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Working Paper

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Tübinger Diskussionsbeiträge, No. 1

Provided in Cooperation with:
University of Tuebingen, Faculty of Economics and Social Sciences, School of Business and Economics

Suggested Citation: Cansier, Dieter (1990) : The cash flow tax as a local business tax, Tübinger Diskussionsbeiträge, No. 1, Eberhard Karls Universität Tübingen, Wirtschaftswissenschaftliche Fakultät, Tübingen

This Version is available at:
https://hdl.handle.net/10419/104942

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The Cash Flow Tax as a Local Business Tax

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Tübinger Diskussionsbeiträge

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Diskussionsbeitrag 1

Februar 1990

The Cash Flow Tax as a Local Business Tax[1)]

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In the discussion on reforming the local business tax, little attention has been payed until now to the cash flow tax, although this tax opens up interesting perspectives and has been intensively discussed in tax theory.[2)] For this reason we want to examine the suitablilty of the cash-flow tax for use as a local business tax, and in particular how this tax fares in comparison with the existing local business tax as well as with the local value added tax which has been proposed by the Finanzwissenschaftlicher Beirat beim Bundesfinanzministerium[3)]. The criteria for this comparison arise from the special requirements of a local tax: It should be cyclically neutral, simple to impose, show only a slight geographical dispersion in its revenues and enable a just distribution of the tax burden according to the benefit principle.

There are several types of cash flow taxes. The original version is derived from real economic transactions (Brown tax or R base tax). It is levied upon receipts from sales of goods and services (including payments in kind) less current expenditures (exclusive of interest payments) and investment outlays. This is a sort of net value added tax. In contrast to a value added tax of the consumption type, wages and rent in addition to current purchases of goods and services and gross investment would have to be deductable. The disadvantage of the Brown tax is that actually only producers are subject to taxation. Banks are exempt. This violates the benefit principle, by which all firms using local government services should share in its costs.

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1) The German local business tax has two bases, earnings (Gewerbeertrag) and business capital (Gewerbekapital). Earnings consist of profits plus half of the interest payments on long term debt. Business capital equals assests in addition to half of the long term debt. Local governments can determine the tax rate within given limits. About 15% of the receipts from this tax must be given over to the provincial and federal governments. Other local taxes are the property tax and local consumption taxes.

2) The basic source is the report of the Meade Commission in Great Britain: The Structure and Reform of Direct Taxation, Report of a Committee chaired by Professor J. E. Meade, London 1978, p. 227 ff.

3) See also W.F. Richter and W. Wiegard, Cash-Flow-Steuern: Ersatz für die Gewerbesteuer? Regensburger Diskussionsbeiträge; Nr. 207, September, 1989. This article could not be taken into account here.

The second version of the cash-flow tax covers financial transactions as well. The tax base consists of net revenues from the sale of goods and services (E) and net credit revenues (KF), less investment outlays (I) and net interest payments (Z): E + KF - I = Z (RF base tax).[4)]

The total sources of funds to a company equal its total uses of funds. From this identity the real and the financial cash flow can also be indirectly derived as the difference between distributed profits (D) and new share capital (BF), D - BF: (S base tax).

Because the tax should be as general as possible, we wish to consider only the expanded form of the cash-flow tax as the appropriate candidate for a local tax. In doing so we leave open whether the direct or indirect approach should be preferred.

Introducing the cash flow tax would require an amendment to the Grundgesetz (the West German constitution) just as the value added tax would. Article 106, paragraph 6, assigns to local governments revenues only from the property and the business tax (Grundsteuer and Gewerbesteuer). According to Art. 105, par. 2, legislative competence for these taxes rests with the federal government. Concurrent legislative responsibility is held by the federal government for all important taxes whenever it is wholely or partially entitled to revenues resulting from such taxes or whenever according to Art. 72, par. 2 a need exists for a uniform nationwide regulation of a tax. This applies to the local business tax as well as to any other possible local taxes on businesses. Under Art. 100, par. 6, local governments would be conceded only the right to determine the local multiplication factor (Hebesatz) allowed within the statutory ceiling. Their financial autonomy would remain untouched.

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A local tax should be as simple as possible to levy. This requirement is well fulfilled by a cash flow tax. It is easy to determine cash flow funds statements. Difficulties in valueing assets are avoided. The dividend tax is probably the

4) This expression corresponds to profit plus net new debt and minus net investment: $G + KF - I_n$.

easiest to levy, since in this case only net payments (including payments in kind) to the owners of the firm must be known.

Assessing financial institutes is also accomplished without great difficulty. Problems which would arise here through the use of the Brown tax are avoided by providing RF base or S base taxation. In contrast to this, special important problems result when the value added tax is used. When a bank grants a producer a credit and receives $100 in interest, and pays its depositors in turn $80 in interest, leaving $20 in wages and profits, the value added amounts to not $200 but only $100. Interest revenues can only be assessed once, either on the production firm or on the bank. It is standard practice to assign the creation of value to the production firm. In this case the bank pays no taxes. Banks, however, provide auxilliary services (checking services) which are financed in part directly by fees and in part indirectly by the relatively low interest rates on deposits. The problem is to calculate from a bank's total of wages and profits that part which is the taxable value added. The same problem exists for life insurance companies and other institutional investors. Whether these and other difficulties can be satisfactorily solved appears dubious. A solution without conflicts is not possible: By attempting to distinguish between financial and real transactions, a tax violates the desired universal validity of the benefit principle, because financial institutes use local government services for which they are not taxed. If, however, a bank is levied a tax on its profits, wages and rents, the benefit principle is maintained only at the cost of double taxation on value added.

For firms with several business sites in different local jurisdictions a division of their tax must be undertaken. This same problem exists today with the local business tax or with the value added tax. Using the simplest method the tax is divided up in accordance with the size of wages. This is the present procedure. Better, but more complicated, would be to directly divide the base according to the share each individual site has on the total tax of the firm.

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An important criticism on the local business tax is directed at the high cyclical sensitivity of tax revenues, which promotes a pattern of procyclical expenditures by municipalities. Responsible for this are the strong fluctuations in profits. We will demonstrate the cyclical characteristics of the cash flow tax using the S base

tax. Distributed profits correspond to profits minus internal financing. Thus the tax base can also be defined as profits minus new share capital and internal financing. The degree of equity financing is represented by e. In national income terms we thus obtain for the tax base: G/Y - eI/Y. In times of prosperity, not only profits (G) but investments (I) as well increase more than proportionally. At the same time, the share of internal financing increases. During a recession, the opposite occurs. The tax base is thus considerably less sensitive to the business cycle than the local business tax is. Revenue elasticity is determined by changes in the profit rate in relation to fluctuations in the weighted rate of investment. Profit changes more than investment does. To the extent that this takes place, revenue elasticity will be greater than one. This value, however, is still reduced by changes in financing. In general there need be no great difference to the value added tax, whose revenues develop proportionally to the business cycle. It can thus be shown that the cash flow tax is superior to the local business tax and that it compares well to the value added tax as well.

It is obvious that the postulate of proportional growth as well is fulfilled by the cash flow tax -- tax revenues should increase at the rate of long term growth -- for in a growing economy profits and investments increase relatively similarly.

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A local tax on businesses should be efficient. This condition is well fulfilled by the cash flow tax. Its particular advantage lies exactly in that it acts neutrally on the form of financing, on the propensity to invest and on the employment of labor resources. This can be made clear with a simple example: An equity financed investment of $100 with a lifetime of one period results in net revenues of $120. The market interest rate is 10%. We assume the RF base tax. The tax rate is 40%. On the revenues a tax of $48 is due. Investment outlays results in a tax allowance of $40. Thus $8 in total taxes must be payed. This is 20% of the $20 earnings. The firm receives beyond that a (taxfree) interest advantage of $4 due to immediate depreciation. The actual tax burden is thus $4. This equals exactly the taxation of the surplus of earnings over capital costs. Because the tax falls upon this surplus, it has a neutral effect on investment activity. Important here is to distinguish between effective taxation and tax payment. Tax payment is a proportional function of the investment earnings.

The local business tax fares especially poorly under efficiency considerations. The financial structure is distorted, investment is inhibited and labor intensive production methods are favored. Under the local business tax on earnings, distortions result due to interest on debt being 50% deductable. Investment projects financed through borrowings have their net interest rate reduced to half of the tax rate. With projects that are equity financed, the discount rate remains constant, because investments with money from capital markets are not subject to the local business tax. Debt is favored. The local tax on business capital in contrast exerts no influence upon the imputed interest rate, nevertheless it effects debt financing -- because the value of long term debt is taxed only by half -- less severely than equity financing. Therefore in this case as well debt financing is encouraged. In regard to the willingness to invest, a definite uncertainty of the effect exists only for debt financing. This is because both net revenues and the discount rate are reduced, so that the capital value of an investment does not necessarily decline. But even here the willingness to invest will as a rule decrease, due to limited compensation for losses and to a lack of immediate depreciation. The promotion of labor intensive production methods results from the discrimination against real investment as well as from the neutral effect on the use of labor: Under a tax on commercial earnings the treasury benefits equally from the costs and earnings of labor employment and the tax on commercial capital has no effect on the use of labor.

Although the value added tax acts neutrally upon the form of financing and the employment of labor, it impairs the willingness to invest. This is because the tax reduces net revenues while leaving untouched interest on debt and interest income from securities. The cash flow tax is thus also superior to the value added tax. The disadvantages of the value added tax are admitedly somewhat relativized when the tax can be shifted, which is possible at least in part. Shifting the cash flow tax would be more difficult to realize since both dividends and equity shares -- in terms of a unit of production -- vary more between firms than added values do, making a similar shifting in the tax burden more difficult. But this changes nothing in the basic superiority of the cash flow tax, since it is already favorable to investment even when a shifting is not possible. Beside that, the disadvantages to economic stability in general price increases should not be overlooked.

Efficiency and competition neutrality goals can not be fully realized by a local business tax. Differences in local multiplication factors distort by necessity commerce and the location of business sites. A cash flow tax would change nothing in this either. Within these limits, however, it is superior to other local taxes on businesses. Its implementation would improve factor allocation and promote growth.

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An equal distribution of per capita tax revenues among local governments is also something to be desired. This would avoid divergences in the development of tax weak and tax strong municipalities. The local business tax fares poorly here because profits among firms and thus among municipalities as well vary considerably. With a cash flow tax the deduction of investment from the tax base acts favorably in this respect. Firms with high profit rates are generally also those with a high rate of investment. When profits rise, investment also increases; when profits decline so does investment. The tax base is distributed more evenly among local governments than business profits are. The cash flow tax is thus superior to the local business tax. As to its relationship to the value added tax, whose revenues are relative uniformly distributed due to the high share of wages, little can be said. It would have to be known how differences in profits, investment and financing relate to one another. Only empirical examination can give conclusive answers to this question. Nevertheless it can be concluded that the cash flow tax need not fare much worse here than the value added tax.

Certain problems may arise for small communities with few taxpayers. Fluctuations in investment are reflected in tax revenues and thus make fiscal planning more difficult. In spite of this, it is hard to find where the cash flow tax lies at a disadvantage to the business tax; rather, only advantages can be seen. Investment and profits are so tightly linked up to one another that the profits component provides a stabilizing counterweight. Furthermore, changes in investment have an immediate effect upon tax revenues only under pure equity financing. With debt financing nothing would change in the momentary tax payment. Not until the debt is amortized would any impact be felt, and then

only in considerably weakened form, since profits have in the meantime increased (decreased) from the (abandoned) investment. Finally it is to be observed that for large firms, which are generally located in several communities, fluctuations in taxes affect individual communities only in weakened form. This is overlooked by Feldhoff when he argues by way of the Deutsche Bank that the S base tax can undergo extreme fluctuation, causing problems for smaller communities.[5] It is, however, exactly in this case that the tax would be distributed among a number of communities.

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A tax should not only be efficient, it should also be just. Firms should pay for the services they receive from communities. This concept would also have to be persued by the cash flow tax and by the value added tax. The business tax is criticized because local government services benefit not only businesses but also residents, and these services cannot be reasonably divided up. Furthermore, businesses already pay fees for a number of services and their total tax burden is too high. These objections can also be directed at the cash flow tax and the value added tax. However, this argument is weakened when a complementary taxation of (consumption) households is introduced, as has been proposed by the Wissenschaftliche Beirat beim Bundesministerium for the value added tax. Costs to local governments are not then solely borne by businesses. According to the benefit principle all businesses should be subject to taxation because they all benefit from local government services. There is thus no reason for exempting the selfemployed from taxation. Along the same line of reasoning it would be consistent to tax agriculture and forestry as well as rents, abolishing property taxes A and B as compensation.

The tax base ought to be a good indicator of the level of public services actually provided. Utilization best corresponds with private factor input. The appropriate indicator for this is added value. Therefore, the local business tax has been criticized because its base is too narrowly defined. At first glance the cash flow tax makes absolutely no sense from the standpoint of the benefit principle. For the more that a business invests, the less that it pays in taxes, although it certainly does not use public services any the less. This viewpoint takes into account only the single period. However, by using a long term

[5] Cf. Feldhoff, Die Cash-Flow-Besteuerung und ihre Problematik, in: Steuer und Wirtschaft, 1989, Nr. 1, S. 62

average it can be taken into consideration that in the end the use of municipal services always presupposes private investment. It can be postulated that throughout the lifetime of an investment in average an equivalency should exist between tax payments and public services. This way it is possible to obtain a correspondence to the benefit principle. Tax payments under the Brown tax are a proportional function of the internal rate of return. This base includes, in addition to profits, the complete costs of debt financing and is for this reason broader than earnings are. In this respect the Brown tax is superior to the tax on earnings. On the other hand, however, it excludes important areas of economic activity. Under the expanded forms of the cash flow tax, equity financed projects as well would be proportionally taxed according to their internal rates of return. The same results are also obtained for this case under an earnings tax (when the limited possibilities for depreciation and write-offs are ignored). On the other hand, for projects which are debt financed, tax payments are a function of yield minus interest costs, i.e. of (average) profit. However, this base is narrower than that of earnings. Thus the expanded forms of the cash-flow tax fare rather worse than does the tax on earnings when judged according to the benefit principle.

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Every tax which is taken into consideration as a substitute for the local business tax has its disadvantages. This holds true for the cash flow tax as well as for the value added tax. The cash flow tax is superior to the local business tax in several important aspects. It is favorable to investment and promotes proper cyclical budget policy by communities and leads to a uniform dispersal of tax revenues. On the other hand, it does not stand so well in accordance with the benefit principle. In contrast to the value added tax the advantages of greater efficiency and of an easier and more general assessment are to be emphasized. The problem with interest found in the value added tax does not occur here. Financial institutes and other institutional investors would probably not have to be exempted. On the other hand, it is less based in the benefit principle. Another disadvantage can possibly arise in the unequal distribution of tax revenues among communities. Taking political considerations into account, the value added tax creates a more favorable impression in that the broader base permits a lower tax rate. For both taxes certain complications are unavoidable because -- unlike the business tax -- they do not harmonize with federal taxes on

income, on corporate earnings and on wealth which still have to be payed. Nevertheless, this new tax idea appears to us important enough to be included in the discussion on the reform of the local business tax and to merit further study.