

# THE CASE FOR TAXING CONSUMPTION PART II



## 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.

The author is indebted to Professor HK  
Lucke who has translated the article.

*The author favours threefold reform of income tax law: (1) making the extent of tax liability independent of the legal form in which business is being conducted, (2) exempting from income tax that part of income which the taxpayer needs for subsistence, including the subsistence of those who depend upon the taxpayer for their maintenance, and (3) abolishing exemptions, deductions and other tax privileges which tend to create different tax rates for different types of income. A tax system so constructed would lend itself to the major reform which the author proposes: the creation of a dual income tax regime which would impose a progressive form of tax upon income which is appropriated to consumption, and a generally much lower and proportional tax upon income which is appropriated to the formation of capital. In this second and final part of his article, the author considers the practical problems associated with such a tax regime and makes proposals for their solution.*

A useful starting point for the construction of a taxation system which is no longer dependent upon the legal form in which personal or business affairs are conducted, is the business or firm tax, many greatly differing variants of which are being discussed internationally.<sup>1</sup> I have developed the concept of a *Betriebssteuer* ("firm tax") which embraces the non-consumption sphere as a whole, and which accordingly is, in essence, a tax on the formation of capital.<sup>2</sup> The English expression "business tax" seems an appropriate name for this type of tax.

- 
- 1 See R. Elschen, *Institutionale oder personale Besteuerung von Unternehmensgewinnen?* (Institutional or personal taxation of enterprise profits?), Hamburg 1989; J. Lang, "Reform der Unternehmensbesteuerung" ("Reform of the taxation of enterprises") *StuW* 1989, 3, 8ff.
  - 2 J. Lang, "Reform der Unternehmensbesteuerung" ("Reform of the taxation of enterprises") *STuW* 1989, 3, 8ff.

The terminological starting point for the construction of such a tax is an already existing legal concept, viz the "enterprise" as defined in para. 15 II, first sentence, of the Income Tax Act (*Einkommensteuergesetz*) which reads as follows:

An independent and persistent activity which is undertaken with a view to profit and which represents participation in general economic intercourse constitutes an enterprise, provided the activity does not amount to an agricultural or forestry business or to a free profession or some other independent activity.

If one frees this statutory definition of the ballast of legal delimitations, the core definition of "enterprise" is "independent and persistent participation in market activity undertaken with a view to profit". This core definition suggests that market income is earned by means of three types of economic activity:

- independent and persistent economic activity;
- independent and non-persistent (occasional) economic activity;
- dependent economic activity.

The business tax which I have proposed would be levied on market income from every independent and persistent economic activity, ie from every type of business activity: trade and manufacture, freely exercised professional activity (according to para. 18 I No 1, 2nd sentence of the Income Tax Act this includes scientific, artistic, literary and educational activity as well as the independent professional activities of medical practitioners, lawyers, accountants etc), and also agricultural and forestry activity, leasing, letting and other activities involving the private administration of assets (eg the administration of private investments, shares, savings books, insurance policies etc). The existing income tax law distributes all these forms of income in various ways and subjects them to different rates of taxation.<sup>3</sup>

There is an urgent need to subject incomes from all the above-mentioned activities to a uniform rate of tax. My proposal is that all such income should be subjected to business tax only if the minimal requirements of book-keeping are fulfilled so that it is possible to practise a rebate system (*Anrechnungsverfahren*).

### **Relationship between proportional business tax and progressive consumption income tax**

If the minimal requirements of book-keeping are not fulfilled, the income from the above-mentioned activities should be subject to the progressive tax which applies to income available for consumption. This legal consequence

---

3 J Lang, "The Case for Taxing Consumption, Part I" (1990) 1 Revenue LJ 186, 193, n 25.

is based upon the following relationship between the proportional business tax and the progressive consumption income tax.

My concept of the business tax is based upon the assumption that the consumption income tax is the principal tax and that it takes definitive account of the citizen's capacity to pay. It follows that the business tax should be understood as merely a pre-tax (provisional tax) which is intended to burden the saved or invested income from the foregoing (above-mentioned) activities at a very low proportional tax rate until it is transferred to a private consumption fund. As long as earned profits remain part of business capital they are subject only to the business tax. Distributions of profits from business capital will be income and will be subject to the progressive consumption income tax; business tax already paid may then be deducted.<sup>4</sup>

The proposal for turning the business tax with a low proportional tax rate into a provisional tax in relation to the progressive consumption income tax should be carried into effect as follows.

The assessment principles of the consumption income tax must be so arranged that income which is needed for subsistence purposes, and for maintenance obligations in particular, are fully taken into consideration in the sense that no tax is levied on it. In relation to this matter I refer to the relevant findings of German tax research and to the resolutions of the German Legal Congress.<sup>5</sup>

Once the income which is thus unavailable for tax purposes has been excluded, the income subject to the tax should realistically reflect the consumption capacity of the particular taxpayer, and consumption income tax can then commence, without any tax-free threshold, at the same rate as that which attaches to the business tax. Thus, the progressive rate could commence with the kind of income which is high enough for saving to be a practical possibility. To establish this point, statistical data concerning the actual savings behaviour of the general population could be used. The business tax which I have proposed should therefore mean that saving will extend the income level at which the proportional tax rate is charged to the extent that income is being saved, and that progressive tax rates will commence at a correspondingly higher point on the income scale. By this means the taxpayer will not only be induced to save, but also to fulfil for the

4 For further details, see J Lang, above n 2.

5 In 1988 the German Legal Congress supported proposals such as these by passing the following resolution:

"Income tax should be levied only upon that part of income which is at the free disposition of the taxpayer. Expenses for subsistence and for the maintenance of family members must therefore be entirely free from tax. . . . The existing tax thresholds must be lifted to realistic levels. For constitutional reasons the tax-free portion of a taxpayer's income must be significantly higher than the support made available to welfare recipients."

In a recent decision of fundamental importance the Federal Constitutional Court has also endorsed the principle that income required for subsistence must not be taxed - judgment of 29 May 1990, reported in (1991) 82 BVerfGE 60, 85f.

business tax the minimal bookkeeping requirements so as to withdraw the saved portion of his income from the burden of progressive taxation.

In principle, my concept envisages two spheres in which different tax burdens apply—the sphere of progressive taxation through the consumption income tax and the sphere of significantly lower taxation through the business tax.

The business tax will include the following two categories of enterprise:

- 1 The enterprises of organisations subject to corporation tax, and the enterprises of individual businesses and partnerships which are subject to book-keeping duty. All these enterprises are legally obliged to keep books. Their market income is unavoidably subject to the business tax.
- 2 Those enterprises which are not obliged to keep books. In these cases the taxpayer has a choice: to ascertain the income from his independent economic activity by the bookkeeping methods required by the tax laws and thus attract the application of the business tax, or to ascertain his income by simpler methods. In this latter case his income will become directly subject to the immediately progressive consumption income tax. It will be presumed that all this income will be used for private consumption. This choice will exist, for example, for small business people in free professions with limited investment requirements. It is these enterprises which are the targets of the business tax. The tax subject and tax debtor is the person on whose behalf the enterprise is being conducted, ie its owner. The enterprise concept serves to delimit, in a legal-technical way, some identifiable independent economic activity. It is not necessary to create a new tax subject or to depart from the civil law concept of legal personality in order to achieve this.

In practice, taxpayers who do not consume all of their market income are likely to create a "participation enterprise" which will absorb all payments made by enterprises in which the taxpayer has an interest. Such a participation enterprise would serve the purpose of keeping neatly separate the two spheres (*Belastungssphaeren*) of the progressive consumption income tax and the proportional business tax respectively.

The participation enterprise could be created without any formal-legal complications. In principle, it would be sufficient to have a bookkeeping system which identified the participatory interests, shares, savings accounts, insurance policies etc which were administered within the enterprise. A home computer would be all the equipment needed to establish such an accounting system, or it could be offered as a service by a bank.

As long as market income remains invested in the form of the working capital of corporations or of individual enterprises, or, as a last resort, as the working capital of the participation enterprise itself, the business tax with its low proportional tax rate will apply to it. In the event of a simple distribution

of profits by one enterprise to another enterprise, the distributed income (which might have undergone several distributions) will remain subject to the low business tax. On the other hand, funds withdrawn or profits distributed by the participation enterprise into a consumption fund will become subject to the progressive consumption income tax, the business tax already paid being deducted.

In principle, the cashflows which occur between the business tax sphere/participation enterprise and the progressive consumption income tax sphere may be defined as follows.

Payments to the participation enterprise are to be regarded as investments (*Einlagen*). In principle, one should distinguish two legal consequences which flow from such investments.

If the investment is made from income which is subject to consumption income tax, the sum invested can be freed from consumption income tax and can become subject to business tax. The most common instance of this would be the case of an employee who wishes to save a portion of his wages or salary. Wages paid into a savings account, for example, will be free from consumption income tax, but subject to business tax. In this way employees will benefit to the extent to which they pay the lower business tax, despite the fact that they are engaged in dependent economic activity, for their saving activity qualifies as an independent economic activity which is not subject to a duty to keep accounts. Thus they can opt for the business tax. They are not obliged to subject themselves to the business tax. Such a flexible solution seems appropriate to the situation of employees.

Should the investment have been made, not from income, but from assets which have already been subjected to taxation, then it is to be treated as neutral from the point of view of business tax.

Payments made by the participation enterprise are to be treated, by analogy to the rules which apply to investments, either as income (withdrawals or distributions of profits) and so subject to consumption income tax, or as neutral from a tax point of view (ie simply as repayments of investments which have been made by the participation enterprise).

### **Concerning the implementation of the proposed consumption income tax/business tax**

The effect of the consumption tax can, in my opinion, only be achieved gradually by creating an accounting mechanism which serves to identify savings, so as to subject them to a separate non-consumption tax in the form of a business tax. It is for future legislation to decide, as a matter of policy, how far it will go in refraining from redistribution and turning instead to the economic advantages inherent in the consumption tax concept.

The basic requirement of practicability makes it impossible to measure the capacity to pay tax by using as a yardstick detailed personal

consumption. Rather, the situation resembles that existing in relation to indirect consumption taxes. The enterprise owner (within the meaning of the tax laws) must do the work necessary for the practical application of the tax laws. He is the tax debtor. The customer pays the tax which is included in the price. He is not in contact with the revenue authorities.

The proposed enterprise concept as the object of the business tax is intended to be no more and no less than a legally and economically serviceable accounting unit. This accounting unit may be invested with legal personality (it may, for example, be a corporation), but this is not essential. As explained, the proposed "participation enterprise" can be established in the living room of an employee armed with his savings account book and can be administered by means of a home computer.

In the Federal Republic many employees have no personal contact with the revenue authorities because their income tax is deducted from their wages and transmitted to the relevant tax office. This highly convenient procedure must be continued at all costs. If, in such cases, no business tax return is submitted and there is no evidence of savings having been made from wages or salaries, it can be assumed that all the income from dependent work has been appropriated to private consumption.

From the point of view of the practical application of the tax laws, the proposed business tax involves an accounting system which will affect only those persons who are already under an accounting obligation or who, because they have accumulated significant assets, have a practical need to keep accounts so that an obligation to keep accounts imposed by the tax system is not an undue imposition. Such a business tax opens up new possibilities for taxation theory. Any accounting system could be adapted for its purposes. It represents a challenge to the sciences of finance and commerce<sup>6</sup> to develop an accounting system which best reflects peoples' capacity to pay tax (*die Liquiditaet zur Steuerzahlung*). An accounting system which would particularly merit discussion would be one involving taxation based upon cash flow.<sup>7</sup>

---

6 D Schneider, *Steuerbilanzen, Rechnungslegung als Messung steuerlicher Leistungsfähigkeit* (Tax accounting and general accounting as the measure of capacity to pay tax), Wiesbaden 1978, p 27: If personal consumption records were used as the sole measure of capacity to pay tax, there would be no such thing as enterprise taxes. Then the tax theory proposed by the *Science of Commerce* with its plea for an expenditure tax would have succeeded in making itself redundant. The business tax concept proposed here would have the opposite effect: enterprise accounting would be substantially expanded and so would the field of activity of the tax theory of the *Science of Commerce*.

7 See the lecture by Franz W Wagner, "Der Einfluss einer Cash-Flow-Steuer auf Organisationsstruktur und Kapitalmarktbeziehungen einer Unternehmung" ("The impact of a cash-flow-tax upon organisational structure and capital market involvement of an enterprise"), and the lecture by David F Bradford, "Zur Implementierung einer Cash-flow-Konsumsteuer" ("Concerning the implementation of a cash-flow tax").

## Summary

The present state of income taxation justifies the inference that tax systems have been moving in the wrong direction and that only a fundamental re-orientation can restore them to a state of health.

The existing income tax system and the principles upon which it is based, in particular the capacity to pay principle, have been shaped by the redistribution of wealth ideology of the nineteenth century. Resistance to high income tax rates has undermined the acceptance of the income tax system as a fair and just system. This has created an urgent need to base the tax system more upon consumption than has been the case hitherto. Moreover, the economic arguments which can be advanced in favour of a personal expenditure tax all point in the direction of a consumption-oriented tax system.

The main impediment in the way of such a reform is the considerable inertia of existing legal institutions. This means that tax systems can only be reformed by small steps. Such "legislation by small steps" requires a concept which indicates the right direction, for without such an indicator each step could be a backward one. In such a situation, tax legislation tends to operate in a backwards-forwards manner. The economic theories of optimal taxation should be given the indicator function which they deserve.

The lawyer who is concerned with the formulation of legislative policy must take cognizance of these economic theories and must consider which of the existing legal institutions are suited to the bringing about of those taxation consequences which have been identified as economically correct. From the point of view of practical legislative policy, it is desirable that familiar conceptual systems be used in this process so as to reduce to a minimum the effort and expenditure involved in the learning of a new system.

Moreover, tax reform can only be achieved if it accords with the requirements of equality, freedom and solidarity which are constitutionally, socially and morally entrenched. Should a consumption-oriented reform of the tax system be seriously envisaged, the re-distribution principle will have to be subjected to a fundamental debate. At the present time it does not seem politically feasible to abandon all forms of taxation of capital accumulation completely.

The economic arguments in favour of the personal expenditure tax yield a good reason why the lawyer involved in the formulation of legislative policy should strive to develop legal institutions which will enable the legislature to introduce, step by step, the reduction and eventual abandonment of taxation of capital accumulation. However, the legislature needs a certain amount of freedom of movement—the possibility of retreat must therefore be retained in case the introduction of a consumption-oriented tax system should prove unacceptable socially and politically.