Recent tax revenue trends

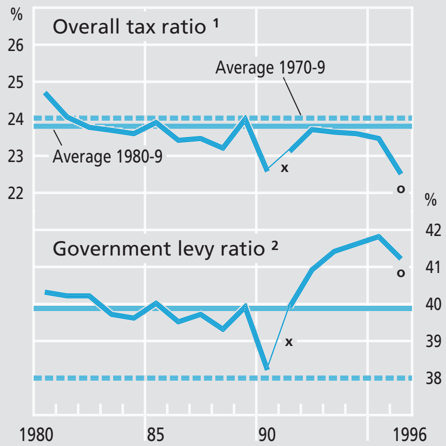
The correlation between economic growth and tax revenue trends in Germany has become less rigid in the past few years. Despite continual tax increases until 1995 (tax relief did not come until 1996), the tax ratio has been tending to decline. Firstly, this was due to the partially delayed effects of the economic recovery, which set in after 1993, on revenue trends. Secondly, the substantial use of special tax concessions and opportunities to achieve the most favourable tax results caused an erosion of the tax base, which, on top of the cyclically-induced reductions after 1995, led to surprisingly large shortfalls in government receipts. This structural tax weakness, which is continuing in the current year, could be counteracted by a tax reform which with lower tax rates and fewer exemptions would reduce the attractiveness of tax avoidance strategies – including recourse to foreign finance centres – or restrict their use and which would therefore permanently improve the allocation of the factors of production at the same time.

Basic trends

Tax ratio tends to decline…

In the past few years the budgetary situation of the central, regional and local authorities has been marked by a perceptible decrease in receipts, resulting from the unfavourable trends in tax revenue. Whereas tax receipts had grown significantly during the first two

Overall tax ratio and government levy ratio



1 Tax revenue as a percentage of the nominal gross domestic product. — **2** Tax revenue and receipts of social security contributions as a percentage of the nominal gross domestic product. — **x** From 1991 onwards, the figures refer to the whole of Germany. — **o** Slightly more than ½ percentage point of the decline in 1996 was attributable to the conversion in booking child benefit.

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years after German unification, owing to the initial economic boom that unification set in motion and the tax increases that were necessary to finance the process of unification,[1] they grew only moderately during the period from 1993 to 1996, with distinct differences from year to year. Total tax receipts have grown by an average of only 2¼% during the past four years; even if the conversion of child benefit to a tax-reducing factor at the beginning of 1996 is excluded,[2] tax receipts have increased by no more than approximately 3% per year.

Consequently, the rise in tax receipts has no longer kept pace with developments in the underlying macroeconomic base either; between 1993 and 1996, nominal gross domestic product grew by an average of just over 3½%. What is more, the overall tax ratio – the relationship between tax receipts and nominal GDP – declined successively whereas it had increased sharply in the first two years after unification. After adjustment for the conversion of child benefit, it was still 23.2% (as defined in the financial statistics) in 1996 and thus just over ½ percentage point lower than in 1992.[3] This reduction in the tax ratio is only partially attributable to last year's easing of the tax burden, especially as increasing taxes had prevailed over tax relief measures for budgetary reasons until 1995. This remarkable trend reflected several factors – to be discussed below – which impaired the improvement in the revenue trends actually expected in view of the economic recovery after 1993.

... despite even greater tax burden

In contrast to the tax ratio, the share of social security contributions in GDP has continued to increase during the past four years. In 1996 the ratio of social security contributions (as defined in the financial statistics) reached 18.7% and thus was 1½ percentage points

1 For further details see Deutsche Bundesbank, Trends in tax revenue since 1990, Monthly Report, March 1993, page 17 ff.
2 Here the trends in tax revenue are merely adjusted for the reductions in the public authorities' balance-sheet totals resulting from transferring child benefit from the expenditure side to the revenue side; at around DM 20 billion, the effect of this transfer is the same as in the case of the former child benefit payments. The improvements in the family allowance system made since 1996 are treated as a reduction in the tax burden.
3 If the definition used in the national accounts is applied, the reduction in the tax ratio, at ¾ percentage point, was even more distinct because in 1996 the "coal penny", which had been included in the taxes in this classification, was abolished. Furthermore, the tax ratios determined on the basis of the national accounts are generally slightly higher than those determined on the basis of the tax revenue statistics, especially as they contain various tax-like public levies and as some tax concessions here are entered as gross amounts; last year the difference was 0.6 percentage point.

higher than in 1992, pushing up ancillary labour costs even further and perceptibly increasing the cost of employing labour. This increase reflected the rise in the contributions to the statutory health insurance and pension schemes as well as the introduction of the obligatory nursing care insurance scheme in 1995. As a consequence of higher social security contributions, the total ratio of levies in Germany continued to grow, in spite of a decrease in the tax ratio; at almost 42 % of GDP (as defined in the financial statistics and adjusted for the conversion of child benefit), it exceeded the level of 1992 by slightly less than 1 percentage point in 1996. The burden of taxes and social security contributions in Germany continues to be among the highest by international standards, too (see the adjacent table); although it is only slightly above the EU average, it is the second-highest (after France) among the seven major western industrial countries.

Burden of taxes and other government levies on an international comparison in 1996

Country	Government levy ratio [1]		Percentage of total tax revenue	
	Total	of which Tax ratio	Direct taxes	Indirect taxes
Sweden	54.2	38.1	58.8	41.2
Denmark	52.8	49.7	62.7	37.3
Belgium	46.4	31.1	58.5	41.5
France	46.3	24.9	39.6	60.4
Austria	45.5	29.9	50.2	49.8
Netherlands	44.8	26.6	49.9	50.1
Federal Republic of Germany	42.9	23.1	44.5	55.5
Italy	42.9	27.4	55.5	44.5
Switzerland	41.1	22.4	67.3	32.7
Portugal	39.1	25.7	40.9	59.1
Canada	36.3	31.0	56.6	43.4
Spain	35.5	21.7	53.5	46.5
United Kingdom	33.9	27.7	45.6	54.4
United States	31.8	22.7	64.0	36.0
Australia	31.5	31.5	56.3	43.7
Japan	28.6	18.2	55.9	44.1

Source: OECD. — **1** Taxes and social security contributions as a percentage of GDP. The figures in this table are based on the national accounts, in which – in contrast to the revenue data used elsewhere in this article – the tax revenue is shown before deduction of certain concessions (such as investment grants) and wage tax revenue is shown with a time-lag of one month. Hence the ratios and percentages for Germany given in this table differ to some extent from those of the financial statistics.

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Further tax increases in conjunction with selective tax relief until 1995

Conflicting requirements

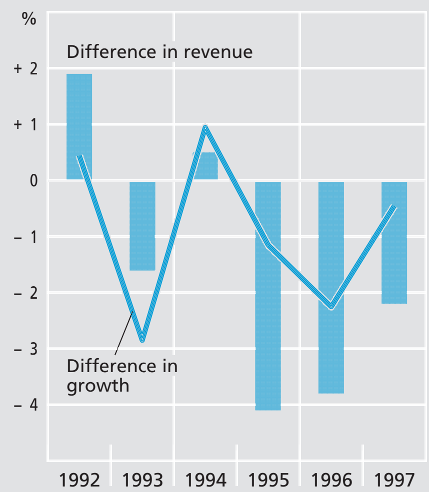
Taxation policy has been characterised by conflicting requirements during the past four years. On the one hand, it has continued to serve budgetary policy purposes, owing to the considerable financial burdens associated with unification. On the other hand, a considerable need for tax relief measures has built up. This has been due to conditions imposed by the Federal Constitutional Court and to macroeconomic requirements resulting from the deteriorating employment situation and the ever increasing international competition in tax levels. This conflict of objectives was solved to a certain extent in the period from 1993 to 1995 by combining further tax increases with selective tax relief.

Tax shortfalls in the recession of 1993

In 1993 this taxation policy stance became particularly evident in the fact that, on the one hand, trade and wealth tax concessions to enterprises came into effect while, on the other, the standard rate of value-added tax was raised by 1 percentage point (to 15 %). Furthermore, two new provisions had to be introduced following decisions by the Federal Constitutional Court. In line with these, the tax on interest income was introduced. This constituted a deduction at source from interest credited or disbursed in Germany to taxpayers resident in Germany. The aim was to ensure that the tax treatment of such income was more consistent. In addition, in anticipation of a subsequent and more comprehensive ruling, the minimum subsistence level for people in the lower income brackets was exempted from tax by a provisional solution outside the agreed pay scales. On the whole, tax increases predominated in 1993. They were counterbalanced, however, by the abolition of the solidarity surcharge in mid-1992, which had been in force for only one year.

The changes in tax legislation occurred during a period which was characterised by a recession in the west German economy following the earlier "unification boom". This boom with its dislocations – particularly in the form of sharp wage increases – had already borne the seed for the subsequent crisis. As a result of the cyclical downturn, tax receipts in 1993 grew by no more than just under 2 ½ %,

Deviations of tax revenue and nominal GDP from original expectations *



* In % or percentage points of tax revenue or nominal economic growth, respectively, according to the official estimates of autumn 1996. The deviations shown for 1997 are based on the forecast of May 1997.

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compared with an increase of more than 10 % the year before. They were therefore DM 12 billion below the comparable forecast in the autumn of 1992, whereas during the previous economic boom they had gone far beyond expectations.

Additional receipts limited in 1994 despite a strong economic upswing

Although the increase in tax receipts accelerated (to almost 5 %) in 1994, it did not quite keep pace with nominal economic growth. While economic recovery distinctly exceeded original expectations, tax receipts were only DM 4 billion more than estimated. In the case of assessed taxes, the scene was largely dominated by the preceding period of weakness. At a time of moderate wage trends and a continuing decline in employment economic growth was also relatively unsuccessful at providing additional tax receipts.

Furthermore, the taxation policy, which had been predominantly geared towards further improvements in the receipts situation, did not yield the desired results. Although the increase in mineral oil tax to help finance the reform of the railways led to significant additional receipts, the Industrial Location Protection Act, intended to improve the underlying tax conditions for enterprises, was much more costly for the tax authorities than originally envisaged. The loss of revenue expected from this legislation was considerably underestimated, especially as a result of a transitional regulation on profit distribution (see page 92 f.). This shortfall, incidentally, resulted from a lowering of the tax rates on earnings, which had been rather high by international standards. It had been intended to keep it within bounds by limiting the scope of various tax concessions and loopholes.

Underlying deficiency of the taxation system apparent in 1995

The fact that German fiscal policy makers were in a situation that was characterised by an underlying deficiency of the taxation system first became apparent in 1995. Although at that time additional tax increases of around DM 30 billion – including, in particular, the new solidarity surcharge – were becoming effective, tax receipts continued to rise at a slower rate (around 3½ %) than would have been consistent with the nominal economic growth rate (which had moderated perceptibly anyhow). On the whole, tax receipts in 1995 were just over DM 35 billion short of the return expected in the autumn of 1994. Only a small proportion of this shortfall was attributable to the slackening of the economic driving forces. Not only further after-effects of the earlier period of economic weakness then became visible; clear signs of an erosion of the domestic tax base then became apparent, too, and this erosion of the tax base had to have more deep-rooted causes.

Extensive relief measures reintroduced in 1996

Annual Tax Act 1996

The disappointing trend in tax receipts continued during 1996 when extensive relief measures came into force again for the first time in a long while. For example, a new income tax scale was implemented although this brought relief only to some tax-payers. The corrective measures were limited to a sharp rise in the basic allowance, but the relief arising from this was successively reduced again by a new scale segment affecting lower and middle-income levels. The taxpayers in eastern Germany – whose income is still generally lower than that in the west – particularly benefited from this restructuring. By contrast, recipients of higher incomes did not gain at all from the tax relief, and in the lower income brackets the reduction in the average burden had to be payed for by higher general marginal tax rates than before, which amounts to an aggravation of the progression. The tax relief for lower income groups was accompanied by a distinct improvement in the family allowance system which, like the raising of the basic tax allowance with a view to exempting those at the subsistence level, was required for constitutional reasons. It was combined with a reorganisation of the system which involved moving child benefit – which now impinges on tax revenue – into the forefront ahead of the tax allowance for children (which is now granted only as an alternative to child benefit). All in all, the tax package led to tax relief of approximately DM 21 billion, whose stimulating effect on consumption was, however, partially undermined by higher rates of social security contributions.

Continued revenue weakness

Quite apart from this shortfall in receipts which was caused by the tax legislation – and which, together with the effects of the conversion of child benefit, actually amounted to more than DM 40 billion – tax revenue in 1996, which declined by 1¾ %, again fell far short of expectations. Thus, the official tax estimate in the autumn of 1995 was undershot by almost DM 32 billion. This was primarily attributable to the fact that real economic growth had decreased faster than originally forecast and that price inflation had continued to fall. An additional factor was that the growth process was largely supported by exports, which are exempt from turnover tax. However, the shortfalls in tax revenue eventually amounted to an order of magnitude which again could only be partially explained by general economic developments and hence further confirmed the presumption that the tax base was being permantly eroded.

Share of direct taxes in total revenue decreased

Direct "tax burden" somewhat lower

The unfavourable revenue trend of the past few years has primarily concerned direct taxes, whose share in total tax receipts has decreased distinctly. While the proportion of these taxes had been 48½ % in 1992, in 1996 it was around 46 % (after adjustment for the above-mentioned conversion of child benefit). This corresponded to an average annual increase of 1½ % in the receipts from direct taxes during the past four years, which was only half the increase of tax receipts as a whole.

In terms of income, too, the direct "tax burden" eased somewhat during that period. If the total income is measured on the basis of total gross wages and salaries plus civil servants' pensions as well as gross entrepreneurial and investment income, direct taxes amounted to approximately 16 % of total income (adjusted for the child benefit conversion) in 1996 against almost 17 % in 1992. Owing to the – sometimes considerable – time-lags between the generation of income and the respective tax payments, this general ratio naturally cannot yet be equated with the average effective tax burden affecting incomes through direct taxes. However, it is a rough indication that only part of the total income generated in the economy is subject to the relatively high tax rates. Even so, it obscures the differences in the magnitude of the burdens – which cannot be quantified due to insoluble problems of classification – arising from the various types of income as well as the significant discrepancies which have developed between the various taxes over the past few years.

Relatively favourable trend in wage tax receipts

Given the slower growth in incomes after 1992, wage tax – the most important single tax – developed rather favourably. This is true at least of the period from 1993 to 1995, when, at an annual average of 4½ %, wage

Tax revenue *

DM billion

Period	Total tax revenue	Direct taxes 1	of which: Wage tax	of which: Assessed income tax	of which: Corporation tax	Indirect taxes	of which: Turnover tax	of which: Other taxes mainly based on consumption	of which: Non-personal taxes 2
1970	154.2	67.8	35.1	16.0	8.7	86.5	38.1	31.5	14.8
1975	242.1	117.3	71.2	28.0	10.1	124.8	54.1	43.5	25.0
1980	365.0	179.6	111.6	36.8	21.3	185.3	93.4	55.1	33.8
1985	437.2	220.1	147.6	28.6	31.8	217.2	109.8	64.8	38.1
1990	549.7	264.4	177.6	36.5	30.1	285.3	147.6	84.1	47.5
1991	661.9	318.7	214.2	41.5	31.7	343.3	179.7	107.0	51.2
1992	731.7	354.1	247.3	41.5	31.2	377.6	197.7	119.1	55.6
1993	749.1	351.7	258.0	33.2	27.8	397.4	216.3	120.8	53.9
1994	786.2	354.7	266.5	25.5	19.6	431.4	235.7	131.5	56.8
1995	814.2	382.2	282.7	14.0	18.1	432.0	234.6	135.1	55.8
1996	800.0	357.0	251.3	11.6	29.5	443.0	237.2	138.6	60.5
	Percentage of total tax revenue								
1970	100	43.9	22.7	10.4	5.7	56.1	24.7	20.4	9.6
1975	100	48.5	29.4	11.6	4.2	51.5	22.3	18.0	10.3
1980	100	49.2	30.6	10.1	5.8	50.8	25.6	15.1	9.3
1985	100	50.3	33.8	6.5	7.3	49.7	25.1	14.8	8.7
1990	100	48.1	32.3	6.6	5.5	51.9	26.8	15.3	8.6
1991	100	48.1	32.4	6.3	4.8	51.9	27.1	16.2	7.7
1992	100	48.4	33.8	5.7	4.3	51.6	27.0	16.3	7.6
1993	100	47.0	34.4	4.4	3.7	53.0	28.9	16.1	7.2
1994	100	45.1	33.9	3.2	2.5	54.9	30.0	16.7	7.2
1995	100	46.9	34.7	1.7	2.2	53.1	28.8	16.6	6.9
1996 3	100	44.6	31.4	1.5	3.7	55.4	29.7	17.3	7.6

* Until the end of 1990, old Länder; from 1991 onwards, the whole of Germany. — **1** Wage tax, assessed income tax, corporation tax, tax withheld on interest income (from 1993), non-assessed taxes on earnings, income tax surcharge (1991-2 and from 1995: solidarity surcharge) plus wealth tax, inheritance tax and Equalisation of Burdens levies (applicable until the end of the seventies). — **2** Tax on land and buildings and trade tax (until 1981, including tax on total wages paid). — **3** After adjustment for the conversion of child benefit into a tax-reducing factor, direct taxes in 1996 amounted to 46 % of total tax revenue, with wage tax accounting for approximately 33 %.

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tax revenue increased twice as fast as the wages and salaries affected by this deduction at source and as civil servants' pensions. Then, in 1996, revenue decreased sharply (by 11%), mainly because the new form of child benefit now impinges on the revenue from this tax. The exceptionally high elasticity of the revenue from wage tax at times was associated with the negative trend in employment; by contrast, per capita earnings were subject to a progression similar to that of earlier years.[4] On the whole, the burden arising from this deduction at source increased significantly up to 1995.

However, overall economic "wage tax ratios", which are obtained from the tax statistics and the national accounts, do not give an accurate picture of the ultimate extent of the tax burden on wages and salaries, let alone the tax burden on employees' total income. This is due to the fact that, in ratios of this kind, the significant statistical overlapping existing between wage tax and assessed income tax is disregarded (see the overview on page 91). It is more appropriate to present trends in the tax burden and comparisons of the burdens by way of the actual tax liabilities of selected households arising in certain circumstances. This method illustrates the very diverse effects of the measures which came into force in 1996.

For example, for an average unmarried wage or salary earner who has no other source of income and who does not claim any tax allowances other than the general deductions already incorporated into the wage tax schedule the tax burden increased even further in 1996. This is due to the fact that, in such a situation, single persons benefited very little from the relief afforded by the Annual Tax Act, which focused mainly on lower income groups and ceased to have any effect at a taxable annual income of just under DM 56,000. Even in the case of an average gross income of slightly more than DM 51,700 in the old Länder in 1996, the tax relief arising under the abovementioned conditions was very slight, at DM 65 per year. Much of the increase in gross wages was eroded here as a result of higher social security contributions. By contrast, the tax burden for an average married wage or salary earner with two children, given the same "model assumptions", was eased by the higher basic tax allowance and the new family allowance system to such an extent that the disposable income from a given gross wage was higher than at the beginning of the nineties (see the tables in the Annex).

Assessed income tax just a small "residual"

Of all the types of tax, assessed income tax showed by far the most unfavourable trend in receipts; its yield has declined dramatically from year to year since 1993, that is, from DM 41½ billion in 1992 to a mere DM 11½ billion, or 1½ % of the total tax receipts, in

4 On the one hand, wage tax revenue increases disproportionately faster than the rise in actual average earnings owing to the progressive income tax rate; on the other hand, given average earnings at any one time, it increases roughly in proportion to the number of persons employed. Total revenue elasticity is the result of these partial elasticities and, when the number of persons employed is growing (which is usually the case), it is below the "per capita elasticity". In the event of a decreasing number of employed persons, however, it exceeds the per capita elasticity, because the negative employment trend diminishes the growth rate of the gross wage and salary total (i.e. the denominator of revenue elasticity) relatively faster than the growth rate of the wage tax revenue (i.e. the numerator of revenue elasticity), which benefits from the rate progression.

Statistical overlapping in the field of income tax

Sometimes specific tax ratios are used in public to support existing prejudices regarding the distribution of income. Particularly macroeconomic "wage tax ratios" are employed which have been taken from tax statistics and the national accounts and which show wage tax revenue in relation to total gross wages and salaries (and, where applicable, civil servants' pensions, which are also subject to wage tax). It is often concluded from the relatively substantial size of these ratios that the income of wage and salary earners is taxed more heavily than that of other socio-economic groups. A rising "wage tax ratio", combined with a declining trend in assessed income tax revenue, is sometimes also considered to be proof of a distinct redistribution upwards.

However, calculating burdens in such a way is inaccurate since it completely disregards the classification problems resulting from an income tax structure which, in principle, imposes a standard progressive rate of tax on the aggregate of different kinds of income. Within such a "synthetic" income tax structure the receipts from various methods of levying income tax – such as the deduction of wage tax at source – cannot be equated with the definitive tax liability which arises for various categories of income according to their function or, indeed, for certain social groups. On the contrary, there is considerable statistical overlapping of the different methods of levying income tax; this has a negative impact, especially on the revenue from assessed income tax which reflects the difference between the definitive tax liability and the tax amounts already deducted at source.

As a consequence of growing advance tax payments through various deductions at source – including the tax withheld on interest income since 1993 – the revenue from assessed income tax has increasingly developed into a "residual". It is being particularly diminished by the ever increasing amount of refunds to wage and salary earners (see the chart on page 92). Firstly, these are tax refunds to wage and salary earners who are liable to income tax assessment because they have sizeable sources of income other than their wages or salaries (notably investment income). Secondly, since 1992 those amounts which replaced the annual wage tax adjustment and which are refunded to wage and salary earners under the so-called "assessment on application" scheme have also impinged on the level of assessed income tax. As only the refunds are known, and not the employees' additional payments of income tax made on the basis of the assessment, no definite share of the revenue from assessed income tax can be ascribed to wage and salary earners. Furthermore, since these earners increasingly receive additional income from assets, apportioning actual tax revenue to the individual income components is quite impossible.

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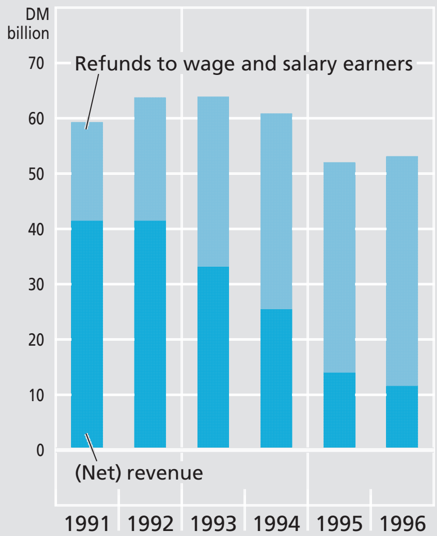
1996. The yields from this tax had been very volatile in earlier years, too, not least because they gradually turned into a statistical "residual" reflecting the difference between the final tax liability and the tax amounts already deducted at source. However, this "downward slide" that has become apparent during the past four years is on an unprecedented scale. The increasing tax refunds which were paid to employees to the debit of the assessed income tax were a major reason for this. In 1996 these refunds, at DM 41½ billion, were three and a half times greater than the remaining tax revenue whereas in 1992 they had amounted to approximately one-half of this, or just over DM 22 billion (see the adjacent chart). Only some of these refunds were in connection with wages and salaries; others concerned employees' additional incomes – as well as the corresponding advance tax payments and deduction possibilities – notably from rents and leases and from capital assets.

Assessed income tax revenue before and after deduction of refunds to wage and salary earners *



* Figures for the whole of Germany; up to 1992, refunds exclude Hamburg and Hesse.

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The introduction of the tax on interest income in 1993, which was a new deduction at source, and the sharp rise in the savers' tax allowance at the same time had particularly limiting effects on receipts. In addition, the extensive use of other kinds of tax concessions increasingly reduced the receipts from assessed income tax, which have been declining appreciably since 1993, even before deducting the above-mentioned tax refunds to employees. The generous fiscal promotion of investment in eastern Germany was significant here as it offered not only to enterprises but also to private investors (in the rented house-building sector) considerable scope for reducing tax liabilities. The successive cutting-back of subsidies in the west German housing sector[5], too, induced many to carry out work before the respective deadlines. Furthermore, some tax relief measures (such as the "savings depreciation") for small and medium-sized businesses might ultimately have led to greater shortfalls in tax receipts than originally expected. That apart, in the corporate sector, in particular, the after-effects of the 1992-3 recession were still perceptible at first.

5 Thus, the tax incentives for older owner-occupied dwellings were curtailed from 1994, and the temporary tax relief on loan interest for building new owner-occupied dwellings elapsed in 1995; furthermore, the diminishing-balance depreciation facilities for the construction of rented accommodation were reduced in 1996.

Corporation tax receipts also decrease

Corporation tax, too, has produced decreasing receipts in the past few years. Although this trend has reversed since 1996, yields, at DM 29 ½ billion in 1996, were still lower than the 1992 level (which had been slightly more than DM 31 billion). In spite of a continual improvement in corporate earnings since 1994, the fiscal significance of corporation tax declined. The after-effects of the unfavourable profits situation in the years 1992 and 1993 and the tax relief from the Industrial Location Protection Act were major causes of this divergence; in particular, corporation tax rates were cut markedly in 1994 (even though this relief was virtually nullified when the solidarity surcharge was reintroduced a year later). A further cause of the sometimes sharp decline in receipts was the fact that many enterprises made use of a transitional regulation which, until the end of 1994, enabled them to take advantage of a greater reduction of corporation tax on dividends stemming from retained profits made before 1990 (and taxable at the then valid retention rate of 56 %); this, however, had only a temporary adverse effect on the tax base. Not only the tax relief measures but also restructuring in the corporate sector – including the taking-over of enterprises with high losses brought forward – may have significantly reduced corporation tax revenue or limited it even further. Incidentally, there are signs that the continuously large gap between German tax rates and those of other countries has induced enterprises to shift an increasing share of their profits or activities abroad.[6]

Evasive reaction to the tax on interest income

The fact that the high degree of mobility of financial assets, in particular, may lead to considerable evasive reaction became evident when the tax on interest income was introduced in 1993. The new deduction at source affecting interest which is credited or payed out in Germany triggered extensive transfers of funds abroad.[7] However, owing to the particular nature of this tax on interest income (which, in contrast to the earlier "small investment income tax", does not adversely affect German borrowers and, in addition, exempts non-residents relatively unbureaucratically), a substantial amount of these funds flowed back into the German market after a "detour" through foreign financial centres; to that extent, this was "merely" tax avoidance and not a definitive capital flight. Only some of these transactions were made in connection with tax evasion; reactions – particularly in the corporate sector – were often merely aimed at legitimately avoiding the shortfalls in liquidity arising from the new advance tax charge. The tax on interest income has only been partly successful in achieving the objective of broadening the tax base. Thus, at DM 10 ¾ billion, receipts in 1993 fell far short of the original expectations (of DM 24 billion). Between 1994 – the first year in which this tax had a full impact on revenue – and 1996, they actually declined from

6 More attractive general tax rates and the special tax concessions granted by some countries (such as Ireland, Belgium and the Netherlands) played a major role in leading to an increasing trend towards shifting the location of German groups' financing subsidiaries abroad.

7 In connection with the sharp rise in the savers' tax allowance, it also led to an increasing number of capital transfers to children. For the different "response channels" and the fiscal consequences see Deutsche Bundesbank, Revenue from and economic implications of the tax on interest income, Monthly Report, January 1994, page 43 ff.

DM 13¾ billion to just over DM 12 billion. This was mainly attributable to the average rates of interest, which were declining markedly during that period.

"Old" investment income tax profitable, by contrast

In the wake of the improved corporate earnings situation, by contrast, the "old" investment income tax – which applies mainly to dividends – yielded receipts which exhibited a tendency to rise; at slightly more than DM 13 billion in 1996, the return from this tax was DM 2 billion higher than in 1992. At nearly DM 18 billion, its yield reached a peak in 1994, owing to the above-mentioned special dividends paid by many enterprises, thus compensating part of the shortfalls in revenue from corporation tax.

Indirect taxes

Substantial tax increases

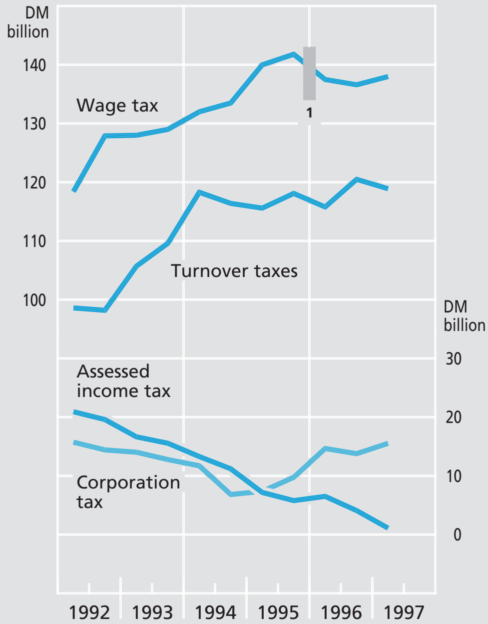
In the period from 1993 to 1996 receipts from indirect taxes went up at an annual average rate of 4 %; this means that they actually increased slightly faster than nominal GDP. The sole reason for this, however, was the extensive increases in turnover, mineral oil and insurance taxes which occurred until 1995 (totalling approximately DM 25 billion in 1995) and which came into effect during that period; without these measures, the rise in revenue would have been perceptibly slower than the rise in nominal economic growth.

Turnover tax receipts sluggish since 1995

Following the raising of the standard rate, which came into effect in 1993, receipts from turnover tax – which is by far the most important indirect tax – rose sharply in 1993

Revenue from major taxes

Seasonally adjusted



1 Comparability impaired by the conversion in booking child benefit.

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and 1994. Since 1995, however, they have more or less stagnated. During that period the trend in revenue therefore lagged perceptibly behind overall economic growth. This can only be partly explained by the sharp rise in tax-free exports and the sluggish trends in housing and government investment, both of which are subject to tax. Another factor may be that, with the raising of the tax rates in 1993, the incentives to evade tax (for example, by "disappearing" into the shadow economy) increased even more at the same time. Tax evasion on an international scale was also made easier by the fact that, with the introduction of the "transitional system" for value-added tax within the European Union in 1993, the former border controls on intra-Community trade in goods were disbanded.

Other taxes, mainly based on consumption

Between 1993 and 1996 the receipts from other, mainly consumer-based, taxes increased at an annual average of 4 %. In that time, receipts from mineral oil tax (+ 5½ %) and insurance tax (+ 15½ %) went up particularly sharply. In both cases, this was mainly due to steep tax increases which came into effect in 1994 (mineral oil tax) and in mid-1993 and at the beginning of 1995 (insurance tax). Moreover, the shortening of payment periods for mineral oil tax at the end of 1996 yielded additional one-off receipts. By contrast, other consumer taxes – some of which are dependent on quantity – showed only a slight increase in revenue (e.g. tobacco tax) or a decline in revenue (e.g. tax on spirits).

Trade tax revenue low

With an average annual rate of increase of around 2 %, receipts from non-personal taxes – most of which count as indirect taxes[8] – increased only moderately during the past four years, taken as a whole. Trade tax receipts actually declined until 1995, although not to the same degree as corporation tax. The reason for this was not only the tax relief measures applying to enterprises but also, from 1993, the deterioration in the profits situation caused by the slowdown in economic activity, which until 1995 adversely affected the revenue trend of this tax, which is highly dependent on earnings. It was not until 1996 that this negative trend gave way to a steep rise, as more profitable years were then being assessed again. As in the case of corporation tax, the revenue trend, which was rather poor overall, might also be attributable to factors which had tended to erode the domestic tax base. In contrast to trade tax, receipts from the tax on land and buildings rose sharply (by 8 % per year), not least because the local authorities raised their collection multipliers particularly in respect of this tax.

Further outlook

Measures taken at the beginning of 1997

Judging by the indications so far, the volume of tax receipts in the current year will hardly appear in a more favourable light, especially as the economic upswing in Germany, which is gradually gaining breadth and strength, will, for the time being, be primarily supported by components which are not tax-yielding. In respect of changes in tax legislation some measures came into force at the beginning of the year which have the effect of reducing tax revenue. Firstly, child benefit was raised further, reducing receipts from wage tax, in particular. Secondly, following an earlier ruling by the Federal Constitutional Court, wealth tax is no longer levied, a change which, from an overall economic point of view, must be regarded as positive because it means that a tax on real assets, which had been damaging to enterprises, has been eliminated and that corporate enterprises are no longer affected by a dually burdening element.[9] However, the losses in

8 The main reason for this is the fact that, in the national accounts, the trade tax and the tax on land and buildings are deductable as operational expenditure when determining profit for income or corporation tax. Hence, they are treated as taxes chargeable as expenses although the trade earnings tax, as far as its basis for assessment is concerned, is similar to the other taxes on income and, to that extent, ought rather to be seen as a direct tax.

9 Wealth tax had put corporate enterprises at a disadvantage compared with partnerships since this tax affected their wealth both at the corporate and at the shareholder level. In addition, wealth tax as a whole had been problematic because it generated a dual tax burden on investment income and constituted an alien element in a system which is based on the two "pillars" of income tax and consumer tax.

receipts resulting from the lapsing of this levy are intended to be offset by other measures. These include not only a sharp increase in the tax on the purchase of land and buildings but also, and more importantly, the reform of the tax on inheritance and gifts, which, in compliance with the constitutional requirements, came into effect retroactively from 1996; in spite of higher allowances and, in some cases, lower tax rates than before, this reform is expected to yield a marked net increase in receipts from the higher valuation of land and buildings for tax purposes.

Receipts persistently sluggish

However, these improvements in revenue, in contrast to the lapsing of wealth tax, hardly manifested themselves in the trend during the first half of the year which continued to be disappointing. Thus, particularly the inheritance tax reform has yielded no additional receipts so far, a fact which may be attributable to the considerable amount of time needed for an assessment; it is unlikely that expectations for the whole of 1997 will be fulfilled either. With regard to other individual taxes, the receipts situation has likewise been much more unfavourable than had been expected by the official forecast of May 1997, which had actually been DM 18 billion down on the estimate in the autumn of 1996. Assessed income tax, in particular, has again been below expectations. Refunds are now almost as high as tax receipts, which may be largely due to the persistently extensive use of facilities to achieve the most favourable tax result. [10]

On the whole, tax receipts [11] in the first half of the year were 2 ½ % lower than in the corresponding period of 1996. Even though the flow of receipts is likely to increase in the second half of the year, due to the favourable economic outlook and the greater effectiveness of tax-raising measures, as things stand today, revenue in 1997 will probably still be lower than in the May forecast, which had anticipated an increase in revenue of around 1½ % for the current year, with a nominal economic growth of 3 ½ %. This means that the structural sluggishness in tax revenue in 1997 – which is seen in the further decline in the overall tax ratio – would be even more pronounced than had been anticipated so far.

Need for a fundamental tax reform

The gradual and, lately, increasing erosion of the tax base shows the dilemma of a taxation policy which is trying to alleviate the burden of high tax rates by a quantity of concessions that is neither transparent nor assessable with respect to its possible impact on tax revenue. The result of high tax rates and a declining tax ratio is ultimately not surprising.

Only a "major" comprehensive tax reform can lead the way out of this dead end. Such a tax reform would have to focus on a fundamental reform of income tax, which would combine a sharp cut in general tax rates with as comprehensive a reduction of the existing tax exemptions and special concessions as possible. This would also create the prerequis-

10 One of the influencing factors here is the fact that the special 50 % depreciation facility for investment in eastern Germany, which had been in force up to the end of 1996, was still being used rather heavily up to the end, and this has diminished advance payments particularly since last December. In addition, tax refunds for previous years have continued to increase considerably.
11 Excluding receipts from local authority taxes, which are not yet known.

ites for a more transparent and simple tax system which would distort economic operations to a lesser extent and make tax avoidance strategies appear in a less attractive light. One important component of such a major reform would be a certain shift of the tax burden from income to consumption.

The reproach that such a reform would lead to a less equitable tax distribution is not justified from an economic point of view. Firstly, the current system, hardly manageable in its incidence, benefits precisely those people who are particularly apt at finding ways to avoid tax payments. Secondly, an economically efficient system would improve the allocation of the factors of production, create incentives to engage in economic production and thus foster growth. In the end there would be more jobs and less unemployment.

Annex

Major tax policy measures since 1993

1992 Tax Amendment Act of February 1992

At the beginning of 1993, various tax relief measures were introduced for enterprises, relating especially to trade earnings tax and corporate wealth tax. On the other hand, some tax benefits were curtailed and loopholes closed, and the standard rate of value-added tax was raised by 1 percentage point (to 15 %). On balance, the Act's provisions (including the improvement in the family allowance system introduced in 1992) were expected to yield additional revenue, which increased from DM 3 billion to DM 8 billion between 1993 and 1995.

Act on Turnover Tax in the Single European Market of August 1992

This Act regulated the technical details of levying turnover tax from the beginning of 1993 – i.e. after the abolition of border controls within the EU. With a few exceptions, the country-of-destination principle was generally adhered to for a transitional period; however, the old import turnover tax on intra-Community merchandise transactions was replaced by a tax on the purchase of goods payable by the enterprises concerned in the importing country. In addition, some minor Federal taxes were abolished at the beginning of 1993 (annual revenue loss: about DM ½ billion).

Act Introducing a Withholding Tax on Interest Income of November 1992

In response to a ruling of the Federal Constitutional Court, which demanded a more uniform tax treatment of interest income, a flat-rate tax on investment income ("withholding tax") of 30 % of net interest received (or 35 % in the case of over-the-counter transactions) was introduced at the beginning of 1993; this tax was to be withheld and remitted to the tax authorities by the domestic paying agents, and the amount paid was later offset against the assessed tax bill. At the same time, the tax-exempt portion of savings income was increased tenfold (to DM 6,000 for single persons and twice that amount for married couples). For the rest, the tax treatment of old age provision was improved, and the tax-free portion of civil servants' pensions was increased. This package of measures was expected to yield additional receipts which amounted to slightly less than DM 3 billion in 1993 and increased to about DM 6 billion by 1996.

Act Regulating Consumer Taxes in the Single European Market of December 1992

This Act was designed to bring the German consumer tax regulations into line with the EU Directives on the harmonisation of taxes, which applied from the beginning of 1993 following the abolition of border controls within the Community. In addition, the investment grant for machinery and equipment in the new Länder was prolonged (although the range of potential beneficiaries was reduced) and in some cases increased. All in all, compared with the previous regulations this Act led to revenue losses which were estimated to have grown to more than DM 6 billion by 1996.

Act Implementing the Federal Consolidation Programme of June 1993

Several taxes were increased by this Act, which set out primarily to regulate the assumption of the debt "inherited" from the former GDR, to restructure the revenue-sharing scheme between the Federal and Länder Governments and to ensure an adequate financial position for the new Länder. Net of the relief measures for low earners necessitated by a ruling of the Federal Constitutional Court (which were implemented outside the pay bargaining process by a transitional regulation on the exemption from taxation of the portion of incomes necessary for subsistence), these tax increases raised an estimated DM 30 billion related to 1995. The bulk of this came from the reintroduction at the beginning of 1995 of the solidarity surcharge of 7 ½ % on payable income tax and corporation tax. Furthermore, the insurance tax was raised in two phases to 15 % by 1995, and – coupled with a rise in the personal liability threshold – private wealth tax was increased to 1% in 1995 (except for participating interests, including investment fund certificates). The tax on interest income was extended in the middle of 1993 to distributions of profits by foreign investment funds, and tax relief on the acquisition of older owner-occupied dwellings was cut for properties purchased from 1994 onwards.

Industrial Location Protection Act of September 1993

This Act, which aimed to lastingly improve the general tax conditions for investment and jobs in

Germany, cut corporation tax rates distinctly from 1994 (to 45 % for retained earnings and to 30 % for distributed profits). In addition, the top rate of income tax on industrial earnings was limited to 47 %, and a tax-exempt investment reserve ("deductible savings facility") further eased the situation of small and medium-sized enterprises. Furthermore, the tax concessions in the new Länder were extended to the end of 1995 and the end of 1996, respectively. By contrast, the depreciation allowances for commercial buildings and company cars were reduced, and various other tax benefits and potential abuses were curbed. On balance, this package of measures was expected to result in shortfalls in tax revenue amounting to just under DM 4 billion in 1994 and around DM 5 billion in each subsequent year.

First Act Implementing the Retrenchment, Consolidation and Growth Programme of December 1993

This Act raised the mineral oil tax imposed on petrol and diesel fuels from the beginning of 1994 by DM 0.16 and DM 0.07 per litre, respectively, in order to partly fund the reform of the railways (expected additional revenue: around DM 8 billion in 1994 and just under DM 9 billion in each subsequent year).

Act Combatting Tax Avoidance and Streamlining Tax Legislation of December 1993

This Act aimed mainly to further eliminate unjustified tax privileges and undesirable tax loopholes. The measures taken to this end included extending the coverage of the tax on interest income (primarily to financial innovations and domestic income from foreign growth funds), tightening the Foreign Tax Relations Act in order to limit the opportunities for tax-saving transactions by relocating profits to other countries, and further reducing tax deduction facilities on owner-occupied dwellings purchased after 1993. In addition – to supplement the relatively moderate increase in mineral oil tax on diesel fuels – motor vehicle tax on cars with diesel engines was raised at the beginning of 1994, whereas for lorries this tax was lowered as of April 1, 1994 so as to lessen the disadvantages for German lorry proprietors compared with their foreign competitors. The flat-rate road travel allowance was raised, too, to offset the burden on commuters arising from the increase in mineral oil tax. On balance, the additional revenue expected from this tax package amounted to around DM 1½ billion in 1994 and approximately DM 3 billion in each subsequent year.

Act Amending the Tax Regulations Applying to Corporate Restructuring of October 1994

Enterprises were given various opportunities to restructure on a more tax-neutral basis; no significant losses in revenue were expected to result from this Act.

1996 Annual Tax Act of October 1995

This Act notably exempted from taxation the level of incomes needed for subsistence by redefining the income tax scale, which raised the basic tax allowance sharply (to around DM 12,000 from 1996 and to DM 13,000 from 1999). In order to partly offset the resulting losses in revenue, the marginal tax rates in the lower income brackets were increased markedly (starting at a new bottom rate of almost 26 %). In addition, a new system of family allowances was introduced which, while sharply raising child benefit and the tax allowance for children, envisaged alternative utilisation (rather than the previous parallel utilisation) of these two components. Furthermore, the bequeathing of enterprises was made easier through an amendment of the inheritance tax, and tax concessions for investment in the new Länder were extended to the end of 1998 and concurrently streamlined. A small part of the tax relief measures, amounting to an estimated grand total of slightly more than DM 23 billion, was to be financed by further restricting special tax benefits, including the reduction of diminishing-balance depreciation facilities in the rented housing construction sector. On balance, it was estimated that this Act would entail additional fiscal burdens amounting to just over DM 21 billion in 1996.

Act Amending the Tax Incentives to Acquire Owner-Occupied Dwellings of December 1995

This Act changed the system of promoting home ownership from tax-deductible special allowances to grants to home owners not based on tax progression. This change was designed to have little impact on the level of tax revenue. Furthermore, the additional allowances granted to home buyers with children were improved.

1997 Annual Tax Act of December 1996

As this Act contained no provisions on wealth tax, this tax could no longer be imposed from 1997 onwards, according to a decision of the Federal Constitutional Court. The resulting shortfalls in tax revenue were partly offset by additional receipts from the reform of inheritance and gift tax, which was likewise necessitated by a ruling of the Federal Constitutional Court. These changes (applied retroactively from the beginning of 1996) entailed a higher assessment of real property for tax purposes, on the one hand, and higher tax thresholds and, in some cases, lower tax rates, on the other hand. In addition, the tax rate applying to purchases of land and buildings was raised to 3 ½ % from the start of 1997, and the further rise in the income tax threshold was postponed by one year to 1998. After adding some other changes in tax legislation, this package of measures was expected to have virtually no impact on revenue.

Act Prolonging Economic Support Measures in the New Länder

The tax concessions for investment in the new Länder were extended until 2004. Simultaneously, the range of promotional instruments was streamlined – i.e. it was limited to a higher investment grant and the former special depreciation facilities were abolished – and the tax incentives were focused more on the problematical industrial sector. The expected loss in revenue compared with the former regulations will be DM 5 ½ billion to DM 6 billion from the year 2000.

1998 Tax Reform Bill and 1999 Tax Reform Bill

These two bills, which comprise a substantial lowering of general income and corporation tax rates coupled with a reduction of tax concessions and exemptions, were passed by the Lower House *(Bundestag)* but rejected by the Upper House *(Bundesrat)*. They were subsequently again rejected in a first inter-House mediation hearing initiated by the Federal Government.

Act on Further Corporation Tax Reform

In early August 1997 the inter-House mediation committee agreed to abolish trading capital tax from 1998; the introduction of this tax in the new Länder has been further suspended for the duration of the current year. On balance, the losses in revenue resulting from the elimination of this levy amount to around DM 4 billion per annum. These shortfalls will be offset by cuts from 1997 in enterprises' accounting leeway in respect of provisions and the carryforward of losses and by reducing the tax allowances for extraordinary income (initially the expected additional receipts from these measures will outweigh the losses). As compensation for the former trading capital tax, local authorities will receive a 2.2 % share of the revenue from turnover tax from 1998 onwards.

The tables accompanying this article appear on the following pages.

Burden of direct taxes and social contributions on an average unmarried wage or salary earner

Employee in the old Länder, tax category I/0

Year	Gross annual wage	Wage tax	Solidarity tax	Employee's share of social contributions	Overall burden	Net wage
	Deutsche Mark					
1990	41,969	7,049	–	7,449	14,498	27,471
1991	44,430	7,729	290	8,077	16,096	28,334
1992	47,000	8,473	318	8,601	17,392	29,608
1993	48,354	8,757	–	9,042	17,799	30,555
1994	49,288	9,028	–	9,587	18,615	30,673
1995	50,795	9,481	711	9,981	20,173	30,622
1996	51,745	9,710	728	10,499	20,937	30,808
	as a percentage of gross wage					
1990	100	16.8	–	17.8	34.5	65.5
1991	100	17.4	0.7	18.2	36.2	63.8
1992	100	18.0	0.7	18.3	37.0	63.0
1993	100	18.1	–	18.7	36.8	63.2
1994	100	18.3	–	19.5	37.8	62.2
1995	100	18.7	1.4	19.7	39.7	60.3
1996	100	18.8	1.4	20.3	40.5	59.5
	Increase from previous year in %					
1991	5.9	9.6	.	8.4	11.0	3.1
1992	5.8	9.6	9.6	6.5	8.0	4.5
1993	2.9	3.4	.	5.1	2.3	3.2
1994	1.9	3.1	.	6.0	4.6	0.4
1995	3.1	5.0	.	4.1	8.4	– 0.2
1996	1.9	2.4	2.4	5.2	3.8	0.6
	Additional burden of taxes and social contributions as a percentage of additional income (change from previous year)					
1991	.	27.6	11.8	25.5	64.9	.
1992	.	28.9	1.1	20.4	50.4	.
1993	.	21.0	– 23.5	32.6	30.1	.
1994	.	29.0	–	58.3	87.3	.
1995	.	30.1	47.2	26.2	103.4	.
1996	.	24.1	1.8	54.5	80.4	.

Deutsche Bundesbank

Burden of direct taxes and social contributions on an average married wage or salary earner with two children

Employee in the old Länder, tax category III/2

Year	Gross annual wage	Wage tax	Solidarity tax	Employee's share of social contributions	Overall burden	Net wage	Net wage plus child benefit
	Deutsche Mark						
1990	41,969	2,906	–	7,449	10,355	31,614	33,774
1991	44,430	3,374	127	8,077	11,578	32,852	35,012
1992	47,000	3,466	130	8,601	12,197	34,803	37,203
1993	48,354	3,534	–	9,042	12,576	35,778	38,178
1994	49,288	3,692	–	9,587	13,279	36,009	38,409
1995	50,795	3,966	[2] 260	9,981	14,208	36,587	38,987
1996 [1]	51,745	842	–	10,499	11,341	40,404	41,856
	as a percentage of gross wage						
1990	100	6.9	–	17.8	24.7	75.3	80.5
1991	100	7.6	0.3	18.2	26.1	73.9	78.8
1992	100	7.4	0.3	18.3	26.0	74.0	79.2
1993	100	7.3	–	18.7	26.0	74.0	79.0
1994	100	7.5	–	19.5	26.9	73.1	77.9
1995	100	7.8	0.5	19.7	28.0	72.0	76.8
1996 [1]	100	1.6	–	20.3	21.9	78.1	80.9
	Increase from previous year in %						
1991	5.9	16.1	.	8.4	11.8	3.9	3.7
1992	5.8	2.7	2.7	6.5	5.3	5.9	6.3
1993	2.9	2.0	.	5.1	3.1	2.8	2.6
1994	1.9	4.5	.	6.0	5.6	0.6	0.6
1995	3.1	7.4	.	4.1	7.0	1.6	1.5
1996 [1]	1.9	– 78.8	.	5.2	– 20.2	10.4	7.4
	Additional burden of taxes and social contributions as a percentage of additional income (change from previous year)						
1991	.	19.0	5.1	25.5	49.7	.	.
1992	.	3.6	0.1	20.4	24.1	.	.
1993	.	5.0	– 9.6	32.6	28.0	.	.
1994	.	16.9	–	58.3	75.2	.	.
1995	.	18.2	17.3	26.2	61.7	.	.
1996 [1]	.	– 328.8	– 27.4	54.5	– 301.7	.	.

1 For systematic reasons and for the sake of better comparability with earlier years the wage tax calculation was based on the new tax relief for children of DM 6,264 which was included in the relief provided by the Annual Tax Act 1996. Where the new child benefit (of DM 200 per month and per child) exceeds the tax saving arising from this tax relief for children, it is reflected in the last column. — **2** Only a reduced solidarity tax is payable on the relevant income (in the transitional area).

Deutsche Bundesbank