in question. Such an objection would be justified not only where consumption takes place on a luxurious scale, absorbing nevertheless only a small fraction of total income, but also in the event of consumption being exceedingly modest, as in the case of the rich miser who, depending upon the circumstances, might end up paying less tax than his employees.[55] Thus, the problem of insufficient utilisation of real capacity to pay tax could not be resolved satisfactorily by imposing tax rates in excess of 100%.

The cases mentioned are extreme ones which are of little statistical significance when one considers that the great mass of taxpayers tend to consume about 90% of their incomes. However, a purely statistical view is inappropriate to the solution of problems of fairness and justice. Justice is a value which must be put into effect in relation to each individual person. Thus one must demand that the

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54 Such is the proposal made by J Mitschke, above n 45.

55 WE Weisflog has commented upon the model proposed by WD Andrews (above n 16) appropriately: 'Whether a progressive expenditure tax would promote tax justice in the case of Mr Scrooge is very much open to question.'

legal system deal justly even with the unusual individual case.[56] Experience teaches that such unusual cases tend to dominate parliamentary debates so that in the end some compensatory solution would have to be found which taxes capital formation.[57]

3 Finally, it seems very unlikely that a complete abandonment of capital formation as a tax base can be achieved in a way which is revenue-neutral. Too many question-marks hang over such calculations as have been produced so far. In particular, theoretical notions about comprehensive assessment principles seem to me incapable of being put into practice. It would be a significant achievement if it were possible to impose tax upon all market incomes without gaps and tax privileges.[58]

It is very easy to advocate that government functions and sources of revenue be abandoned and very difficult to put such demands into practice. The 'Leviathan' syndrome is difficult to attack effectively by using academic (constitutional and economic) arguments. In the final analysis it is social trends and mentalities which determine the appropriate scope of government and the efficiency of public administration. Reducing the scope of state tasks and strengthening the self-reliance of citizens is not achieved by academic analyses but rather by the difficult process of political persuasion.

The network of social responsibilities upon which the present-day state is based was made apparent politically in the 19th century. The value system of the socially oriented state has as its central core the concept of human dignity and requires the elimination of poverty. Rich industrialised societies have no excuse for poverty which exists within their borders. Despite the continual growth of their gross national product and of their tax rates, the rich industrialised states left this postulate of the ideal of the socially oriented state largely unfulfilled. New responsibilities have been added to the old established ones. Social ethic as viewed nowadays tends to embrace all aspects of interpersonal relations between all the members of the modern state. The philosopher Hans Jonas[59] has made it clear that there is a completely new set of responsibilities, ie those vis-a-vis the developing countries.

56 It is surprising that WD Andrews (above n 16 at 1174ff) is dealing only very cursorily with the redistributional effects and dismisses the politically and legally highly sensitive cases of the high income earners with the observation that for such persons 'other ways of effectively taxing' them could be found.

57 Estate and gift taxes cannot be used for this purpose, for it would be too easy to transfer assets to other countries. Enterprises which operate on a multinational basis, film and sports stars would not be willing to submit to rigorous estate and gift taxes. Thus, the only remaining practical solution would be the continuing taxation of capital accumulation.

58 Above n 25.

59 *Das Prinzip Verantwortung, Versuch einer Ethik fuer die technologische Zivilisation* (The responsibility principle. Proposals for an ethical system suited to our technological civilisation) (Frankfurt 1979). See also H Jonas, 'The concept of responsibility: an inquiry into the foundations of ethics for our age' in: *Knowledge, value and belief*, HT Engelhard & D Callahan (eds) (Hastings-on-Hudson NY 1977).

A realistic solution

In view of the existence of such new responsibilities, one cannot treat the reduction of government functions and of the tax take as serious possibilities. However, these new responsibilities do require that a consumption-oriented reorientation of the tax system be accepted as necessary, for the productive capacities of national economies can no longer be concentrated, as much as they have been in the past, upon the task of satisfying the consumption requirements of private households. National economies are facing other tasks which involve enormous costs. The citizen will need to understand that he is required to shoulder an appropriate share of these costs, which may seem 'external' to him when he proceeds to satisfy his needs. This is a social and ethical lesson from which there is no escape.

The arguments for consumption as the essential basis for taxation carry a great deal of persuasive weight, whether from a legal or from an ethical point of view. The focal point of the debate of these issues must be the waste of resources which is occurring in developed countries at the expense of future generations. However, at this stage a double-barrelled system consisting of consumption and capital elements is still indispensable.

The appropriate solution is to offer the legislature a concept which is flexible enough to fit both the old and the new tax philosophies. The legislature needs a great deal of scope to be able to adapt to the new thinking. The possibility of a retreat from the new philosophy should not be cut off, if it should so happen that the privileged position of capital formation occasions social tensions. Thus, taxation of capital formation cannot be completely abandoned. If the new thinking is to have any impact at all, a taxation duality needs to be created which subjects consumed and saved incomes to separate tax regimes. Once this has occurred, the legislature will find it possible either to create gradually an immunity of capital formation from income tax by reducing the relevant tax rate, or to combat unwanted social and political effects by increasing it.