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Fundamental Reform of Income Tax – In how far Can the Assessment Basis be Broadened and Tax Law Simplified?

Stefan Bach

Intensive discussion is now underway on the tax reform concept put forward by Paul Kirchhof. Analyses based on extrapolations of individual tax return data from the income tax statistics show that ending the main tax concessions and allowances would not be enough to compensate for the loss of revenue from lowering the top rate of tax to 25%. Moreover, the importance of simplifying the tax system is being exaggerated in public discussion. A much simpler tax system is neither necessarily efficient nor fair. Politicians must look for reasonable compromises here.

With the appointment of Paul Kirchhof, Professor of Tax Law and former Judge at the Constitutional Court, to the Union parties' competence team the discussion on fundamental reform and simplification of the German income and corporate tax system has intensified. Kirchhof has put forward the most far-reaching proposal for tax reform of recent years in a concept developed with his research group on the Federal tax code.¹ He wants to see an almost flat rate income tax of 25% on all taxable income over euro 18 000; in return, all tax concessions and exemptions related to specific types of income would be dropped, while lump sums would be allowed for some income-related expenses and operating expenditure. The tax regulations would also be tightened and their application simplified by thoroughly systematizing and redrafting the income tax laws.

DIW Berlin carried out a study of this and other proposed reforms in April 2004 in regard to the revenue they would yield and their distribution effects, as well as their effects on the supply of labour.² The main conclusion was that a clear drop in the rates of tax, particularly in the upper incomes range, would cause considerable loss of revenue, and that this could not be made good by broadening the tax base or stimulating growth. The propos-

¹ Cf. www.bundessteuergesetzbuch.de/.

² Stefan Bach, Peter Haan, Hans-Joachim Rudolph and Viktor Steiner: 'Reformkonzepte zur Einkommens- und Ertragsbesteuerung: Erhebliche Aufkommens- und Verteilungswirkungen, aber relativ geringe Effekte auf das Arbeitsangebot', in: *Wochenbericht des DIW Berlin*, no. 16/2004, pp. 185-204
(www.diw.de/deutsch/produkte/publikationen/wochenberichte/docs/04-16.pdf).

Table

Distribution of Income Tax Liability, Effective Tax Burden and Share of Tax Concessions and Deductions in Taxable Income in 2005, by Income Groups

Gross income ¹ of persons assessed for income tax ²	Top income in each decile	Average income	Income tax set		Higher losses on renting and leasing and commercial shareholdings ³	Tax-free income on investment ⁴	Income from employment, tax-free bonuses, higher allowable expenses ⁵	Special expenditure (without insurance contributions)	Extraordinary charges	Total	Memo item: Increase in business profits ⁶ by 15%
	Euro 000s		Structure in deciles (%)	As % of gross income	As % of taxable income ⁷						
1st to 3rd decile	21	8	1.5	3.7	5.2	5.7	4.7	2.2	2.7	20.5	2.5
4th decile	27	24	2.8	6.8	0.8	2.1	4.1	1.6	2.0	10.5	1.7
5th decile	31	29	4.2	8.6	0.7	1.8	3.5	1.7	1.8	9.5	1.1
6th decile	37	34	5.7	9.9	0.9	1.6	3.4	1.8	1.7	9.2	1.0
7th decile	44	40	7.6	11.2	0.8	1.6	3.3	1.8	1.7	9.2	1.2
8th decile	54	49	10.8	13.1	1.4	1.6	3.1	1.8	1.2	9.1	1.2
9th decile	73	62	16.1	15.3	1.8	1.5	2.8	1.9	1.1	9.2	1.4
10th decile	.	135	51.3	23.0	5.8	4.1	1.6	2.3	0.6	14.5	5.1
Total	.	40	100.0	15.0	3.1	2.7	2.7	2.0	1.2	11.8	2.7
Top 1%	.	442	20.6	28.9	9.5	8.3	0.3	2.4	0.3	20.9	9.1
Top 0.1%	.	1741	8.3	30.1	8.0	12.3	0.1	2.3	0.2	22.9	10.8

1 Taxable and non-taxable income, as far as shown in the income tax statistics, without capital gains, before deduction of high losses on renting and leasing and commercial shareholdings, and adjusted for declared tax concessions, without income from social assistance and housing benefit. — 2 Married couples taxed jointly are treated as one tax payer, the total is 29 million tax payers in 2005; with their children entitled to child allowances they account for 71% of the population. — 3 Losses of at least euro 5000 on real estate directly owned, of at least euro 2500 on shareholdings (closed property funds, property developer partnerships etc.), and at least euro 2500 on commercial partnerships, with positive income of other types. — 4 Saver's free allowance and half-income procedure on dividend income. — 5 Tax-free bonuses for Sunday and public holiday work and night shifts; estimate based on the DIW Berlin German Socio-Economic Panel; higher allowable expenses above the general employee's allowance. — 6 Without capital gains. — 7 Taxable income (after deduction of special expenses and extraordinary charges) before deduction of the child allowance for those eligible for family benefits. Source: Calculations using the DIW Berlin income tax simulation model based on extrapolated data from the 1998 income tax statistics (Scientific Use File FAST from the Federal Statistical Office).

als by Paul Kirchhof, as well as the concept put forward by the Free Democrats,³ would mean that tax payers on high incomes would pay very much less tax, not only in absolute terms but also in relation to their incomes, than tax payers on average earnings, so these proposals would also lead to greater inequality of income.

In view of the current discussion on the scope for broadening the tax base a consideration of the main concessions and allowances is of interest. These are shown in the tax statistics or can be estimated from (table). An extensive and representative random sample was taken

³ Hermann Otto Solms (ed.): 'Niedrig – einfach – gerecht: Die neue Einkommenssteuer' (www.hermann-otto-solms.de/sitefiles/reden/372/1066741545.pdf); cf. FDP-Fraktion: 'Entwurf eines Gesetzes zur Einführung einer neuen Einkommenssteuer und zur Abschaffung der Gewerbesteuer', Bundesdrucksache 15/2349 (<http://dip.bundestag.de/btd/15/023/1502349.pdf>).

from the income tax statistics for 1998 – the latest year for which data is as yet available – and the key features that are relevant for taxation policy were extrapolated to the year 2005.⁴ According to the forecast 29 million tax payers will be liable for income tax in 2005, of whom

⁴ The FAST data base was used. This is based on a stratified random sample of 10% of tax payers (just under 3 million cases) in the full 1998 income tax statistics and made available to research institutes as a scientific use file. For reasons of data protection and tax confidentiality some of the information on a few tax payers with very high positive or negative incomes has been erased or randomized, entailing estimates or imputations on these cases referring on marginal totals from the published results. On the editing and extrapolation of the data and the construction of the DIW income tax micro-simulation model see also Stefan Bach et al.: 'Aufkommens- und Belastungswirkungen der Lohn- und Einkommenssteuer 2003 bis 2005'. *Materialien des DIW Berlin*, no. 38 (www.diw.de/deutsch/produkte/publikationen/materialien/docs/papers/diw._rn04-04-38.pdf).

14.8 million will be single and 14.2 million married couples taxed on their joint incomes.⁵ Simulation calculations of the income tax charged for the 2005 tax year using DIW Berlin's income tax micro-simulation model are in line with the current tax revenue and current estimates of tax. Revenue from income tax charged will be euro 171.4 billions, and revenue from non-assessed non-assessed wage tax euro 15.1 billions.

Income tax as charged is progressive

In quantiles of effective gross income from economic activity⁶ there is a considerable concentration of income tax payable in the upper range of the income pyramid (table).⁷ The ten percent of tax payers in the highest income groups account for more than 51% of tax revenue; the 1% wealthiest a good 20%, and the 0.1% right at the top – 29 000 tax payers – provide 8.3% of revenue. There is a clear progression in relation to gross income, that is, the tax paid rises as income rises. In contrast to claims made in many debates the 'rich' pay large amounts of income tax, and they make a big contribution to financing public expenditure.

However, the effective average tax paid is clearly lower, in relation to gross income, than the top tax rate of 42%, even for tax payers on very high incomes. That is interesting, as it is often postulated in German tax policy discussions that the total burden on income through direct taxes should remain close to 'equal private and public shares', that is, taxation should not exceed 50% of total gross income. That is the famous 'half-and-half principle' established by the German Federal Constitutional Court.⁸ However, the rate of tax charged depends on the taxable income, that is, income after deduction of all income-related expenses, and personal allowances (special expenses, in particular insurance contributions, extraordinary charges, child allowances). As well as these items, the basic free allowance and the progressive tax schedule in the lower and middle ranges, other amounts are deducted when calculating income, and these also have to be taken into account, as do tax concessions. There is also tax-free income (part of which

falls under the exemption with progression rule) and reduced tax rates on capital gains.

Limited scope for broadening the tax base

Potential tax concessions or scope for broadening the tax base can be identified using the extrapolated model data base for 2005 (table). The relevant figures were related to income in the meaning of § 2, Para. 4 of the Income Tax Law, i.e. taxable income after deduction of special expenses and extraordinary charges, and before deduction of the child allowance within the framework of eligibility for family benefits. The income tax scale is then applied to this.

Many tax payers, particularly those in the upper ten percent, declare losses on renting and leasing or commercial shareholdings, and this is an indication of tax-saving activities.⁹ However, even in the top income groups these losses amount to less than 10% of the considerable taxable income of these households. The saver's free allowance and the half-income procedure on dividends are taken into account in calculating tax-free income from capital assets – the latter, however, balances the advance payment on the final corporation tax payable.

Bonuses paid for sunday, public holiday and night shift work have not so far been taxed, and taxing them is being discussed by all sides. They are not included in the data in the income tax statistics, so appropriate information from DIW Berlin's German Socio-Economic Panel Study (GSOEP) was integrated in the tax data set.¹⁰ In addition, higher allowable expenses above the general employees' allowance were taken into account in income from employment. This is mainly the commuter's allowance, which Paul Kirchhof and the FDP propose dropping. The table also includes special

⁵ With children entitled to child allowances this is about 71% of the population.

⁶ Including non-taxable income as far as this is shown in the income tax statistics, without capital gains, before deduction of high losses on renting and leasing and commercial shareholdings, and adjusted for tax concessions declared (Annex ST), without income from social assistance and housing benefit.

⁷ Statistical information is not available on the distribution of non-assessed wage tax.

⁸ BVerfGB 93, 121 and 165.

⁹ In the forecast it is assumed that the losses on renting and leasing will fall clearly from 1999 (starting from the 1998 level), and will stabilize from 2002 at 65% of the 1998 level. This is confirmed by the first results of the new current statistics on income tax published by the Federal Statistical Office, which include most of the results of the assessments for 2001. Cf. Volker Lietmeyer et al.: 'Jährliche Einkommenssteuerstatistik auf Basis der bisherigen Geschäftsstatistik der Finanzverwaltung', in: *Wirtschaft und Statistik*, no. 7 /2005, p. 676. This is also plausible in view of the ending of the investment promotion in the new federal states, the excess supply on many regional property markets and the introduction of a minimum tax payable from 1999.

¹⁰ Using as base the R-Wave of GSOEP from 2001 the probability of such income was estimated with a probit model and imputed to the income tax data. However, there is no information on the amount of these tax-free bonuses, so a global figure of 12% of hitherto taxable gross income was assumed for these tax-free bonuses.

expenses (except insurance contributions)¹¹ and extraordinary charges,¹² again Kirchhof wants to see most of these dropped.

It is also difficult to estimate to what extent the proposals on the calculation of profits will affect taxable income. Kirchhof and the Union parties want to redraft the tax balance sheet laws; Kirchhof in particular wants to restrict the scope for building up hidden reserves drastically, and probably fix lump sums for part of operating expenditure and the calculation of income.¹³ There is no information on these relations in the tax statistics, as profits are only shown on balance, that is, after deduction of all operating expenditure. The Red-Green Coalition Government (SPD and Green Party) has already introduced a number of measures in this area in recent years, from more stringent regulations on profit determination through the introduction of a minimum tax payable to more stringent documentation requirements for transfer pricing with related firms abroad. Moreover, many of these measures involve higher tax payments in the short term with lower tax payments later (depreciation regulations, provisions), and to that extent the effect on the actual tax liability and on tax revenue is rather low in cash terms. In addition, reactions by tax payers to the new rules would have to be taken into account, with the corresponding effects on location conditions. There is hardly any empirical evidence on this.

Lacking more detailed information DIW Berlin made general assumptions on the increase in profits in its study. It was assumed for Kirchhof's concept that taxable profits (without capital gains) would rise permanently by 15%. The effects of this assumption on taxable income are shown as a memo item in the table.

Altogether, the result for the regulations included here shows a potential for broadening the tax base of just under 12%. If more taxable profits are included the figure would be 14.5%. This would finance corresponding reductions in the rates of tax. But this potential volume would not be enough to cover the loss of tax revenue from the high earners in the upper income groups, if the top rate of tax were reduced to 25%. There would be considerable loss of tax revenue, and, as DIW Berlin has calculated for Paul Kirchhof's proposal, the distribution of net incomes would be more unequal.

Nor are greater 'self-financing effects' to be expected from rising employment and stronger growth in the medium term. The effects on the labour supply estimated by DIW Berlin are noticeable, but they are slight compared with the considerable loss of tax revenue.¹⁴ This is particular true in the case of the radical tax reform concepts. Marked changes in taxation rules can also have a rather negative effect on economic development in the short to medium term, if they entail some depreciation of investments yet promoted (e.g. real estate) and other adjustment costs. That applies particularly if business decisions are negatively affected when lump sums are fixed for deductions and more stringent conditions are imposed on the calculations of income.

Too much importance attached to simplifying the tax system

Simplifying the tax system is not an end in itself. If that were the only objective income tax could be abolished altogether and other taxes increased. And then even the 'tax declaration on a postcard' (as promoted by some radical reformers) would be superfluous. But VAT rates would have to go up to 39%, or the revenue needed from income tax could be shared out evenly among the entire population, in the form of a lump-sum tax on individuals. Everyone, from babies to the very old, would have to pay euro 190 a month. If the 18.6 million children eligible for child allowances were exempt, the charge would be euro 240 a month. Clearly that is not feasible.

Economists are primarily interested in the efficiency of taxation and its effects on distribution.¹⁵ That should also be the main concern of tax policy. Simplicity and transparency cut the costs of running the tax system, for both the tax authorities and tax payers, and insofar they make the tax system more efficient. But they should be balanced against the other objectives of taxation. There are conflicting aims here that need to be recognized and acknowledged.

Taxing incomes as the expression of 'ability to pay' is regarded as the central aim of taxation. That has been established by the Federal Constitutional Court, where Paul Kirchhof played a major part as justice. Econo-

¹¹ Donations and contributions, education costs, maintenance payments, church tax, tax accountants' fees, pensions, permanent charges and school fees.

¹² Persons can claim these for subsistence and education costs, for handicaps and nursing care, for child care and for unusual hardships.

¹³ The depreciation regulations are to be made more stringent; especially declining balance depreciation on mobile assets is to be reduced or abolished; furthermore the scope for building up hidden reserves is to be limited and some reserves returned to income.

¹⁴ Cf. Stefan Bach et al., loc. cit., p. 199.

¹⁵ On the following see Franz W. Wagner: 'Steuervereinfachung – mit ökonomischem Sachverstand gegen populistische Versimpelung', in: *ifo Schnelldienst*, 1/2004, pp. 5-9; *ibid.*: 'Steuervereinfachung und Entscheidungsneutralität – konkurrierende oder komplementäre Leitbilder für Steuerreformen?' In: *Steuer und Wirtschaft*, no. 2, 2005, pp. 93-107; Christoph Spengel and Wolfgang Wiegand: 'Duale Einkommenssteuer: Die pragmatische Variante einer grundlegenden Steuerreform', in: *Wirtschaftsdienst*, vol. 2, 2004, pp. 71-76.

mists also want the tax system to be largely neutral for decision-making, that is, decisions on investment, financing and the legal form of an enterprise should not be influenced and 'distorted' by the tax system. In that case there can be no really simple income tax system, because the calculation of incomes is complicated. Any government that embarks on the taxation of the complex worlds of business and individuals' lives will have to make compromises.

The key to a simpler tax system is ultimately lower and more even rates of tax, as the radical reformers have rightly recognized. The idea of a 'dual income tax' points in the same direction.¹⁶ If the local business tax were to be abolished and the rate of income tax limited to 25% many of the problems now encountered in business taxation would disappear of their own accord and tax avoidance arrangements would no longer be so worthwhile. But the consequence would be the distribution effects outlined above. Moreover, as with the considerable loss of tax revenue the effects of increasing other taxes or lowering expenditure would need to be taken into account.¹⁷

Furthermore, even with a flat rate of tax of 25% it will still be worthwhile to shift earnings abroad to a lower tax country or argue with the tax authorities over special depreciation. An examination of tax practice *en masse* shows that it is not so much the often criticized tax concessions and special exemptions that most occupy the accountants, the tax authorities and the courts as the fundamental questions of calculating profits and deducting allowable expenses. It is difficult to separate operating expenditure and other income-related costs from private living costs or to estimate the appropriate economic life of machinery and equipment.¹⁸ Setting lump sums for type categories here could greatly simplify the tax system, but they will not necessarily create more efficiency and fairness. Either the lump sums would have to be high amounts, in order to cover as many cases as possible, then there would be big loss of tax revenue, or only one lump sum would be fixed, which is evidently Kirchhof's idea for many areas. But that would be unfair to many tax payers, and it could

have economic consequences that are not desirable. If, for example, the lump sums meant that small firms were taxed less than larger firms, many entrepreneurs would aim to stay small. If employees were no longer allowed to deduct commuting costs or double household costs they would be less willing to take a job further away from home, and more inclined to accept a job in their neighborhood, even if the pay were lower.

¹⁶ Cf. Christoph Spengel and Wolfgang Wiegard, loc. cit.

¹⁷ Ultimately there are no scientific criteria for a fair distribution of incomes or taxation. But see the study of people's attitudes of how fair the tax system is: Jürgen Schupp and Gert C. Wagner: 'Gerechtigkeit der Einkommensbesteuerung aus Sicht der Bürger', in: *Wochenbericht des DIW Berlin*, no. 29/2005, pp. 451-453

¹⁸ Cf. the older studies by Lutz Haegert: 'Eine empirische Widerlegung der gängigen Thesen über die Ursachen für die Überlastung der Finanzgerichte', in: *Betriebs-Berater*, 1991, pp. 36-47; and Wolfgang Stegmaier: 'Ursachen für die Überlastung der Finanzgerichte und Vorschläge zu ihrer Beseitigung', *Hochschulschriften zur Betriebswirtschaftslehre*, vol. 105, Munich 1993.