

Boss, Alfred

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## Reform of capital income taxation in the Federal Republic of Germany: Policy options

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## **Reform of Capital Income Taxation in the Federal Republic of Germany — Policy Options**

### **1. The Problem**

Tax reform is a major economic policy issue in the Federal Republic of Germany. Having already adjusted the personal income tax in three steps [Presse- und Informationsamt der Bundesregierung, 1988], the government announced a reform of company taxation during the next period of administration (starting at the end of 1990). There are some substantial defects in the German system of capital income taxation; a relatively low rate of economic growth in the 1980s and persistently high net capital outflows are seen as an indication of this. Possibly, the detrimental effects have increased because several other industrialized countries enacted significant tax cuts and/or tax reform measures during the eighties [Pechman, 1988].

The purpose of this paper is to summarize the major defects in the German system of capital income taxation and to discuss some of the policy options available. These relate to structural tax reform measures that are not necessarily combined with cuts in government expenditures. However, options to cut the level of taxes and expenditures should be given priority because the degree of subsidization is high in the German economy: overall subsidies amounted to DM 128 bill. (6 percent of gross national product) in 1988 [Klodt, Schmidt et al., 1989].

### **2. Defects in the System of Capital Income Taxation from an Efficiency Perspective**

Measuring the defects in a tax system is possible only if measurement criteria are established. The criteria underlying this paper are:

- neutrality, e.g., with respect to the consumption-saving decision, the kind of financing investment expenditures, the type of investment goods purchased or the choice of the legal status of the firm (corporation versus unincorporated firm),
- neutrality in the case of inflation,

- the share of investment risks the government bears, and
- the administrative burden.

Thus, liquidity effects of tax policy are neglected; this implies that the analysis abstracts from capital market restrictions. Equity considerations are set aside, too.

An important defect in the German tax system is that it leads to the non-neutrality of the individual's choice between present and future consumption. Because of the dominance of the income tax instead of a consumption tax, savings are discriminated against. The opposite could be considered to be necessary to correct a distortion in the intertemporal allocation of capital.

There are some economic arguments in favor of subsidizing savings [Sinn, 1987b; 1989]. First, a case can be made for some subsidization of savings because of the incomplete guarantee of property rights as concerns material resources (e.g., loss of property as a result of changes in the economic order) or because of positive utility externalities of private savings that are not taken account of in private savings decisions [Marglin, 1963; Sen, 1961]. However, it is not quite clear what the empirical relevance of the argument is. If it is relevant, government interference will not necessarily increase efficiency; government failure instead of market failure might result. Second, as labor supply is variable, second-best considerations according to optimal taxation theory may lead to the conclusion that present consumption should be taxed at a higher rate than future consumption in order to have a kind of substitute for a tax on leisure that cannot be implemented directly. The plausible assumption behind this is that leisure and present consumption are in a stronger complementarity relationship than leisure and future consumption [Sinn, 1987a].

One argument in favor of promoting investment (and/or savings) maintains that tax policy has to compensate the negative effects of wage (wage structure) rigidities on employment. However, following such a line of reasoning would mean taking away the unions' and the employers' associations' responsibility for providing full employment; the responsibilities for the achievement of macro-targets would be blurred. An inefficient assignment of economic policy tools to economic policy targets would be the result.

The arguments in favor of subsidizing savings may be assessed as not convincing. However, discrimination against savings is a major defect in the German system of capital income taxation.

Apart from the basic non-neutrality of overall savings, there are other reasons for the inefficiency in the system of capital income taxation in the Federal Republic of Germany.

First, various forms of savings are exempted from the income tax base (e.g., exemptions for life insurance premiums). Second, investment in inventory is taxed higher than other investment, especially investment in nonresidential construction. Investment in specific regions or for specific purposes is treated preferentially (e.g.,

by granting tax credits). Third, given the increasing marginal income tax rates, favoring real assets (e.g., by using the realization principle for capital gains taxation or by allowing accelerated cost recovery) and thus discriminating against financial assets results in portfolio specialization [Sievert et al., 1989]. High-income earners see incentives to hold real capital, low-income earners are driven into financial assets. The problem is aggravated because discriminating against financial assets means favoring negative financial assets, i.e., liabilities.

Fourth, equity financing of real capital formation is punished, e.g., by the specific business capital tax (*Gewerbekapitalsteuer*). Fifth, corporations are generally discriminated against. The specific reasons for both of these defects are as follows [Sievert et al., 1989]: Debt financing of investment is cheaper for the unincorporated firm than financing by issuing equity because the specific taxes on business profits and capital (business profits tax + business capital tax = business tax) need only be paid on part of the debt and on part of the interest on debt. For the unincorporated firm there is tax neutrality between financing by issuing new shares and financing investment expenditures by retaining profits. Comparisons of the legal status of firms show that financing investment expenditures by retaining profits is taxed higher in corporations than in unincorporated firms. This is due to the (additional) tax on corporate property and to the incomplete integration of the corporation and the individual income taxes (i.e., to the deferred shareholder's tax credit for the corporate income tax on retained profits). In the case of debt financing, corporate marginal investment is taxed less than noncorporate marginal investment. If three kinds of financing and two types of the legal status of a firm are compared, debt financing by corporations is taxed at the lowest rate, while corporate financing using retained profits is taxed at the highest rate.

Sixth, "income," e.g., nominal (realized) capital gains, is taxed even if it results from inflation and thus does not indicate a change in real income. A point related to this is bracket creep, i.e., the increase in marginal tax rates as a result of inflation; bracket creep, of course, is a problem for wage income taxation, too.

Finally, the government only imperfectly shares the risk of investors. This is due to the effects of the progressive tax rate structure in the case of fluctuating income and to the restricted (though recently improved) possibilities of carrying losses forward. This point is also related to the tax treatment of profits from innovation [Schumpeter, 1918].

### 3. Policy Options for Reforming Capital Income Taxation

#### a. General Comments on the Target of Reform Measures

Any reform measures should aim at abolishing the defects described. This means that the system should gradually approach a consumption tax (possibly a net value-added tax) dominated system.

There are three ways to reduce or even to totally avoid the taxation of capital formation. These are:

- the exemption of savings from the income tax base,
- the exclusion of investment expenditures from the (individual or corporation) income tax base, and
- the exemption of capital income from the tax base.

If capital income were taxed less and if total tax revenues were not to change, other taxes (e.g., the net value-added tax) would have to be raised despite the fact that a partial self-financing of structural reform measures (via higher growth rates of real income) could be expected. However, reform proposals have generally included expenditure cuts as well as tax cuts — apart from structural tax reform measures. Some of the options available are described and assessed in this section.

#### b. Corrections on the Side of Savers

##### *Abolition of the Company Tax (Gesellschaftsteuer) and the Stock Exchange Transactions Tax (Börsenumsatzsteuer)*

The company tax (the tax on new equity of corporations) is an impediment to their issuing shares. It should be abolished because of its discriminating effects (on the different kinds of financing investment as well as on the kind of the legal status chosen by firms). The stock exchange transactions tax has discriminating effects, too.

Both taxes are to be abolished as of 1991 according to an announcement the government made in early November 1989.

##### *Taxation of Consumption instead of Income*

Taxing consumption instead of income would mean the end of punishing capital formation; it would eliminate the distortions between different kinds of savings and it would result in less administrative difficulties: problems in measuring depreciation allowances, capital gains, etc., would not occur any longer (for a proposal of taxing consumption in Germany, see Mitschke [1985]; for a US perspective, see Bradford [1986]). Finally, a consumption tax can be viewed as a convincing solution

from an equity point of view, too. However, politically there seems to be no chance for a switch from the income-tax-dominated system to a consumption tax system in the Federal Republic of Germany.

### **c. Corrections on the Side of Investors**

Reducing taxes on the formation of real capital means that the resident's investment abroad is discriminated against, whereas — contrary to measures reducing taxes on savings — domestic investment financed by foreigners is fostered. Favoring domestic investment is beneficial from a single nation's perspective; a precondition for this could be the levying of some kind of withholding tax on dividends flowing abroad. At first glance, a misallocation of the world capital stock might result. However, if other countries pursue the same policy, general tax incentives for domestic investment may be adequate from a world welfare perspective, too [Sievert et al., 1989].

#### ***Reduction of Taxes on Capital Stock***

The abolition of the business capital tax (Gewerbekapitalsteuer) is one of the reform measures that is recommended most often. The tax is a kind of supertax that cannot be found in other countries (except in Luxemburg). For investment projects to be profitable, a marginal productivity of capital above the market rate of interest is required. Thus, the tax discriminates against real capital formation.

The same is true for the general property tax (Vermögensteuer) on business capital. The tax rules even mean double taxation of the corporate sector's business property. The property concerned is taxed at the personal level as well as at the corporate level. Issuing equity is discriminated against; the choice of the economically optimal legal status of a firm is impeded.

Different measures for avoiding double taxation are possible: One solution is to abolish the corporate property tax. Another option is to introduce an imputation (integration) system comparable to the system used in corporate income taxation. A strong point in favor of abolishing the corporate property tax is that no additional prescriptions would be necessary to prevent foreigners from being discriminated against.

#### ***Indexation of Depreciation Allowances, Changes in Inventory, Capital Gains and Interest Paid and Received***

Indexing the tax system means legislating a formula that automatically removes the influence of inflation on real tax liabilities. Tax indexing is favorable not only because distortions are avoided, but also because automatic tax increases and additional public expenditures as a result of this cannot occur. Indeed, incentives

for legislators to pursue inflationary policies would be removed by indexing capital income taxes.

Indexing means not only restructuring the income tax rates, i.e., avoiding bracket creep (as is the case in France, the UK, the United States, etc.), but also eliminating any mismeasurement of income as a consequence of inflation. This relates to prescriptions concerning depreciation allowances, capital gains, inventory (LIFO accounting) and interest income. As to the depreciation allowances, it is possible to allow firms an immediate deduction equal to the present value of the depreciation deductions to which they would be entitled if there were no inflation [Auerbach, Jorgenson, 1980].

### ***Improving Depreciation Rules and Tax Credits***

Apart from indexation, other measures for alleviating the depreciation of real assets have been proposed: shorter periods of depreciation, interest on depreciation allowances that cannot be used because of current losses, and depreciation allowances of more than 100 percent or anticipated allowances (favoring uninvested retained profits). Tax credits or tax-free grants are another means of not discriminating against investment. All these measures — though imperfect — are also substitutes for adjusting depreciation allowances in line with the inflation rate.

### **d. Corrections in the Taxation of Capital Income**

Apart from introducing measures relating to the tax treatment of savings and/or investment, there are other options for reforming capital income taxation. Some considerations follow.

### ***Reduction of the Marginal Income Tax Rates***

The main issue — in an economic perspective, not in the political debate in the Federal Republic of Germany — is reducing the top rate of the individual income tax. Of course, this can be done together with or without a broadening of the tax base. Reducing the high marginal tax rates (which reached a maximum of 56 percent up to 1989, and which will reach a maximum of 53 percent as of 1990) would probably increase savings. In addition, entrepreneurial activities would become more attractive because the negative effects in the case of uneven income flows would be reduced. The effects of non-indexation of the income tax (e.g., bracket creep) would become less severe. Finally, the corporate income tax rate for undistributed profits could be reduced without creating new distortions with respect to the choice of the legal status of the firm.

A significant reduction of the high marginal tax rates or even the abolishment of the system of (directly) increasing marginal tax rates would be opposed by many

groups in the population despite the fact that there is no (economic) justification for having progressively structured tax rates [Hayek, 1983].

### ***Full Integration of the Personal Income Tax and the Corporate Income Tax***

The German income tax system is already characterized by a relatively high degree of integration of the individual and the corporate income tax (as a result of a reform in 1976). Nevertheless, integration could be completed by attributing not only distributed profits but also undistributed profits to the shareholders and by taxing total profits at the individual income tax rates.

### ***Cash Flow Taxes***

The motivation for a cash flow tax is to apply the principles of a consumption (or expenditure) tax to the corporate sector. Different systems are possible.

The basic principle of the R base (real base) tax is to levy a tax on the net cash flow to the company resulting from its real economic activities [Meade Committee, 1978; King, 1986; Bradford, 1986]. The (tax-inclusive) base is the difference between the receipts from sales of goods and services and the purchases of all goods and services required in the production process (including investment in real capital). Double-entry bookkeeping implies that the tax base is identical to the (tax-exclusive) difference between dividends paid to shareholders and issues of new shares minus real profits from transactions in financial assets (other than equities).

Mainly, the R base tax is characterized by

- immediate expensing of all investment expenditures (100 percent first-year depreciation allowances),
- identical tax rates for retained and distributed profits,
- no deduction of interest paid by corporations (and other firms),
- no taxation of capital income at the saver's level (otherwise retained profits would be favored).

The same rules would be necessary for unincorporated firms [Sievert et al., 1989]. In addition, the imputed "wage" income of the entrepreneur(s) of such firms would have to be subtracted from the tax base. This "wage" income would be hit — as wage incomes paid by corporations — by the consumption (or expenditure) tax. Negative tax payments or similar arrangements (e.g., tax reserve certificates [Meade Committee, 1978], interest-bearing carryforward of losses) would be necessary in order to have a symmetrical treatment of profits and losses.

The R+F (real plus financial) base tax (the base including expenditures and revenues associated with financial transactions) or S (share items) base tax [Meade Committee, 1978; King, 1986] is neutral with respect to the intertemporal allocation of capital and the kind of financing investment [Sinn, 1985]. Its base is net payments to shareholders. A practical problem with such a tax is avoiding tax evasion that



results from paying overly high (untaxed) interest income to shareholders giving loans to the company.

The treatment of overseas investment and profits remitted from abroad would raise some problems if a cash flow corporation tax were introduced. With such a tax the government is a partner in the firm's equity. Thus, there is no obvious reason to grant credit for foreign taxes paid. If, nevertheless, a credit on foreign taxes were granted, the government would not receive the total share in the return on the investment in the firm's activities overseas.

If a cash flow tax were to be introduced, some arrangements for a period of transition would be necessary [King, 1986]. These relate to depreciation allowances not yet subtracted and to "losses" that are expected to be offset against future profits according to the "old" tax system.

A substitute for a cash flow tax of the R or S type was proposed by Sinn [1985]. Contrary to the R base tax, firms should be allowed, according to this proposal, to deduct interest payments — as is the case with an income tax. Interest income, however, would have to be taxed at the receiver's level by the rate used at the firm's level (rate for retained profits). The elements of the proposal are immediate expensing of investment expenditures, identical tax rates for retained profits and the interest income of households (e.g., by applying a flat rate to capital income or by using the rate of the representative shareholder) and a tax on distributed profits.

The advantage of realizing the proposal was believed to be that it was not politically radical. However, the history of the German withholding tax on interest income (Schlesinger, this volume) shows that a precondition for the reform package to be effective, namely, taxing capital income including interest income, can hardly be fulfilled. An international aspect is important, too. It would be advantageous or even necessary to use the source principle when taxing interest income of foreigners; otherwise, income is transferred to foreign countries if the interest rate in relation to the real before-tax rate of return to equity capital rises as a consequence of introducing the new system. However, as concerns interest income, most international double taxation treaties are based on the residence principle of taxation. If the treaties could be changed in the direction of taxing interest income at the source, the Sinn proposal would become more attractive [Sievert et al., 1989].

Using cash flow taxes would mean simplicity of taxation as well as intertemporal and intersectoral efficiency. The measurement of economic income would be removed from the concern of the tax authorities. The calculation of the economic depreciation of an asset and the measurement of realized (and/or unrealized) capital gains would not be necessary; any measures that are required to index the tax system for inflation and that are difficult to implement in practice would be superfluous, too.

### ***Tax Preferences for Undistributed Profits***

A preferential tax treatment of undistributed profits has been called for by some of the German employers' associations. However, this would impede the optimal allocation of capital among firms; new firms would be discriminated against. Savings, not necessarily investment in real capital, would be favored. Nevertheless, there are some foreign countries that have decided upon such a measure (e.g., France).

### **e. Special Issue: Reforming Municipal Taxes**

Reforming capital income taxation in the Federal Republic of Germany raises questions as to the revenue-sharing between the federal government, the states (Länder) and the local governments (municipalities). Currently, most of the revenues from the business tax (Gewerbesteuer), which causes inefficiency in several respects, flow to municipalities. These revenues amounted to 43 percent of their total tax revenues in 1988. Reducing the business tax would create distributional problems within the public sector. These problems as well as the allocative aspects concerned cannot be dealt with in this paper. However, any solution should be based on considerations of fiscal federalism. The British solution, the introduction of a community charge (poll tax), is an answer to the question of how to finance parts of the expenditures of municipalities. A local net value-added tax as recommended by some advisory committees [Sachverständigenrat, 1989; Wissenschaftlicher Beirat, 1982] can be taken into consideration, too.

### **f. Risk-Taking, Entrepreneurial Activities and Taxes**

From a risk-theoretical point of view, taxes on business property are detrimental. They reduce the expected net return on investment expenditures without reducing the risk, i.e., the variance of the expected net returns; taxes on business property have to be paid even in the case of losses. The government does not share the investment risk, as is the case with taxes on profits (and losses). This leads to the conclusion that business property taxes should be reduced. However, this is only part of the story. Leaving these taxes unchanged and cutting taxes on profits means that successful entrepreneurs — compared to the less successful ones, i.e., those with fewer profits — would be punished less. And these entrepreneurs may be the ones who bear (and succeed in overcoming) risks that can be influenced by their own entrepreneurial decisions. Risk, i.e., the probability distribution of the outcome of economic decisions, is not necessarily given; the entrepreneur may react to changes in the economic environment [Sievert et al., 1989]. Low profit tax rates are favorable as concerns the entrepreneur's efforts. Thus, any considerations of risk

effects in a comprehensive sense do not lead to clear-cut conclusions as to the question of whether capital taxes or profit taxes are worse.

## **4. Two Examples for Reform Packages**

### **a. The Underlying Reasoning**

If it were certain that the level of government expenditures is economically optimal, tax reform would not have to result in tax cuts. However, a large part of public expenditures in the Federal Republic of Germany (DM 80 bill. or 3.8 percent of gross national product in 1988) are subsidies. These expenditures should be cut in order to increase (static) efficiency and competition [Klodt, Schmidt et al., 1989]. This would give a great deal of scope for cutting taxes, especially capital income taxes.

All of the reform measures should be steps towards the realization of a system dominated by a consumption tax, possibly the net value-added tax. Actually, there should be tax rate reductions only. Distortions because of exemptions or tax preferences (loopholes) granted by the income tax would become automatically smaller. This would be all the more so, the longer the process of gradually reducing the (capital income and business property) rates continued.

Along these lines, there are of course different options as to the amount of expenditures and tax reductions. Two tax packages are presented below. They include the abolition of the tax on bills of exchange (Wechselsteuer), the company tax and the stock exchange transaction tax. In 1989, the receipts from these taxes were about DM 1.7 bill. or 0.3 percent of the total tax revenues in that year. However, the abolition of these taxes probably would not mean that there would be losses in tax revenues — at least in the medium run.

### **b. The Radical Solution**

If subsidies in the form of government expenditures were reduced, there would be a great deal of room for cutting taxes. As an example, it would be possible — as of 1991 — to reduce these subsidies by 50 percent (DM 40 bill. or about 2 percent of gross national product) and to cut taxes by the same amount.

In detail, the top rate of the individual income tax and the corporation income tax rate could be reduced to 36 percent. This is a rate in the neighborhood of the rates in other countries. As it is the prevailing rate for the distributed profits of corporations, the need for complementary measures for dividends flowing abroad would be less than in the case of a rate of, e.g., 38 or 35 percent. In addition, the

property tax for corporations and the business capital tax could be abolished. This would mean — in a static sense — tax revenue losses for the public sector in the range of about DM 4 bill.

Deciding upon such a reform package would reduce many distortions. All the defects described above would become less severe. The effective marginal tax rates on investment would fall (for simulations of the effects of some measures, see Sievert et al. [1989]). Nevertheless, the income tax rates would have to be reduced further until such time as some kind of consumption tax system (not necessarily supplemented by a personal property tax) emerged. However, the political opposition to tax reform along these lines would be strong, mainly because of distributional or equity considerations.

### **c. A Significant Improvement**

An influential advisory committee to the federal government, the "Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung," proposed a different reform package in November 1989 [Sachverständigenrat, 1989, Sec. 345-346]. It is more in line with prevalent public opinion. It seems to aim at a comprehensive income tax with reduced tax rates. Such a system would leave no space for a property tax. Thus, the general property tax as well as the business capital tax are to be abolished. The latter, together with the business profits tax, are to be replaced by a local net value-added tax for municipalities. The top rate of the individual income tax and the corporation income tax rate are to be identical at a rate of 48 percent or somewhat less. The company tax and the stock exchange transactions tax are to be abolished, too. All these measures would mean a tax cut of DM 13 bill. The tax package would amount to DM 16 bill. if the income tax rates were reduced to 46 instead of 48 percent.

## **5. Concluding Remarks**

Recently, tax policy in other countries has made increasingly apparent that there are some defects in the German tax system, and this has become a powerful argument for reforming capital income taxation. Given tax cuts and/or tax reform measures abroad and given a high degree of capital mobility, comparable tax reform measures at home are recommended by many advisory committees. Otherwise, it is felt that the future real incomes of residents will be lower than in the no-change case, because more domestic or foreign capital would be attracted by foreign countries.

Capital income tax reform measures along the lines discussed would induce more capital inflow into the Federal Republic of Germany and less capital outflow. This

would probably lead to reform decisions abroad, just as the tax reform movement in Germany is driven by tax reform activities abroad. If tax competition arose in such a way, it would be a favorable outcome for the world as a whole. It would not justify any harmonization measures within the EC or even the Western world.

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