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Kiel Working Paper No. 402
Capital Income Taxation
In The Federal Republic Of Germany:
What Is Wrong?
What Can Be Done?
by
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A. The Problem

Tax reform is a major economic policy issue in the Federal Republic of Germany. Having 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 in the end of 1990). Apparently, there must be some substantial defects in the German system of capital income taxation. Possibly, these defects have become more detrimental because other industrialized countries enacted tax cuts and/or tax reform measures during the second half of the eighties (Pechman 1988).

The purpose of this paper is to summarize the major defects in the system of capital income taxation and to give a list of policy options available. Primarily, these relate to structural tax reform measures assuming that the level of government expenditures and thus total tax revenues cannot easily be changed. However, options to cut taxes and expenditures are included, too; actually, these options should be given priority in the public debate because the degree of subsidization is high in some branches of the German economy (Klodt, Schmidt et al. 1989).

B. Defects Of the Tax System From an Efficiency Perspective

1. Criteria

Measuring the defects of a tax system is possible only if a measuring rod is used. The criteria underlying this paper are

- efficiency (avoidance of distortions) e.g. as to the consumption-saving decision, the kind of financing investment expenditures, the kind of investment goods bought or certain characteristics of investors such as the legal status of the firm (corporations versus unincorporated firms),
- the share of risk the government is bearing (e.g. as to the intertemporal income profile),

- neutrality in the case of inflation and
- the administrative burden.

Thus, liquidity effects of tax policy are neglected; this implies that it is abstracted from capital market restrictions. By the way, equity considerations are set aside, too.

2. Defects Of the Tax System

The major defect of the German tax system (and of the systems of other industrialized countries, too) is the non-neutrality as to the individuals' choice between present and future consumption. Savings are discriminated because of the dominance of the income tax instead of a consumption tax.

Actually, the situation is even worse. Based on externalities, there are economic arguments in favour of subsidizing savings (Sinn 1989). Firstly, a case can be made for some subsidization of savings because of the uncomplete guarantee of property rights as to material resources (e.g. loss of property as a result of changes of the economic order, nationalization of property abroad) or because of positive utility externalities of private savings that are not taken account of in private savings decisions (relevance of the isolation paradox). Secondly, second best considerations may lead to the conclusion that present consumption should be taxed more than future consumption in order to have a kind of substitute for a tax on leisure that cannot be implemented directly; the assumption behind this is that leisure and present consumption are in a stronger relation of complementarity than leisure and future consumption (Sinn 1987a). It is not quite clear what the empirical relevance of the two arguments is; nevertheless, thus far the conclusion is that savings and/or investment are taxed too heavily.

There is another argument in favour of promoting investment (and/or savings). It says 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' confederations' responsibility for full employment; it would mean blurring responsibilities for the achievement of macro targets. Generally speaking, the problem of assignment of economic policy tools to economic policy targets is concerned.

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

Firstly, different forms of savings are taxed differently (e.g. exceptions for life insurance premiums); investment in inventory stocks is taxed higher than other investment, esp. investment in non-residential construction. Secondly, favouring real assets (e.g. by using the realisation principle as to capital gains or by admitting more than economic depreciation allowances) and thus discriminating financial assets together with increasing marginal tax rates 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 here is aggravated because discriminating financial assets means favouring financial liabilities, too.

Thirdly, equity financing of real capital formation is punished e.g. by a specific property tax ("Gewerbekapitalsteuer"); corporations are generally discriminated against. In detail: As to unincorporated firms debt financing of investment is cheaper than financing by equity issuance because the "Gewerbesteuer" has to be paid only on part of the debt and on part of the interest on debt; however, there is tax neutrality between financing by issuing new shares and financing by retaining profits. Comparisons as to the legal status of firms show that corporations financing by retained profits are taxed higher than unincorporated firms; this is due to the (additional) tax on the corporations' property and to the incomplete integration of the corporation and the

individual income tax (i.e. deferred tax credit for the corporations' tax on retained profits). In the case of debt financing, the corporations' marginal investment is taxed less than other firms' marginal investment. Finally, debt financing by corporations is taxed at a minimum rate, corporations' financing by retained profit is taxed at a maximum rate, if three kinds of financing and two kinds of the legal status are compared.

Fourthly, "income" is taxed even if it results from inflation only and thus is not real income. A point related to this is bracket creep, i.e. the increase of marginal tax rates as a result of inflation. Fifthly, the government shares the risk of investing money imperfectly. This relates 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. However, the point is also related to the tax treatment of innovation profits (Schumpeter 1918).

More recently, international tax policy made apparent some defects of the system and 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 a case can be made for comparable measures at home. Otherwise the real incomes of residents would be lower because more domestic or foreign capital would be attracted by foreign countries.

C. Policy Options

1. Options As To the Structure Of Reform

a) General Remarks

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.

Of course, risk-theoretic considerations and considerations on the international interrelations have to be added.

If capital income is taxed less and if overall taxation is not to be reduced, other taxes (e.g. the net value added tax) have to be increased despite of the fact that at least a partial self-financing of structural reform measures could be expected. However, any convincing reform proposal should include expenditure cuts as well as tax cuts - apart from structural tax reform measures that are described in this section.

b) Corrections On the Side Of Savers

Taxation of savers can be changed by different measures.

- Reduction Of the Personal Property Tax

Reducing the personal property tax means that the average capital income would be taxed less. The incentives to save would become stronger. However, existing wealth would be taxed less, too.

- Abolition Of the "Gesellschaftsteuer" and the Stock Exchange Transaction Tax ("Börseumsatzsteuer")

The "Gesellschaftsteuer" is an impediment to issuing equity capital by corporations. It should be abolished because of its discriminating effects (as to the different kinds of financing investment as well as to the kind of legal status chosen by firms). The stock exchange transaction tax has discriminating effects, too.

Both taxes are to be abolished as of 1991 according to an announcement of the government 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 distortions between different kinds of savings and it would result in less administrative difficulties: problems of measuring depreciation allowances, capital gains, etc. would not occur any longer (as to a German version of taxing consumption see Mitschke 1985). Finally, it would be a convincing solution from an equity point of view, too (Naust 1983).

- Promoting Savings By Tax Incentives

If applied generally, excluding savings from the income tax base would be the same as using consumption as a tax base. Specific tax incentives for savers, e.g. incentives only for low and middle income earners or for specific purposes, lead to shifts between different kinds of savings; distortions would necessarily result.

c) Corrections On the Side Of Investors

Tax incentives for the formation of real capital mean that the residents' investment abroad is indirectly discriminated, whereas - different from measures reducing taxes for the saver - domestic investment financed by foreigners is fostered. At first glance, favouring domestic investment might result in a misallocation of the world capital stock, although it is beneficial from a single nation's perspective; a precondition may be that a kind of withholding tax is levied on dividends flowing abroad. However, if other countries pursue the same policy, tax incentives for domestic investment may be adequate even from a world welfare perspective (Sievert et al. 1989).

- Reduction Of Taxes On the Firms' Capital Stock

The abolition of the "Gewerbekapitalsteuer" (tax on business property) is one of the possible (and mostly recommended) measures. The tax is a kind of super tax that cannot be found elsewhere (except in Luxemburg). It requires a marginal productivity of capital that is above the market rate of interest and thus discriminates (*ceteris paribus*) real capital formation.

The same is true for the property tax on business capital; therefore there is a case for abolishing it. A step in this direction is reducing the double taxation of the corporate sector's business property. This would alleviate the tax burden on investment (in real capital). For the time being the property concerned is taxed at the households' level as well as at the firm's level; by the way, threefold or manyfold taxation is possible. The results are discriminating equity capital issuing and punishing the choice of the optimal legal status of a firm.

Different measures are possible: The easiest solution is to abolish the corporations' property tax; however, such a measure would rely more upon the taxpayers' honesty than other possible new rules. On the other hand, a strong point in favour of abolishing the corporations' property tax is that foreigners would not be discriminated with no additional prescriptions being necessary.

- Indexation Of Depreciation Allowances, Of Changes In Inventory Stocks and Of Capital Gains

Indexing the tax system means legislating a formula that automatically removes the influence of inflation from real tax liabilities. Tax indexing is favourable not only because distortions are avoided (positive efficiency effects) but also because automatic tax increases and additional expenditures as a result of this cannot occur (positive efficiency effect in a polit-economic sense). Indeed, incentives for legislators to pursue inflationary policies would be removed by indexing income taxes.

Apart from indexing the rate structure of the income tax, i.e. avoiding bracket creep (as is the case in France, the U.K., the United States, etc.), any mismeasurement of income as a consequence of inflation could be avoided. This relates to prescriptions as to depreciation allowances, capital gains, inventory stocks (LIFO accounting as a minimum requirement) 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 (First Year Capital Cost Recovery System, Auerbach and Jorgenson 1980).

- Improving Depreciation Rules

Apart from indexation, other measures of 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, more than a 100 p.c. depreciation or anticipated allowances (favouring uninvested retained profits). Tax credits (taxable or tax-free cash grants) are another instrument of favouring investment. All these measures are also - though imperfect - substitutes for adjusting depreciation allowances in line with the inflation rate.

d) Corrections In the Taxation Of Capital Income

Apart from introducing measures on the side of savers and/or investors, some other options for reforming capital income taxation are possible. Some considerations are following up.

- Reduction Of the Marginal Income Tax Rates

The central point - in an economic perspective, not in the political debate - is reducing the top rate of the individual income tax. Of course, this can be done together with a broadening of the tax base or without it. Reducing the high marginal tax rates (increasing up to 53 p.c. as of 1990) would result in a lot of

favourable effects. First of all, it probably would increase savings. In addition, entrepreneurial activities would become more interesting; the negative effects in the case of uneven income (profit) flows would be reduced. The effects of non-indexation of the income tax would become less severe, too. Finally, the corporate income tax rate for undistributed profits could be reduced more easily without creating new distortions as to the choice of the legal status of the firm; this follows from the already high degree of integration of the individual and the corporation income tax in the Federal Republic of Germany.

As to the details: It would be best to abolish (directly) increasing marginal tax rates. Actually, there is no (economic) justification for having a progressive structure of tax rates (for a libertarian's view see von Hayek 1983).

- Income Averaging Before Taxing

In the system prevailing fluctuating incomes are taxed by inadequately high rates. One procedure to smooth taxable incomes is to offer Tax Reserve Certificates to the taxpayers (Meade 1978); these certificates should be indexed to inflation, however (Siefert et al. 1989).

- More Integration Of the Personal Income Tax and the Corporation Income Tax

The German income tax system is already characterized by a relatively high degree of integration (corporate income tax reform in 1976). Nevertheless, integration could be completed by attributing not only distributed profits, but also undistributed profits to the shareholders and 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 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). The (tax-inclusive) tax base is the difference between the receipts from sales of goods and services and the purchases of all real goods and services required in the production process (R base). Double-entry book-keeping implies that the tax base is 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).

The R base tax (Meade Committee 1978, King 1986) is characterized by

- immediate expensing of all investment expenditures (100 p.c. 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 savers' level (otherwise retained profits would be favoured; non-neutrality as to the kind of financing would occur), i.e. an expenditure (or consumption) tax instead of an income tax.

As to unincorporated firms the same rules would be necessary (Sievert et al. 1989). In addition, an imputed "wage" income of the entrepreneur(s) would have to be subtracted from the tax base. This "wage" income would be taxed - as wage incomes arising in corporations - by the consumption (or expenditure) tax. Negative tax payments or similar arrangements (e.g. tax reserve certificates) would be necessary in order to have an equal treatment of profits and losses.

The S or R+F base tax (Meade Committee 1978, King 1986) is neutral as to the intertemporal allocation of capital and the kind of financing investment, too (Sinn 1985). Its base is net payments to shareholders. A practical problem with such a tax is to

avoid tax evasion resulting from paying too high (deductible) interest income to the shareholders.

The treatment of overseas investment and profits remitted from abroad raises some problems, if a cash flow corporation tax is 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 is granted the government does 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 the period of transition to the new system would be necessary (King 1986). These relate to depreciation allowances not yet subtracted or "losses" that had been expected to be offset against future profits according to the "old" tax system.

A substitute for a cash flow tax was proposed by Sinn (1985). Contrary to the R base tax, firms could be allowed to deduct interest payments - as is the case now; interest income, however, had to be taxed at the receivers' level by the tax rate used at the firms' level (rate for retained profits). The other elements of the proposal are immediate expensing of investment expenditures, identical tax rates for retained profits and interest income of households (e.g. by applying a flat rate for capital income or by using the rate of the representative shareholder) and a tax on distributed profits (Sinn 1985).

The advantage of the proposal was presumed to be that it is not politically radical. However, the history of the German withholding tax on interest income ("Quellensteuer") shows that a precondition for the reform package being effective, namely taxing total capital income including interest income, can hardly be fulfilled. In addition, it would be advantageous or even necessary to use the source principle when taxing interest income; otherwise income is transferred to foreign countries because of the rise of the interest rate in relation to the real

before-tax rate of return to equity capital. However, as to interest income most international double taxation treaties are based on the residence principle of taxation.

Any cash flow taxation would mean more simplicity as well as intertemporal and intersectoral efficiency. The measurement of economic income would be removed from the concern of the tax authorities (King 1986). For example, the calculation of 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 were superfluous, too.

- Tax Preferences for Undistributed Profits

A preferential tax treatment of undistributed profits is called for by some employers' associations. However, this would impede the optimal allocation of capital among firms. New firms would be discriminated, too. Nevertheless, there are some foreign countries that decided upon such a measure (e.g. France).

e) Special Issue: Reforming the Taxes Of Municipalities

A problem strongly related to reforming capital income taxation in the Federal Republic of Germany is the question of revenue-sharing between the federal government, the Länder (states) and the local governments (municipalities). Currently, most of the revenues of the "Gewerbesteuer" that causes inefficiency in several respects flow to municipalities. These revenues amounted to 43 per cent of their total tax revenues in 1988. Thus reducing the "Gewerbesteuer" would create difficult distributional problems. These problems as well as the allocative aspects concerned cannot be dealt with in this paper. However, any solution should be based on fiscal federalism considerations. Possibly, the British solution, the introduction of a community charge or poll tax, is not too bad 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 might be a solution, too.

f) Risktaking, Entrepreneurial Activities, and Taxes

If taxes are to be cut: Is it better to reduce taxes on profits or taxes on business property?

Taxes on business property are bad taxes from a risk-theoretic point of view. They reduce the expected net return on investment expenditures without reducing the risk, i.e. the variance of the expected net returns. Taxes on property have to be paid even in the case of losses. This leads to the conclusion that property taxes should be reduced first. However, this is only part of the story (Sievert et al. 1989). Leaving taxes on property unchanged and cutting taxes on profits means that successful entrepreneurs - compared to those with less success - would be punished less. And these entrepreneurs may be those bearing risks that can be influenced by own entrepreneurial decisions as well as those who succeed in overcoming these risks. Actually, risk is not necessarily given; entrepreneurs may react on changes in the economic environment. In a sense, investment is a combined input of capital and entrepreneurial activity (Sievert et al. 1989). Low profit tax rates are favourable as to the entrepreneurs' efforts. Thus, any considerations of risk effects in a comprehensive sense do not lead to clear-cut conclusions as to the question posed.

2. Options As To the Amount of Tax Cuts

a) The Underlying Reasoning

If it could be taken for sure that the level of government expenditures is economically optimal, tax reform had not to result in tax cuts. However, a lot of expenditures (80 billions DM in 1988)

are subsidies that can be cut in order to increase (static) efficiency and competition (Klodt, Schmidt 1989). Thus there is room for cutting taxes without increasing the public sector's borrowing requirements.

All the measures should be steps towards the realization of a system dominated by a consumption tax. Actually, there should be tax rate reductions only. Distortions because of exemptions (loopholes) would become automatically smaller.

Of course, there are different options as to the amount of tax reductions along these lines. Three tax packages are presented below. All include without mentioning the abolition of the "Wechselsteuer", the "Gesellschaftsteuer" and the stock exchange transaction tax. The receipts from these taxes are about 1.7 billion DM or 0.3 p.c. of total tax revenues in 1989. However, the abolition probably would not mean that there are losses of tax revenues - at least in the medium run.

b) The Radical Solution

If subsidies in the form of government expenditures are reduced, there is much room for cutting taxes. As an example, it is possible to reduce these subsidies by 50 per cent (40 billions DM or about 2 p.c. 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 40 or even 36 per cent, the rate for distributed profits of corporations. In addition, the property tax for corporations and the "Gewerbekapitalsteuer" could be abolished; this would mean - in a static sense - tax revenue losses for the public sector in the range of about 4 billions DM.

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 some measures see Sievert et al. 1989). Nevertheless the income tax rates would have to be reduced further until a kind of consumption tax system (zero effective tax rates on investment, perhaps supplemented by a personal property tax) would emerge. However, the opposition against such a reform would be strong, mainly because of distributional or equity considerations.

c) A Significant Improvement

An advisory committee, the "Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Lage", proposed a different reform package that is more in line with the 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. In addition, according to the committee the "Gewerbsteuer" should be replaced by a local net value-added for municipalities.

D. The Probable Outcome Of the Tax Reform Debate

The actual result of the tax reform efforts in the Federal Republic of Germany probably will be quite different from what could be seen as a significant step towards more efficiency. Presumably, the taxation of the corporations' property will be reduced somewhat, the "Gewerbesteuer" will be abolished, the top income tax rate and the corporation income tax rate could be brought down to e.g. 48 percent. Apart from this, the taxes on capital transactions probably will be abolished. The tax cut could be some 25 billions DM (1 p.c. of GNP) as of 1993.

E. Concluding Remarks: International Interrelations and Repercussions - Tax Competition or Harmonization?

Because of the high degree of capital mobility any 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. Possibly, the tax reform movement in Germany is itself driven by tax reforms abroad. If tax competition in such a way would arise this would be a favourable outcome and would not necessarily be an argument for any harmonization measures within the EC or even the Western world.

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