TAXATION IN GERMANY

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The German government's austerity reputation built up since the outbreak of the banking and government debt crises from 2007 onwards suggests that among members of the EU Germany stands out with a low tax burden on its population. The data paint a different picture. Over the last two decades, the level of taxation in relation to GDP has not decreased, the bureaucratic burden of taxation for firms rose, and the level of fiscal decentralization remained at an extraordinarily low level.

Levels of Taxation: Germany is not a low-tax country

The ratio of the overall tax receipts to GDP in Germany fell during the first years of the new millennium after it had increased during the 1990s and rose again during the recent financial crises. Figure 1 compares the ratio of total tax receipts - including taxes on income, consumption, but also taxes in the form of contributions to social insurances - in Germany and the EU-27. Whereas until 2003 the ratio of taxes to GDP was slightly higher in Germany than on average in the EU-27 (provided by Eurostat since 1995), from 2004 to 2012 the differences in the ratios in Germany and the EU-27 were small with the German government's taxes accruing to 40.4% of GDP in 2012 and the EU-27 governments' taxes to 40.7%.

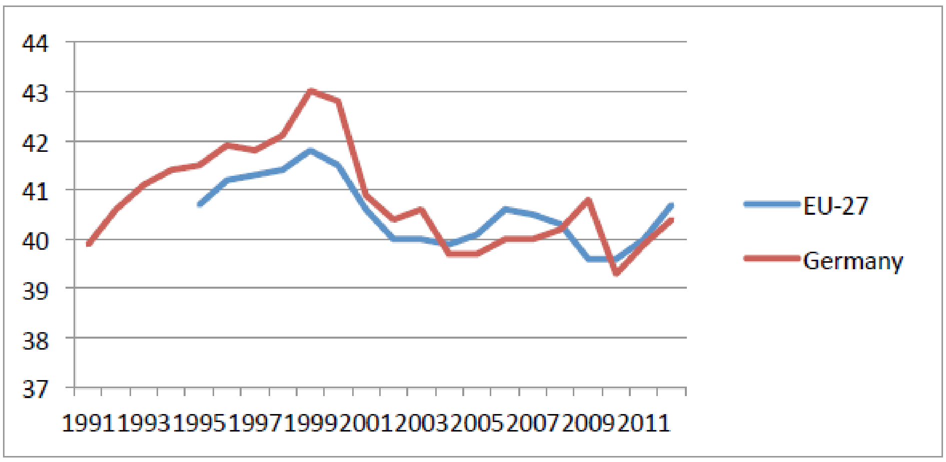

Figure 1: Ratio of total tax receipts to GDP in Germany and the EU-27

Source: Eurostat

These numbers indicate that despite the German government's reputation as being thrifty, the tax burden in Germany is not considerably lower than in the EU-27 overall.

As in other EU countries, three groups of taxes stand out with respect to the size of their accompanying receipts: consumption taxes, income taxes (personal and corporate), and contributions to social insurances.

Figure 2 shows the share of GDP of value added tax receipts in Germany and the EU-27 from 1991 and 1995 to 2012. Both for Germany and the EU-27 the share of GDP going to value added taxes increased over the period under investigation. In 2007, the general value added tax rate was increased in Germany from 16% to 19%, which helps explaining the sharp rise in the ratio of value added tax receipts to GDP from 2006 to 2007. In 2012, the ratio stood at 7.3% in Germany and 7.1% in the EU-27.

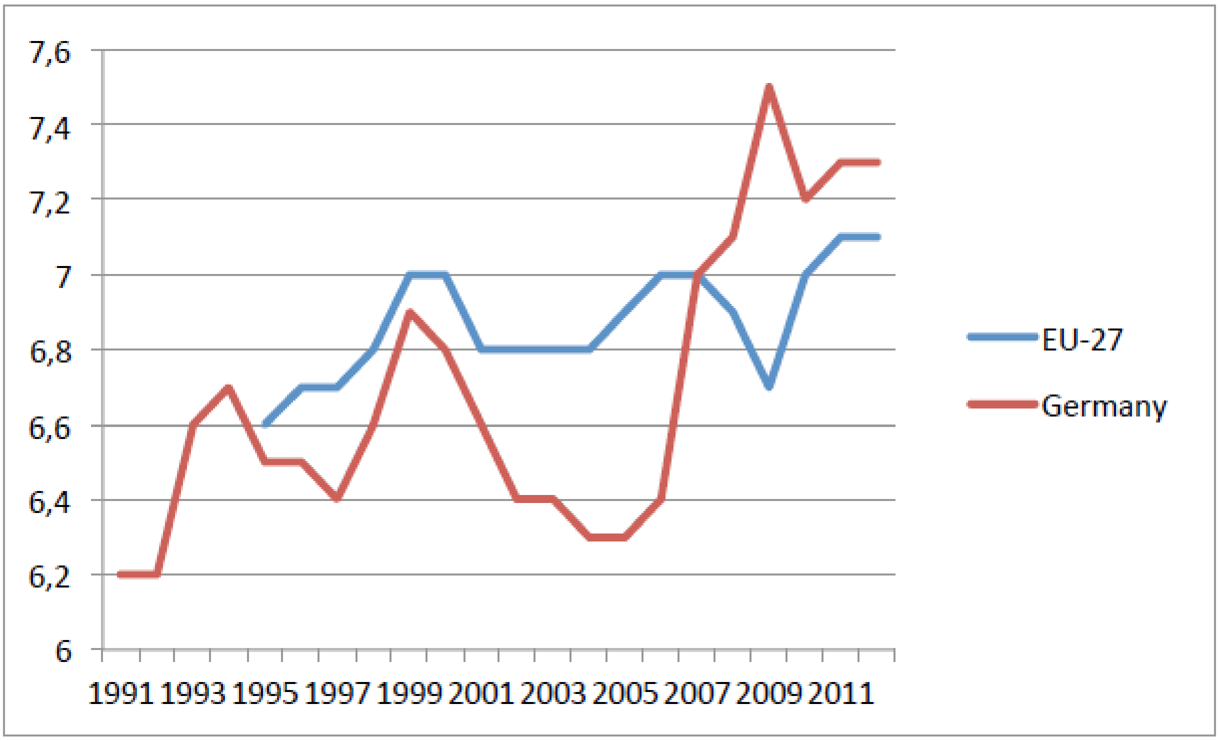

Figure 2: Ratio of value added tax receipts to GDP in Germany and the EU-27

Source: Eurostat

This development may in part have been caused by a more intensive international tax competition triggered through an increase in the mobility of certain factors of production (especially capital and highly-qualified labor). The more mobile factors of production become the more sensitive they are to tax changes within one jurisdiction and to differences in the tax burden imposed on them across jurisdictions. Increases in the mobility of factors of production may make it attractive for governments to increase the relative share of tax revenues from consumption taxes. Such a shift may reduce the overall inefficiencies stemming from tax-evasion, for instance, due to relocations to other jurisdictions or due to a scaling back of productive activity.

Although responses to changes of taxes on income and responses to income tax differences across jurisdictions may be more pronounced than in the case of consumption taxes, income taxes still represent a vastly larger share of total tax receipts in Germany and the EU-27. Income taxes come in the form of taxes on income of corporations, for instance taxes on profits, and of individuals, for instance labor income taxes, but also in the form contributions to social insurances, which are deducted from labor income and in principle have the same effects as taxes on labor income whose receipts are not earmarked.

Figure 3 compares the income tax paid by individuals and corporations in proportion to GDP in Germany and the EU-27 from 1991 and 1995 respectively to 2012. Over the entire period under investigation income taxes as a fraction of GDP were lower in Germany than on average in the EU-27 countries.

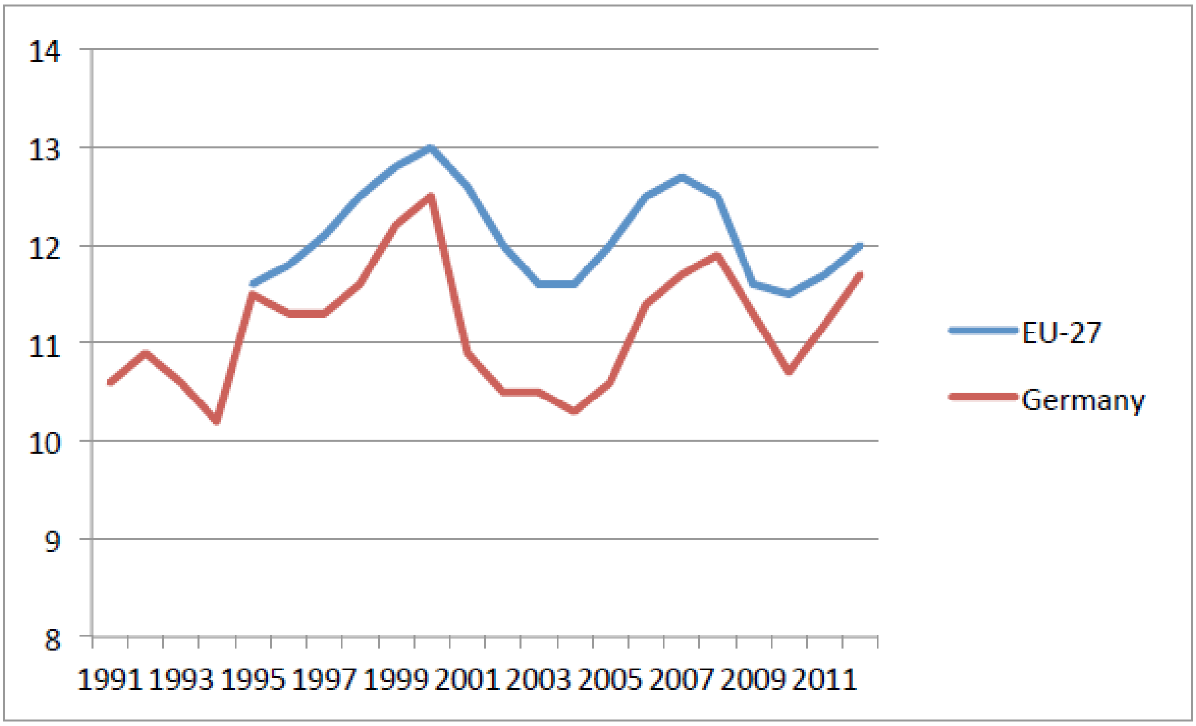

Figure 3: Ratio of income tax receipts to GDP in Germany and the EU-27

Source: Eurostat

Eurostat provides internationally comparable data for Germany and the EU-27 for taxes on income by private households and taxes on income by corporations separately only for the years 2005 to 2012. Figure 4 presents the data. The difference between Germany and the average of the EU-27 countries with respect to the ratio of income tax receipts to GDP stems mostly from the different shares of *personal* income tax receipts in relation to GDP. In 2012, for instance, the amount of income taxes in Germany accounted to 8.8% of GDP, whereas it accounted for 9.4% of GDP in the EU-27. From 2005 to 2012 corporate taxes in Germany amounted to approximately the same fraction of GDP as in the EU-27.

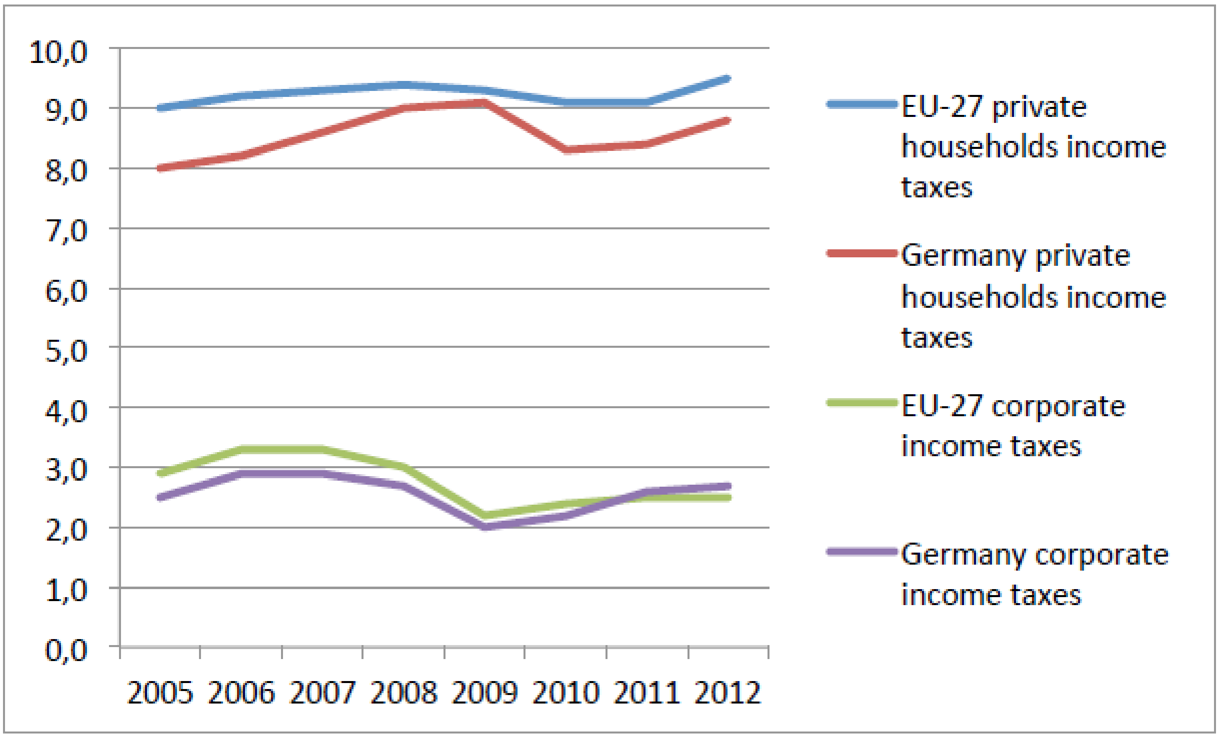

Figure 4: Ratios of corporate and personal income tax receipts to GDP in Germany and the EU-27

Source: Eurostat

The group of taxes with the largest receipts are levied on exchanges of labor and come in the form of contributions to state-run old age pension schemes, health insurance, long term care insurance, and unemployment insurance.

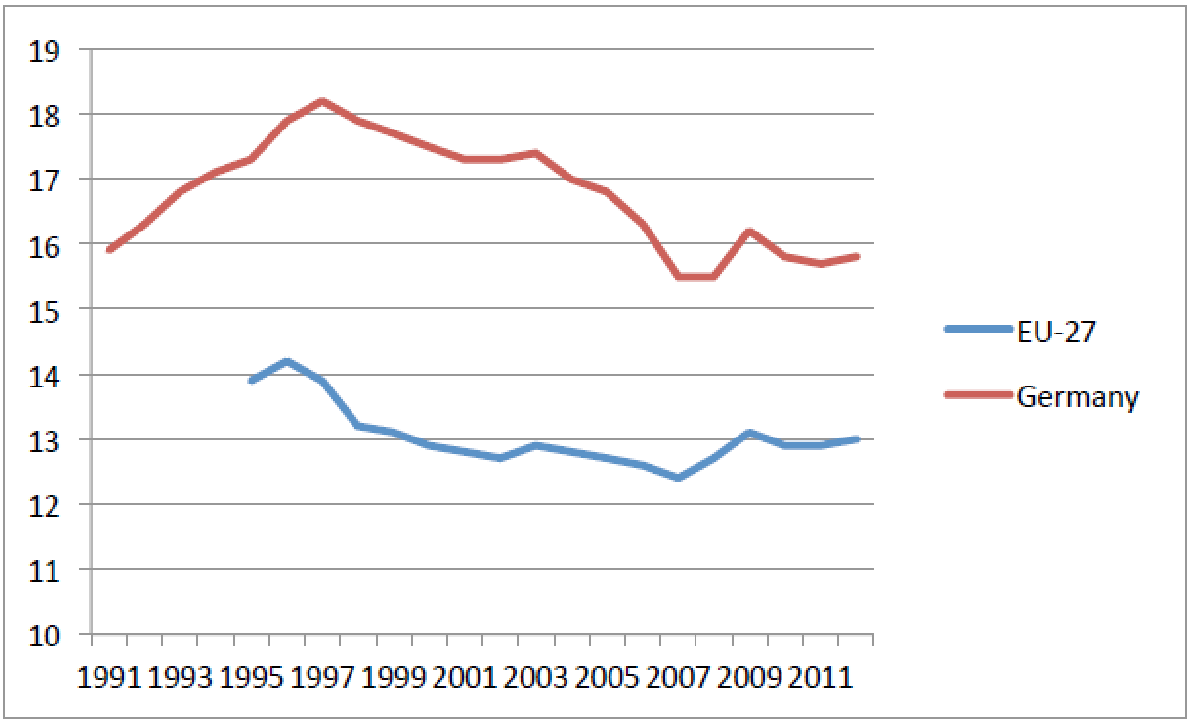

Figure 5: Ratio of social insurance contributions to GDP in Germany and the EU-27

Source: Eurostat

As Figure 5 illustrates the fraction of total taxes coming from contributions to social insurances is considerably larger in Germany than the EU-27. Over the period investigated taxes on labor income in the form of contributions to social insurances accounted for at least two percentage points of GDP more in Germany than in the EU-27. In 2012, the ratio of social insurance contributions to GDP amounted to 15.8% in Germany and 13% in the EU-27. The labor market reforms in the early 2000s in Germany appear to have contributed to bring down the share of social contributions of GDP from a high of 18.2% in 1997, but the share in Germany remains well above that in the EU-27.

The data thus far suggest that although the German government these days has a reputation of holding back on government expenditure, the level of taxation in relation to GDP in Germany is about the same as it is on average in the EU-27 countries. Further, over the last two decades, tax receipts as percentage of GDP did not fall. On the contrary, the ratio of total tax receipts to GDP since 1991 rose from 39.9% to 40.4%.

Implicit tax rates: Heavy burden on labor income

Relating the tax receipts from various tax sources to GDP is a proxy for the tax burden and thus the extent of distortions induced by government. To getter a better grip on the tax burden born by individuals who engage in various activities the implicit tax rates on consumption, labor income, and capital income are analyzed. Eurostat provides such data for the years from 2000 to 2012. The data relate the total tax revenue of a certain category to a proxy of the potential tax base of that category derived from national accounts.

Since the increase in the value added tax rate in January 2007 from 16% to 19%, the implicit tax rate on consumption in Germany is no longer lower than in the EU-27 as Figure 6 shows. The implicit tax rate on consumption is higher than the standard value added tax rate as it also comprises two other elements, a tobacco and alcohol component and an energy component.

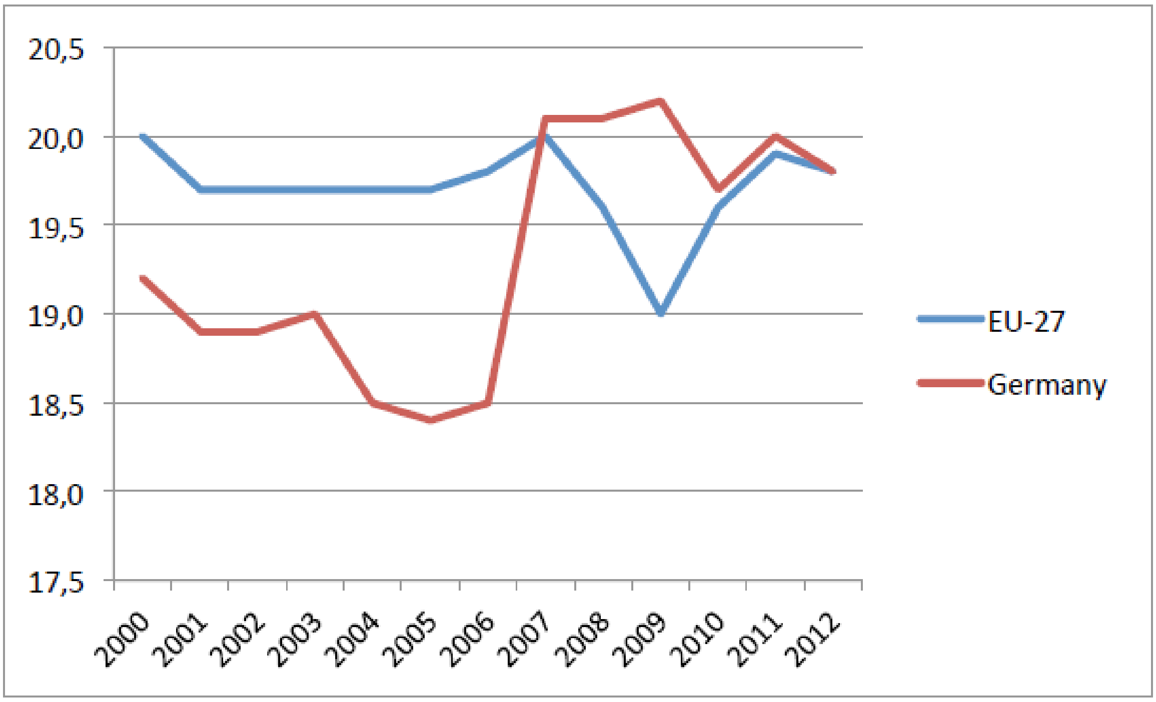

Figure 6: Implicit tax rate on consumption in Germany and the EU-27

Source: Eurostat

Whereas the implicit tax on consumption in Germany currently is close to the average for the EU-27, the implicit tax on labor is considerably higher in Germany than on average in the EU-27.

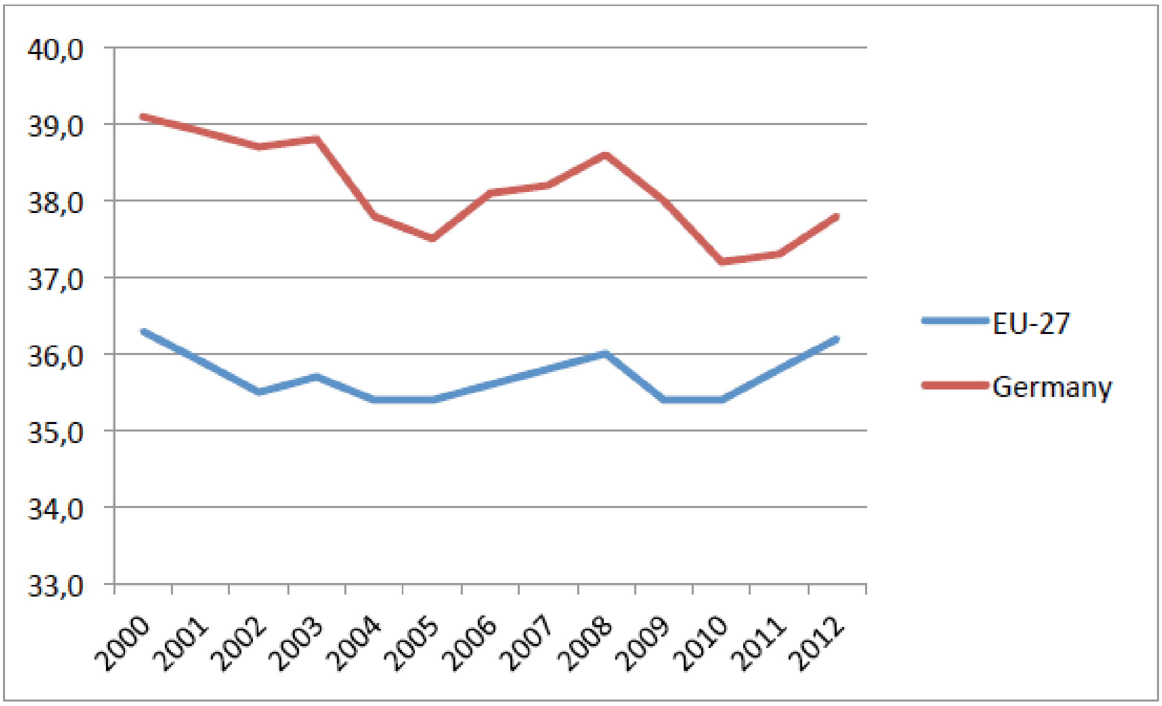

Figure 7: Implicit tax rate on labor income in Germany and the EU-27

Source: Eurostat

As Figure 7 shows the ratio of total taxes on labor (income taxes, pay roll taxes, contributions to social security) to total compensation of employees in Germany fell from the year 2000 to 2012 from slightly more than 39% to 37.8%. However, the share of the employees' compensation that goes to the state was 1.6 percentage points higher in Germany than in the EU-27 countries.

Although there are countries like Belgium and Italy (both 42.8%), Austria (41.5%), or France (39.5%) that put an even heavier burden on exchanges of labor, the German government should make an effort to make it less burdensome for companies and individuals to enter employment contracts. Unfortunately, the German government enacted policies that will increase the tax burden on labor transactions.

Since July 2014 employees can retire at age 63 (instead of at least 65) and receive their full retirement benefits if they contributed to the old-age pension scheme for at least 45 years. Also since July 2014 those who raised children born before 1992 can count additional time of parental leave towards their old-age pension credit and can thus increase their benefit claims. Though these changes benefit some current employees and some currently retired individuals, they will lead to an increase in the burden on labor transactions in the future. The implicit tax on labor in Germany can thus be expected to rise in the long run not only due to demographic changes but also due to short-sighted policies.

The implicit tax rate on labor varies considerably in the EU-27. In 2012, it amounted to 24.5% in Bulgaria and 42.8% in Italy. But the differences in the implicit tax rate on capital income are even more pronounced. In Estonia 8.1% of the capital income tax base had to be handed over to the government in 2012. In France the share of capital income taxes amounted to 46.9% of all capital income. Germany puts less of a burden on capital than does France but more than does Estonia, as depicted in Figure 8 that compares the implicit interest rate on capital income in France, Germany, and Estonia.

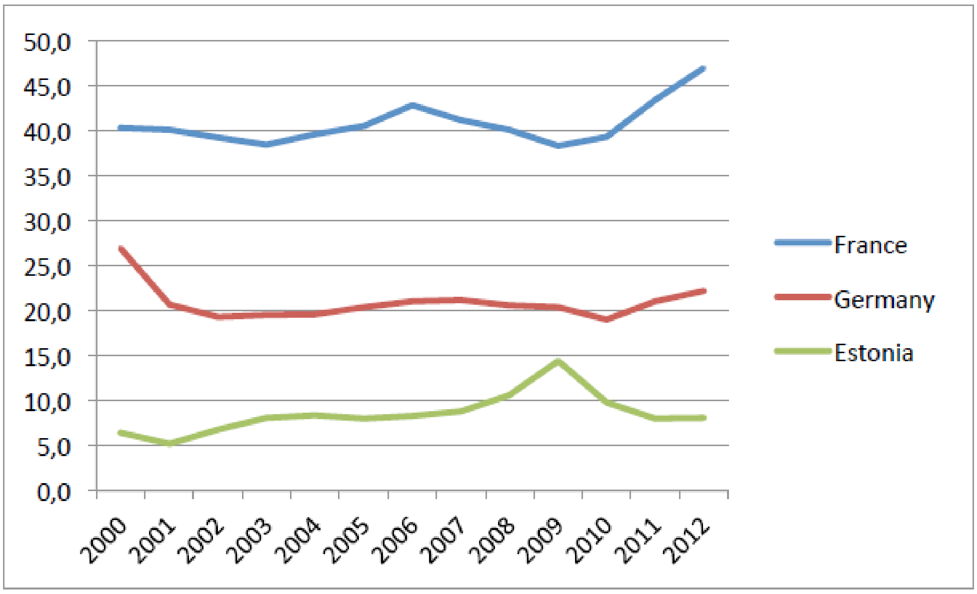

Figure 8: Implicit tax rate on capital income in Germany, France and Estonia

Source: Eurostat

Whereas the implicit income tax rate on labor in Germany in 2012 was above the mean and median of the EU-27, the level of the implicit income tax rate on capital income in Germany was below the mean and median for the EU-27 in 2012. In 2012, Germany remained relatively attractive for flexible investors as it taxed gains from the most mobile production factor, capital, relatively lightly compared to other large EU-countries such as Spain (25.3%), France (46.9%), or Italy (37%).

Administrative tax burden: Room for improvement

Taxes do not only strain productive activities through the direct monetary tax burden they create. Taxes are accompanied by administrative duties. The tax payment itself has to be conducted, documentation has to be provided, and requests by the administration have to be handled, among other things. The World Bank's Doing Business Index contains a sub-index that attempts to provide a measure of how burdensome taxation for mid-sized firms is by taking into account how many payments have to be made and how long it takes to prepare, file, and make the payments.

Figure 9 illustrates that since the mid 2000s the amount of days a mid-sized firm has to spend on preparing, filing, and paying its taxes has increased by roughly 10%. According to the Doing Business Index of the World Bank it took a typical firm in Germany 218 hours in 2014.

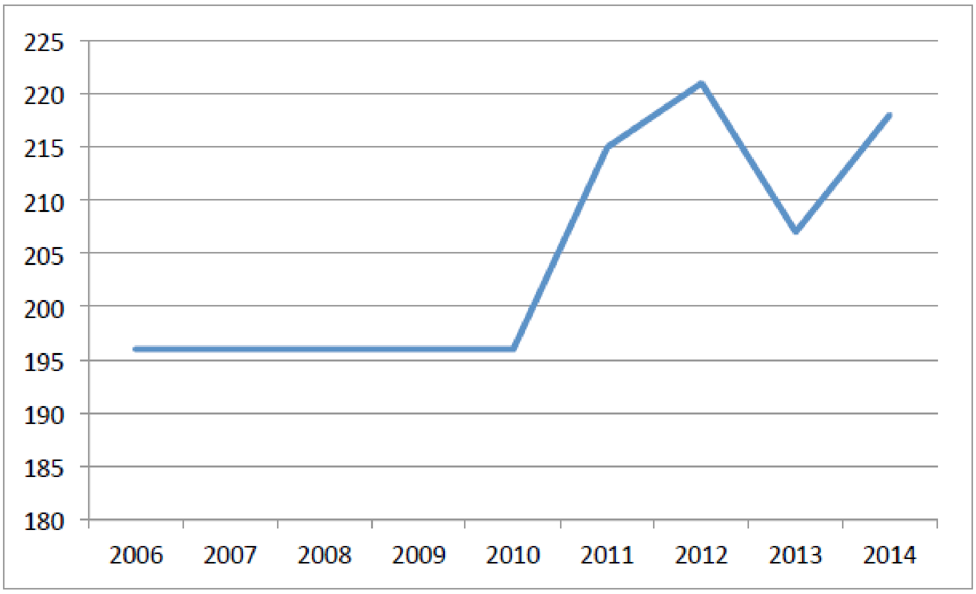

Figure 9: Hours spent by a mid-sized company on preparing, filing, and making tax payments in Germany

Source: World Bank Doing Business Index

For comparison, it only took firms in other large countries of the Eurozone such as France 132 hours, Italy 269 hours, and Spain 167 hours. Firms in Luxembourg spent the least amount of time on administering their taxes (55 hours) and firms in the Czech Republic found themselves on the other end spending 413 hours on the administration of their taxes.

Compared to other aspects of the Doing Business Index Germany performs poorly on the sub-index "Paying Taxes". Whereas Germany is ranked 21 among 189 countries for 2014 in the overall ranking, it only ranks 89 in the sub-index "Paying Taxes".[1] Germany's ranking suggests that the amount of time spent by a typical firm on its administration of taxes could be shortened by reducing the complexity of the German tax code - eliminating rules and deductions that do not apply to all tax payers equally.

1 The Doing Business Index consist of 10 sub-indices and Germany only ranks worse in the sub-indices "Starting a Business" (111) and "Protecting Investors" (98) probably because it is relatively expensive to get the required documents notarized and creditors are usually in a stronger position than equity investors in Germany.

Taxation and federalism: Fiscal decentralization is underdeveloped in Germany

In addition, the transparency of the fiscal apparatus could be increased by granting sub-central jurisdictions more fiscal autonomy. Despite the federal structure of the German governmental system, the degree of fiscal autonomy of the sub-central jurisdictions is rather limited.

Figure 10 displays the distribution of the total tax receipts to jurisdictions on various levels of government and to the social security insurances for 2012. After the redistribution of the receipts from the joint taxes (value added tax and income taxes) and transfers from the central government to the German states, the so called *Länder*, and to the EU the various levels of government received the following shares of the total tax receipts of 1.137 trillion Euro: Social insurances (old age pension, health, unemployment, and long term care) 47.2%, central government 22.6%, *Länder* 20.8%, communes 7.1%, and the EU 2.3%.[2]

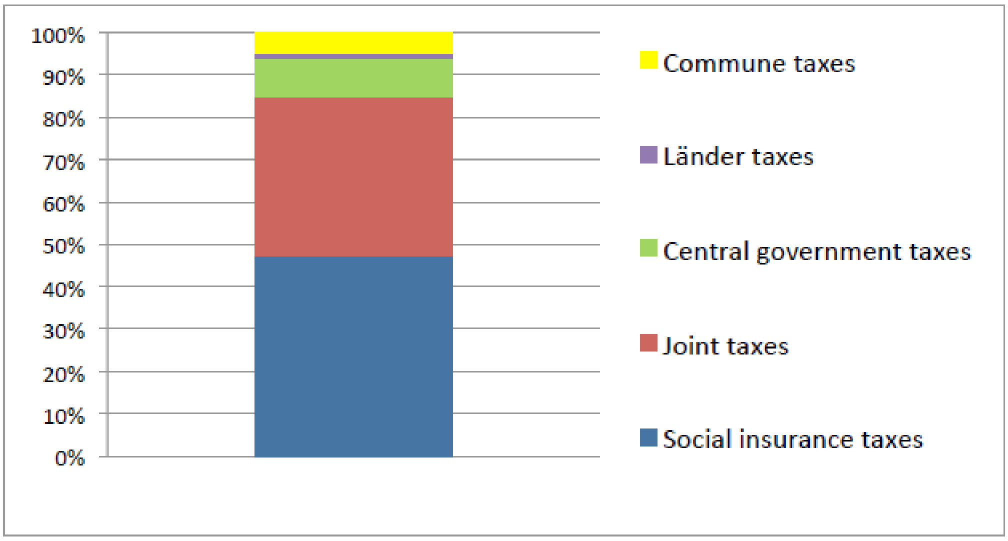

Figure 10: 2012 final distribution of tax receipts among levels of jurisdictions and the social insurances after the redistribution of the receipts from the joint taxes and transfers from the central government to the Länder and to the EU

Source: German Ministry of Finance and German Statistical Office

2 These numbers understate the share of the social insurances, because roughly 100 billion Euro of the central government's budget were transferred to the social insurances, in particular the old age pension fund and the health insurance.

Figure 11 lists the shares of five groups of taxes in the total tax receipts in Germany in 2012. 47.2% of the receipts went to the various social insurances. The central government autonomously controlled 8.8% of the tax receipts. The communes directly controlled 4.9% and the autonomous tax receipts of the *Länder* only amounted to 1.2% of the overall tax revenue in 2012. 37.5% of the total tax receipts were generated by joint taxes from which the central government, the *Länder*, and the communes share the receipts. Changes in the tax base or the tax rates of the joint taxes have to be agreed to by the German Bundesrat, the representation of the *Länder* at the federal level, but the *Länder* cannot autonomously implement changes.

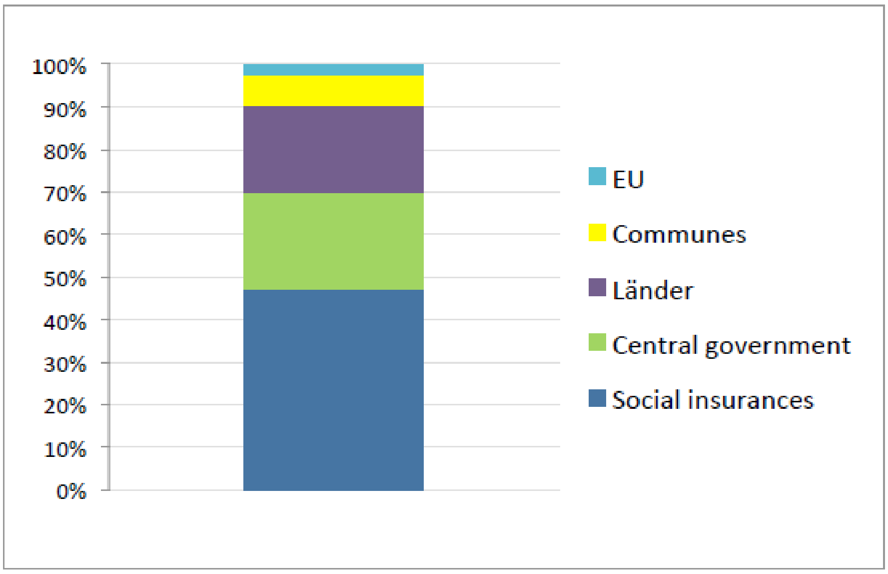

Figure 11: 2012 distribution of tax receipts among levels of jurisdictions and the social insurances before redistribution

Source: German Ministry of Finance and German Statistical Office

Whereas after the redistribution of the joint taxes, 27.9% of the overall receipts enter the books of the *Länder* and communes, the sub-central jurisdiction were in autonomous control of only 6.1% of the total tax receipts in 2012. An increase in fiscal decentralization would be desirable as it could put voters in a better position to monitor politicians in sub-central jurisdictions and to hold them accountable for their actions, both on the revenue side and the spending side.

Conclusion
Shaped or maybe reinforced since the global financial crisis of the years 2007 and 2008, the conventional wisdom portrays the German government as a miser. This portray may lead one to conclude that the tax burden imposed by the German government is relatively low. The numbers presented here paint a different picture. Germany is just a normal European Union country when it comes to the burden of taxation.

Though the German economy and the state's finances appear to be in relatively good shape compared to other large countries in the EU such as France or Italy, Germany's outlook is not too bright. The grand coalition of the Christian Democratic Union and the Social Democratic Party, which has been in charge since autumn 2013, so far enacted policies that aim at redistribution at the risk of stifling productive activity: The changes to the old age pension system mentioned above are, for instance, accompanied by a general minimum wage that will be introduced in January 2015 and the federal government already decided on a rent-control to be introduced early in 2015 that limits the maximum rent per square meter of an apartment that has been rented out before to 110% of the typical local rent.

Whereas the additional tax burden of increases in retirement benefits of some will show up in the official statistics in the future, the burden imposed by policies like the minimum wage and rent controls will not. Though the minimum wage has the same effect as a tax on low-paid labor and the rent control imposes a tax burden on rented apartments in popular neighborhoods.

The mentioned recent policy changes make it more difficult for individuals to coordinate their activities in a decentralized fashion. If the German government stays on its course of increasing interference in the transactions of individuals and other EU governments keep the tax burden on their populations constant, it may well be that with respect to taxation Germany soon will not be a normal EU country anymore.