

# DIW Berlin

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## **Tax Reform in Germany: Cutting high tax rates on labor, business and capital income, increasing consumption taxation**

Danish Embassy Berlin  
June 19, 2006

## Boost economic performance: The sick man of Europe recovers

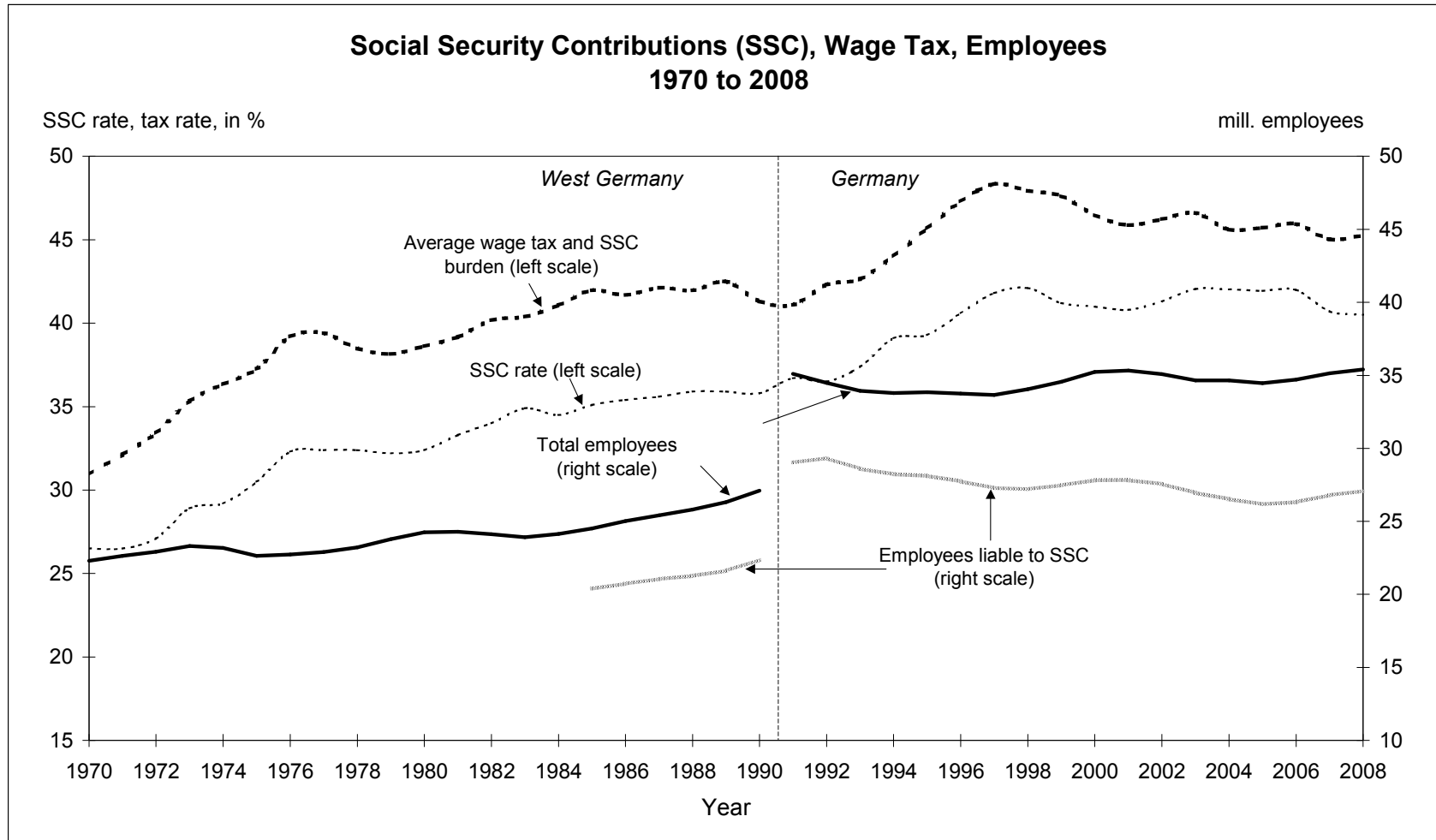
- Remarkable economic growth
  - 2006: +2.7 % real GDP y/y change
  - Robust upturn expected 2007 & 2008 (+2.4 %)
  - After 4 years of paralyzing stagnation
- Despite or because of the reforms?
  - First of all: Regular business cycle
    - Ongoing export boom
    - Sustainable wage moderation, improvements in productivity, strongly increased competitiveness
    - Rebound of private consumption, despite VAT increase
    - Backlog demand in private and public investment
    - Neutrality of monetary and fiscal policy
  - Structural reforms remain at top of agenda
    - Labor market, social security, tax system

## Major tax reform issues

- High burden on labor income
  - High social security contribution (SSR) rate
  - Strong income tax progression
- High tax rate on business profits
- Tax reform agenda
  - Unburden wage income, taxing consumption
  - Reforming and re-financing social security
  - Business tax reform
    - Tax cut and base broadening

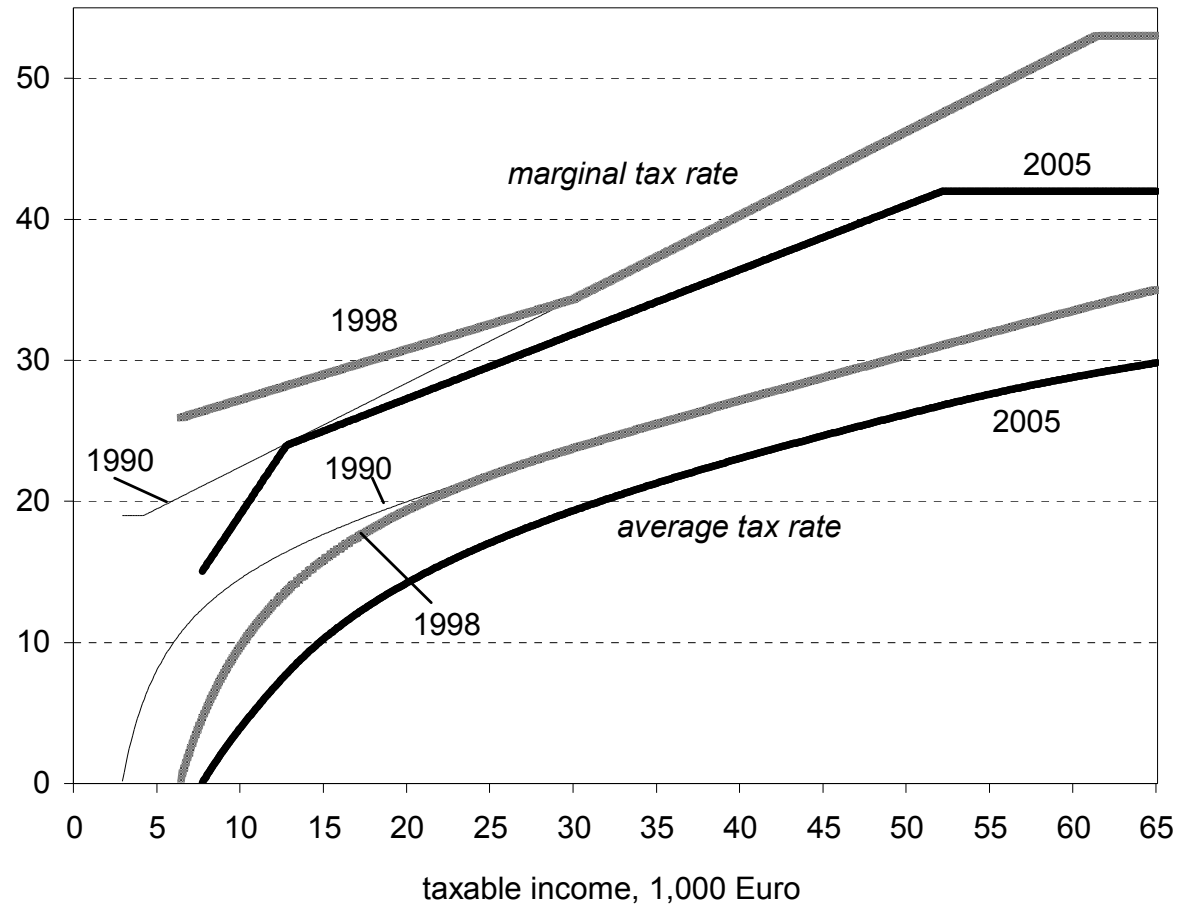
## High tax burden on labor income

- High social security contribution (SSR) rate
  - 39.8 %
    - Pension: 19.9 %, Health: 14.0 %, Unemployment: 4.2 %, Long-term care: 1.7 %
  - Levied on wage income up to an income threshold:
    - Pension, unemployment: Euro 63,000
    - Health: Euro 43,000
  - Exemptions for marginal employment up to Euro 400 per month (“minijobs”)
  - Self employed, civil service are basically not covered
- Strong income tax progression
  - 15 % - 42 % > Euro 52,000 taxabl. income, 45 % > Euro 250,000 taxabl. income
  - solidarity surcharge 5.5 %



## Income tax schedule 1992, 1995, 1998 and 2005

Marginal and average tax rate as % of taxable income



## VAT/General Sales Taxes in Selected OECD Countries

Country	Tax system 2006	Tax rates 2006 in percent			Tax revenue as percentage of GDP			
		Standard rate	Reduced rate	Zero rate <sup>1)</sup>	1995	2000	2003	2004
<b>European Union</b>								
Germany	EU VAT	16	7	no	6,5	6,8	6,4	6,2
France	EU VAT	19,6	2.1; 5.5	no	7,5	7,5	7,2	7,4
Belgium	EU VAT	21	6; 12	yes	6,7	7,3	6,9	7,1
Netherlands	EU VAT	19	6	no	6,3	6,9	7,3	7,3
Austria	EU VAT	20	10; 12	no	7,7	8,0	7,9	7,9
Luxembourg	EU VAT	15	3; 6; 12	no	5,2	5,6	5,6	6,0
Denmark	EU VAT	25	-	yes <sup>2)</sup>	9,4	9,5	9,6	9,7
Sweden	EU VAT	25	6; 12	yes	9,3	8,9	9,2	9,2
Finland	EU VAT	22	8; 17	yes	7,9	8,3	8,7	8,6
United Kingdom	EU VAT	17,5	5	yes	6,7	6,7	7,0	7,0
Ireland	EU VAT	21	4.8; 13.5	yes	6,9	7,3	7,1	7,4
Italy	EU VAT	20	4; 10	yes	5,5	6,5	5,9	5,9
Spain	EU VAT	16	4; 7	no	5,1	6,0	5,9	6,0
Portugal	EU VAT	21	5; 12	no	7,1	8,0	8,1	7,9
Greece	EU VAT	19	4.5; 9	no	7,3	8,1	8,6	8,5
Poland	EU VAT	22	7	yes	6,3	7,1	7,4	7,5
Czech Republic	EU VAT	19	5	no	6,3	6,6	6,4	7,4
Slovak Republic	EU VAT	19	-	no		7,4	6,7	7,7
Hungary	EU VAT	20	5; 15	no	8,2	10,1	9,9	10,9
<b>Other Europe</b>								
Norway	VAT	25	8; 13	yes	8,7	8,7	8,6	8,5
Switzerland	VAT	7,6	2.4; 3.6	yes	3,3	4,0	3,9	4,0
Turkey	VAT	18,0	1; 8	no	7,0	7,8	8,2	7,1

1) Zero rate: Besides export trade, tax is applied at a rate of zero to certain domestic sales, including input tax credit.- 2) Newspapers.- 3) Foodstuffs and parts of other necessities are usually tax exempted.- 4) In some provindes harmonized provincial and federal VAT of 15 %.

Sources: BMF (2007); OECD (2007); European Commission (2005).

## Tax Reform of the Great Coalition 2007

- “Haushaltsbegleitgesetz 2006”
- Increase standard VAT rate from 16 % to 19 %
  - Reduced rate remains at 7 %
- Additional revenue of about 1.2 % GDP
- Reduction of social security contribution (SSC) rate by 1.6 %-points on balance
  - Reduction of unemployment rate by 2 %-points
  - Increase of pension rate by 0.4 %-points
- Budget consolidation



## Distributional effects of the VAT/SSC reform by income decile without and with behavioral adjustment of savings and consumption

Deciles net equivalent household income <sup>1)</sup> , inequality measures	VAT reform		VAT/SSC reform	
	without behavioral adjustment of savings and consumption	with behavioral adjustment of savings and consumption	without behavioral adjustment of savings and consumption	with behavioral adjustment of savings and consumption
	Effect on tax revenue			
bill. Euro	16 623	14 972	5 460	3 808
% GDP	0.77	0.69	0.25	0.18
	Change in tax burden relative to disposable household income <sup>2)</sup> in percentage points			
1 <sup>st</sup> decile	1.68	1.51	1.27	1.10
2 <sup>nd</sup> decile	1.51	1.36	0.78	0.63
3 <sup>rd</sup> decile	1.45	1.30	0.55	0.40
4 <sup>th</sup> decile	1.39	1.25	0.43	0.28
5 <sup>th</sup> decile	1.38	1.23	0.42	0.28
6 <sup>th</sup> decile	1.33	1.20	0.34	0.21
7 <sup>th</sup> decile	1.29	1.16	0.29	0.17
8 <sup>th</sup> decile	1.25	1.13	0.25	0.13
9 <sup>th</sup> decile	1.19	1.07	0.29	0.17
10 <sup>th</sup> decile	0.97	0.88	0.35	0.25
Total	1.26	1.13	0.41	0.29
1) Equivalence scale: square root of the number of household members.- 2) Net household income plus other earnings (e.g. from household production, from refunds on purchases, from daily allowances). Source: German Income and Consumption Survey (EVS) 2003; own calculations.				

## Distributional effects of the VAT/SSC reform by income decile and occupational status of the principal earner with behavioral adjustment of savings and consumption

Deciles net equivalent household income <sup>1)</sup>	Self-employed	Civil servant	White-collar employee	Blue-collar employee	Unemployed	Pensioner	Other non-employed	Private households total
	Shift in tax burden relative to disposable household income <sup>2)</sup> in percentage points							
1 <sup>st</sup> decile	2.31	1.78	0.10	- 0.04	1.36	1.32	1.61	1.10
2 <sup>nd</sup> decile	1.49	1.33	- 0.26	- 0.25	1.20	1.27	1.43	0.63
3 <sup>rd</sup> decile	1.47	1.23	- 0.44	- 0.30	1.18	1.23	1.36	0.40
4 <sup>th</sup> decile	1.23	1.20	- 0.52	- 0.28	1.09	1.19	1.07	0.28
5 <sup>th</sup> decile	1.30	1.15	- 0.52	- 0.31	1.02	1.20	1.23	0.28
6 <sup>th</sup> decile	1.18	0.99	- 0.57	- 0.37	0.88	1.22	1.09	0.21
7 <sup>th</sup> decile	1.15	0.96	- 0.49	- 0.37	0.83	1.13	1.30	0.17
8 <sup>th</sup> decile	0.97	0.97	- 0.55	- 0.45	0.98	1.18	0.97	0.13
9 <sup>th</sup> decile	0.97	0.87	- 0.55	- 0.49	0.70	1.07	1.20	0.17
10 <sup>th</sup> decile	0.81	0.76	- 0.44	- 0.17	0.61	0.88	1.07	0.25
Total	1.00	0.89	- 0.48	- 0.34	1.14	1.13	1.40	0.29
	For information: private households in 1 000							
Total	2 218	1 635	11 222	6 498	2 071	12 645	1 821	38 110

1) Equivalence scale: square root of the number of household members.- 2) Net household income plus other earnings (e.g. from household production, from refunds on purchases, from daily allowances).

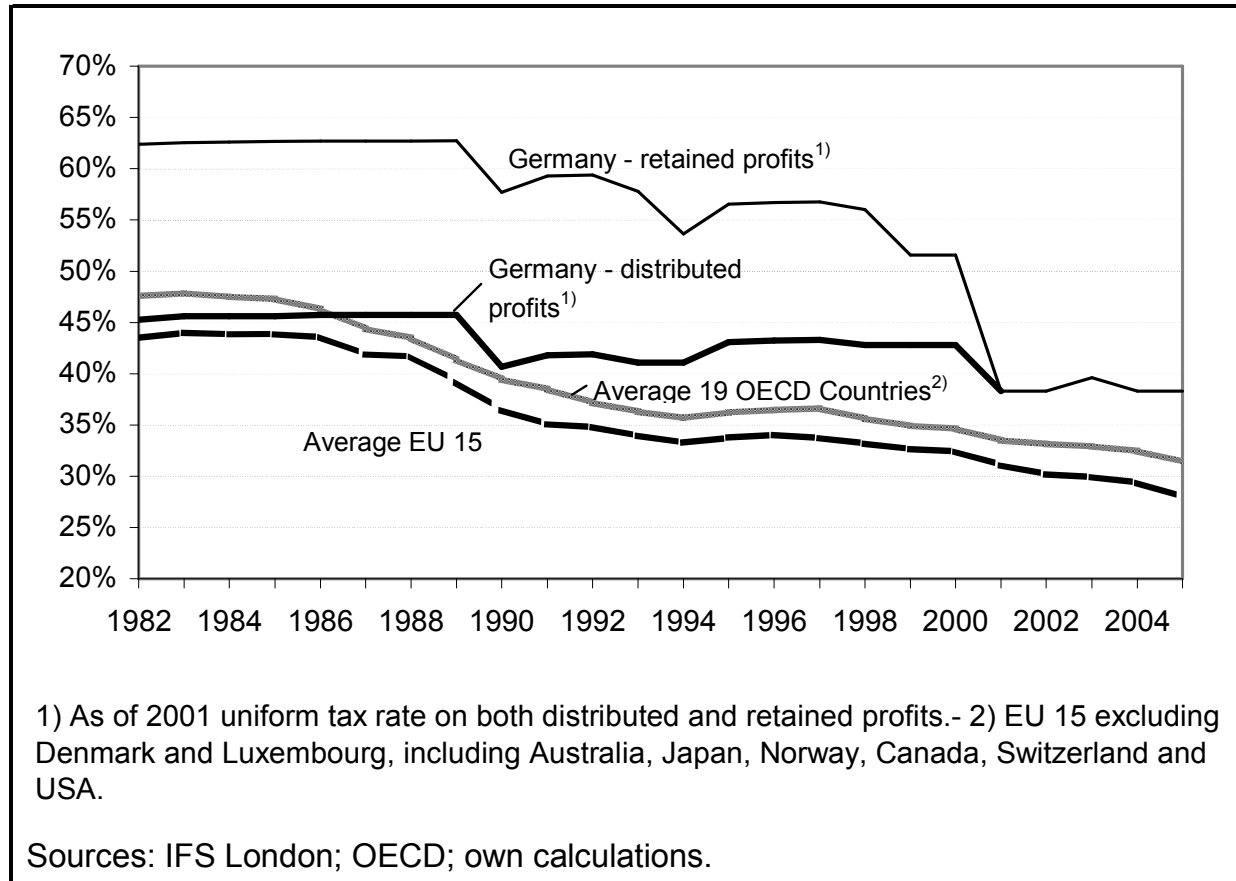
Source: German Income and Consumption Survey (EVS) 2003; own calculations.

## Economic effects of the tax reform 2007

- First-round reduction of net household incomes
  - by 1.3 %-points: VAT alone
  - by 0.4 %-points: VAT/SSC reform
  - slight increase in inequality measured by current income
  - higher burden for households paying lower SSC
    - unemployed, employees in “marginal jobs”, pensioners, self-employed, civil servants
- Labor supply increases by 110 000 people (full-time equivalent)
  - 70 000 women, 40 000 men
  - upper bound of the possible employment effect
    - wage adjustments or demand-side rationing effects

**Statutory Tax Rates on Corporate Profits in International Comparison 1982-2005**

Company/Subsidiary level, excluding taxation of distributed profits at the shareholder level including sub-central and local government income tax rates



## Statutory Tax Rates<sup>1)</sup> on Corporate Profits (Company Level) 2006

Country	Central government corporate income tax rate <sup>2)</sup>	Sub-central gov. corp. income tax rate <sup>3)</sup>	Combined corporate income tax rate		Change in combined corporate income tax rate			System of Corporate Income Taxation (domestic shareholders)	
	%	%	%	% level Germany	2006/2000	2006/1991	2006/1985	2006	1991
					%-points	%-points	%-points		
Germany	26.375 (25.0)	17.0	38.9	100.0	-8.8	-14.5	-20.0	classical, relief	full imputation
France	34.4	-	34.4	88.4	-3.4	0.4	-15.6	classical, relief	part. imputation
Belgium	33.99 (33.0)	-	34.0	87.4	-6.2	-5.0	-11.0	classical, relief	classical, relief
Netherlands	29.6	-	29.6	76.1	-5.4	-5.4	-12.4	classical, relief	classical
Austria	25.0	-	25.0	64.3	-9.0	-14.0	-35.0	classical, relief	classical, relief
Luxembourg	22.88 (22.0)	7.5	30.4	78.1	-7.1	-9.0	-14.6	classical, relief	classical
Italy	33.0	4.25	37.3	95.8	-4.0	-10.6	-9.1	classical, relief	full imputation
Spain	35.0	-	35.0	90.0	0.0	0.0	0.0	part. imputation	part. imputation
Portugal	25.0	2.5	27.5	70.7	-7.7	-12.1	-27.6	classical, relief	classical, relief
United Kingdom	30.0	-	30.0	77.1	0.0	-4.0	-10.0	part. imputation	part. imputation
Denmark	28.0	-	28.0	72.0	-4.0	-10.0	-12.0	classical, relief	classical, relief
Finland	26.0	-	26.0	66.8	-3.0	-14.2	-34.2	classical, relief	full imputation
Sweden	28.0	-	28.0	72.0	0.0	-2.0	-32.4	classical, relief	classical, relief
Ireland	12.5	-	12.5	32.1	-11.5	-27.5	-37.5	classical	part. imputation
Greece	29.0	-	29.0	74.5	-11.0	-17.0	-15.0	classic., ex.	classic., ex.
Norway	28.0	-	28.0	72.0	0.0	-22.8	-23.0	classic., dit	classic., ex.
Switzerland	8.5	14.6	21.3	54.8	-3.6	-8.7	-8.7	classical	classical
Turkey	30.0	-	30.0	77.1	-3.0	-19.2	-16.0	part. imputation	full imputation
United States	35.0	6.6	39.3	101.0	-0.1	1.0	-11.0	classical, relief	classical
Canada	22.1(21.0)	14.0	36.1	92.8	-8.5	-0.3	-9.0	part. imputation	part. imputation
Japan	30.0	11.6	39.5	101.6	-1.3	-10.4	-16.6	part. imputation	part. imputation
Australia	30.0	-	30.0	77.1	-4.0	-9.0	-19.0	full imputation	full imputation
New Zealand	33.0	-	33.0	84.8	0.0	0.0	-12.0	full imputation	full imputation
<i>Mean (unweighted)</i>	27.6	9.8	30.6	78.5	-4.4	-9.3	-17.5		
<i>Standard Deviation</i>	6.4	4.9	6.1		0.1	-0.4	-1.8		

1) Non-targeted central, sub-central and combined statutory corporate income tax rates. Where a progressive rate structure applies, the top marginal rate is shown.- 2) Statutory (flat or top marginal) corporate income tax rate, measured gross of a deduction (if any) for sub-central tax. Where a surtax applies, the statutory corporate rate exclusive of surtax is shown in round brackets ( ).- 3) Combined (average) state/regional and local statutory corporate income tax rate, inclusive of sub-central surtax (if any).

Sources: OECD Tax Database (2007); IFS (2007); KPMG's Corporate Tax Rate Survey (2006); BMF (2007).

## Statutory Tax Rates on Corporate Profits (Company Level) 2006 in the New EU Member Countries

Country	Corporate Income Tax Rate			System of Corporate Taxation (domestic shareholders) 2006
	%	% level <i>Germany</i>	Change 2006/2000 %-points	
Poland	19	48.8	-11.0	classical, relief
Czech Republic	24	61.7	-7.0	classical, relief
Slovak Republic	19	48.8	-10.0	classic., ex.
Slovenia	25	64.3	0.0	classical, relief
Hungary	16.64(16.0)	42.8	-1.4	classical, relief
Estonia	0/24 <sup>1)</sup>	30.8	0/-2.0 <sup>1)</sup>	classic., ex.
Latvia	15	38.6	-10.0	classic., ex.
Lithuania	15	38.6	-9.0	classical, relief
Cyprus	10	25.7	-19.0	classic., ex.
Malta	35	90.0	0.0	full imputation
<i>Mean (unweighted)</i>	<i>19.1</i>	<i>49.0</i>	<i>-6.8</i>	
<i>Standard Deviation</i>	<i>7.0</i>		<i>0.8</i>	

1) Tax rates on retained/distributed profits.  
Sources: OECD Tax Database (2007); KPMG's Corporate Tax Rate Survey; BMF (2007).

# Reform Agenda on Business Taxation

- High statutory tax rates
- Effective tax rates and tax revenue only lower
- Manifold tax planning schemes at the expense of the internal revenue
  - Hidden reserves, tax accounting policy
  - Profit shifting to abroad
    - **Via:** transfer pricing, holding services, cross-border financing, royalty management, leasing
- Domestic distortions
  - Legal form, financing (debt over equity), investment decisions
- Complex and complicated tax law, high compliance and administration costs
- Tax enforcement must be improved

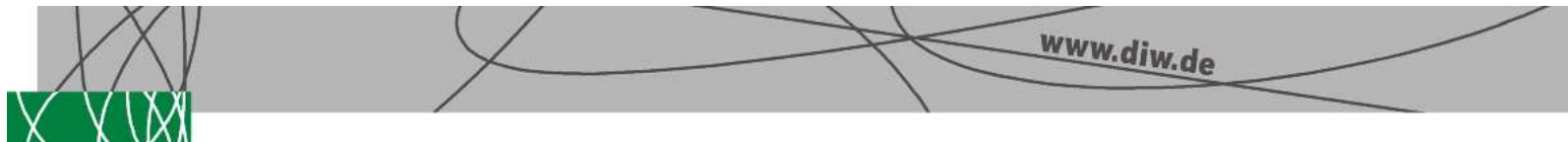
## Reform proposal Great Coalition

- Substantial decrease in tax rates
  - Tax burden of corporations reduces to below 30 %
    - Reduction of corporate income tax to 15%
    - Reduction of local business tax rate
  - Final tax on capital income of 25%
- Broadening the tax base by fighting tax avoidance
  - Earnings-stripping procedure against excessive external debt financing
  - Provisions against profit shifting via relocation of high profit functions to abroad
  - Abolition of declining-balance depreciation
- Nearly revenue-neutral
  - Tax deficit Euro 5 bill., 0.2 % GDP



# Conclusion Business Tax Reform Proposal

- Reducing statutory tax rate to 30 % reasonable
  - Meets European and international tax competition
  - Reduces incentives for tax avoidance
- Broadening the tax base rather discretionary
  - Infringes tax neutrality and equality
  - Tax law becomes more complicated
- Business tax reform still at the agenda
  - Local business taxation
  - International coordination of business taxation
    - EU common tax base
    - Coordination of transfer pricing and tax competition



**Thank You for Your Attention!**