

No. 177 Income Tax Relief Can Be Financed*

Taxation policy could be a major campaign issue in Germany in the coming year. The CDU SME Business Union has recently called for a lowering of the income tax in Germany. Tax cuts have not played a major role in the economic and fiscal policy debates of recent years, for various reasons. Firstly, after anchoring the “debt brake” in the German constitution, the reduction in public deficits has been the focus of attention. Secondly, in recent years the debt crisis in the euro area has kept politicians on tenterhooks.

True, isolated demands for income tax reduction have often been raised, but these demands have gone largely unheard, apart from occasional adjustments to the basic tax-free allowance. This could now change. Demands for tax cuts are coming not only from the CDU. Its sister party, the CSU, has submitted a tax reduction concept, and already in April, SPD chairman Sigmar Gabriel observed that at least the effects of bracket creep need to be offset.

This debate raises two questions. The first is determining whether tax cuts can be financed. The second is which tax should be reduced?

In terms of financing, tax cuts are always financially feasible provided there is a willingness to cut public spending. The refugee crisis is currently causing increased spending, but falling interest rates and rising employment numbers have brought relief to the public budgets. Determining the proper level of government spending is ultimately a political decision.

If in general we assume that the proportion of tax revenue to GDP should remain approximately constant, financial leeway does exist. Tax revenues have risen sharply in recent years, and there are indications that this trend will continue: The tax ratio, i.e. the ratio of tax revenue to GDP, will increase by 0.6 percentage points, according to the current tax revenue estimates for the period 2014 to 2020. Just keeping the tax ratio constant would mean that tax relief in the order of €18 billion would be possible.

In principle, this could also be achieved by lowering taxes other than the income tax, but there are important arguments for income tax cuts. The main argument is bracket creep or fiscal drift. Both inflation as well as real economic growth cause more and more taxpayers to fall into higher tax brackets. These are the “hidden” tax increases.

The effects of fiscal drift are seen in the fact that the share of income tax in total tax revenue is increasing. On the basis of the most recent tax revenue estimate, revenue from the income tax will increase by 35 percent for the period 2014 to 2020, while total tax revenue will increase by only 26 percent. Without a reduction in income tax, the structure of tax revenue would shift towards a higher weight for income taxes.

If for these reasons policymakers opt for income tax relief, how should this relief be designed? Ideally, a regular, automatic shift of the tax schedule would be the correct response to the problem of bracket creep. One-time relief would at least solve the problem temporarily. In addition, it would be possible to re-adjust the tax rates at different income levels and thus also the manner in which the burden is shared among the taxpayers. How could such a reform be designed?

A problem of the German income tax is that the marginal tax rate between the tax-free allowance, currently at €8,653, increases quite rapidly up to a taxable income of €13,669, from 14 to 24 percent. For incomes above this amount, the tax burden rises more slowly. This part of the income tax rate is often referred to as the “middle-class bulge”. Whether this behaviour of the tax rate is regarded as fair or unfair is a matter of political judgment. If the political aim is to provide tax relief to taxpayers with lower incomes, it is obvious that this middle-class bulge needs to be flattened. A complete elimination of the bulge would lead to a tax revenue shortfall of around €30 billion.

The CDU has proposed going not quite so far and reducing the tax rate at the end of the first progression zone from 24 to 20 percent. In addition, the amount of income in which the upper

proportional zone is reached, with a tax rate of 42 percent (with the solidarity surcharge, 44.3 percent), should be increased from the current €53,665 to €60,000. Above this limit, the tax rate is currently constant up to an income of €254,446.

According to the CDU concept, the tax rate should increase in the future until, at an income of €254,446, it reaches the level of 45 percent (with solidarity surcharge nearly 47.5 percent). With this element, relief for high-income taxpayers will be limited. This reform concept would reduce tax revenues by almost €24 billion. This does not take into consideration the subsequent behavioural adaptations, such as increased employment due to the tax relief. The actual tax revenue losses are thus likely to be lower.

It would be possible to finance income tax cuts of this magnitude. We can expect taxation policy to play a key role in the next federal election campaign. Opponents of tax cuts will have difficulties defending their position.

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