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Tax-Cut Time for Germany?

A weakening economy has rekindled an old debate: does Germany need tangible tax relief for its workforce and enterprises in order to remain internationally competitive? Or should taxes go up to provide more funds for social programs and public investment?

Higher taxes create more room for government expenditure, while lower taxes limit the state's spending capacity. The choice between these options is a political matter. But one general approach that might garner cross-party support in Germany would be to ensure that the share of economic output claimed by the public sector neither increases nor decreases over the medium term.

In fact, the ratio of taxes and social-security contributions to GDP in Germany has been increasing for years. A reference point for deciding the overall tax burden could be the year 2014, in which net new debt for the federal budget fell to zero. At that time, tax revenue (including contributions) amounted to 38.6% of GDP. By 2018, the ratio had risen to 39.8%.

Similarly, the tax-to-GDP ratio, excluding social contributions, has also increased significantly, from 22.1% in 2014 to 22.8% last year. By 2020, it will exceed 23%. The main reason for this is that inflation and earnings growth are pushing increasing numbers of income-tax payers into higher rate brackets. Bringing the tax-to-GDP ratio back to its 2014 level would require tax relief in 2020 to the tune of €34 billion ($38 billion). Even to reach the 2017 level, the government would have to lower the tax burden by €22 billion.

But which particular taxes should be cut? Canceling the solidarity-tax, a surcharge on income tax, would be a good place to start. This tax was introduced on the understanding that it would be levied only temporarily to finance the reconstruction of the former East Germany following reunification. Thirty years on, it's time to make good on this promise.

The argument that the end of the solidarity tax would be an unwelcome “gift to the rich” skews the facts. The truth is that its introduction was a special measure that predominantly hit the “rich.” Any German political party eager to tax higher-wage earners more heavily should be campaigning to reform income-tax rates, not block the overdue retirement of the solidarity tax.

The view that it would make more sense to direct the money raised from the solidarity tax toward public investment is also unconvincing, because there is no shortage of funds available for investment. At the same time, government final-consumption expenditure is increasing massively, and redistribution programs often fail to target the poor. The failure of infrastructure projects in Germany owes more to protracted planning processes and resistance from local communities than to a lack of funds.

Urgent action is also required on corporate tax. In Germany, the standard tax rate for companies' retained earnings is around 30%, which is significantly higher than in similar countries. Among the G7, only France's 33% rate is higher, and this will drop to 28% in the coming years, with further reductions to 25% already agreed. To prevent a reduction in tax revenue through companies shifting profits abroad, and to keep investment and jobs in Germany, the federal government should follow France's lead and also gradually reduce the corporate-tax burden toward 25%.

Opponents of corporate-tax reform assert that Germany's high export surplus shows there is no need to make its economy even more competitive. But this is simply wrong. Anyone making that argument is confusing companies' export potential with Germany's attractiveness as a location for investment and jobs.

Germany's export surplus is accompanied by net capital exports, because more investments are being made abroad than at home. Lowering corporate taxes would change that. According to current estimates, if the tax rate were to drop from 30% to 25%, companies in Germany could increase investment by up to 14%. What's more, owing to reduced tax avoidance, profits recorded in Germany would rise by some 4%. All in all, this means corporate-tax reforms could be roughly revenue-neutral.

And there is a final compelling argument for tax relief. It would force German politicians to reexamine existing government expenditure and priorities, instead of always readily serving up new spending programs simply because abundant funds seem to be available.

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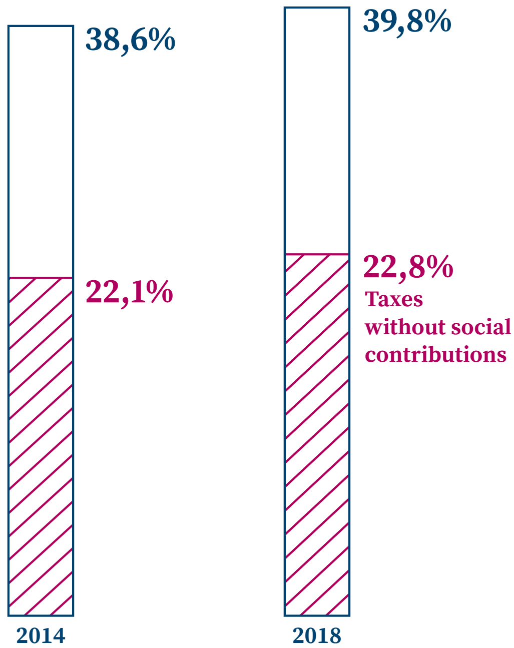
TAX AND CONTRIBUTION
Burden has risen steadily since 2014



Source: ifo Institute.