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*Tax Reforms and "Modell Deutschland":  
Lessons from Four Years of Red-Green Tax-Policy*

by

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**Abstract**

When the red-green (SPD-Bündnis90/DieGrünen) coalition took over the federal government from the Christian-Democrat/Free-Democrat (CDU/CSU/FDP) coalition in 1998, tax reforms had a very high political priority. And, in fact, the government pushed through an astonishing number of far-reaching tax reforms/tax changes within a period of little more than two years. This paper follows two aims. First, it gives a short description of the measures taken and evaluates them with respect to tax theory and the German tax reform debate of the 1990s. Second, it explicitly addresses the question whether the tax changes were influenced by the wish to reform the *Modell Deutschland*, i.e. whether something substantial was done to change Germany's status as a perceived high tax country and if so, whether the attempt was successful. It will be shown that even though the problem of high taxes might have been many observers' and, indeed, also the government's dominant concern, there was much more to the German debate. The chapter will also ask whether generously cutting taxes was the right thing to do. It demonstrates that under Germany's peculiar economic and institutional circumstances at the end of the 1990s, the attempt to cut taxes led to serious problems for fiscal policy, growth, and employment.

## **Tax Reforms and “Modell Deutschland”: Lessons from Four Years of Red-Green Tax-Policy\***

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### **1. Introduction**

When the red-green (SPD-Bündnis90/DieGrünen) coalition took over the federal government from the Christian-Democrat/Free-Democrat (CDU/CSU/FDP) coalition in 1998, tax reforms had a very high political priority. And, in fact, the government pushed through an astonishing number of far-reaching tax reforms/tax changes within a period of little more than two years.

This chapter follows two aims. First, it gives a short description of the measures taken and evaluates them with respect to tax theory and the German tax reform debate of the 1990s.<sup>1</sup> Second, it explicitly addresses the question whether the tax changes were influenced by the wish to reform the “*Modell Deutschland*,” i.e. whether something substantial was done to change Germany’s status as a (perceived) high tax country and if so, whether the attempt was successful. It will be shown that even though the problem of high taxes might have been many observers’ and, indeed, also the government’s dominant concern, there was much more to the German debate and that this is to some extent reflected in the reforms. The chapter will also ask whether generously cutting taxes was the right thing to do. It demonstrates that under Germany’s special economic and institutional circumstances at the end of the 1990s, the attempt to cut taxes led to serious problems for fiscal policy, growth and employment.

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<sup>1</sup> This part of the paper is based primarily on Truger 2001 and 2001a.

## 2. The German Tax Reform Debate in the 1990s

At the end of the 1990s the political pressure to reform taxes had become very strong. Criticism of the German tax system had grown louder and louder. The reasons for the dissatisfaction were many. Certainly the most important feeling, however, was that German taxes, especially those on income and companies, were too high and lowered the incentives to work, save, and invest and damaged Germany's international competitiveness. High taxes in the "*Standort Deutschland*" were seen by many as one of the main "structural" reasons for Germany's sluggish growth and dramatically rising unemployment over the 1990s. This impression was strongly reinforced by the lobbying and press campaigns of German industry. It is, of course, difficult to dismiss such arguments as pure propaganda, as they were backed by many economic advisors. Nevertheless, even a cursory look at the 1998 OECD revenue statistics (see Table 1) casts doubt on the hypothesis that German taxes were too high in international comparison. These figures show that the actual total tax burden in Germany is roughly in line with other advanced capitalist states. In certain categories, the burden is even considerably below EU-15 or OECD averages.

**Table 1: Tax revenues and social security contributions as percentage of GDP in Germany, USA, EU-15, OECD (1998).**

	Germany	USA	EU-15	OECD
Total revenue	37.0	28.8	41.1	36.9
- Social security contributions	15.0	6.8	11.4	9.6
- Total revenue excl. soc.sec.	22.0	22.0	29.7	27.3
- taxes on personal income	9.3	11.7	10.8	10.1
- taxes on corporate income	1.6	2.6	3.5	3.3
- taxes on property	0.9	3.1	1.9	1.9
- taxes on goods and services	10.1	4.6	12.2	11.4

Source: OECD (2001).

Consequently, beside the dominant “high-tax” complaints, there was a quieter debate on the structural deficiencies of the German tax system (DIW 1997; DIW/FiFO 1999; Krause-Junk 1998). One critique aimed at the reliance on social security contributions levied on labour, raising total labour cost and thus lowering employment. Consequently, some called for shifting taxation away from social security contributions and labour to income and consumption, where the burden was comparatively low. A second critique was that corporate income and property taxes were contributing less to overall revenue, as the general wealth tax had been abolished in 1997, and the share of corporate taxes had diminished considerably since the early 1990s. During this period, taxes on labour income and social security contributions were high and rising. A third criticism was the multitude of tax exemptions and allowances. Thus, the revenues in Table 1 resulted from high rates levied on a narrow base, and there was a call for cutting rates while broadening the tax base. This would simplify the tax system, make it more transparent, and thus perhaps increase compliance. There were also potential redistributive gains from such a strategy, especially if reforms reversed the ineffectiveness of capital income taxation in general and interest income in particular (due to tight German banker’s secrecy laws and the fear of capital flight).

A fourth prominent reform proposal was the introduction of an ecological tax that would levy (and steadily raise) taxes on fossile fuels in line with their energy or CO<sub>2</sub> content. Such taxes might lower the emission of greenhouse gases or pollution in general, and the revenue could be used to decrease social security contributions. Fifth, the basic tax free allowance for children/child benefits was an important topic, and the tax splitting in the taxing of married couples had come under pressure as it was both regarded as unfair and as discouraging married women from labor market participation (Seidel/Teichmann/Thiede 1999). Finally, there was the

longstanding necessity of redesigning the communal tax system, especially the local trade tax (*Gewerbesteuer*), as it had been severely criticised since the 1970s.

In addition to the fact that the call for tax cuts dominated the much more subtle diagnosis just sketched, the debate was also conducted with a sense of urgency. There had not been any major tax reforms since 1990 because German tax and fiscal policy had mainly and understandably been preoccupied with managing German unification (Bach/Vesper 2000). Moreover, the Social Democrats had blocked in the Bundesrat a major income tax reform proposal of the last Kohl government in 1998. Finally, there was the widespread feeling that something had to be done about Germany's economic crisis with low growth and rising unemployment, and an important part of the German public had been convinced that tax reforms/cuts would be the right remedy (Cox 2001). Accordingly, the next sections sketch reforms of income, corporate, ecological, property, and communal taxes, as well as Germany's unique system of tax equalization.

### **3. Germany's Institutional Structure and Economic Situation**

Five special characteristics of Germany's institutional structure and economic situation are helpful in understanding tax reforms and their consequences. First, after the Nazis' radical centralization of state control, occupied postwar Germany opted for a federal structure. Every federal system needs a fiscal architecture to make meaningful its rules and division of competencies. Yet Germany is unusual in that its states, while initially collecting most taxes, cannot set their own rates. And while state *executives*, through the upper house (Bundesrat), have significant influence in setting the uniform rates that prevail across the whole country, state *legislatures* generally have much less – a source of significant tension (OECD 1999: 76-79).

Further, the constitution mandates the need for explicit consent of both houses of the German parliament (Art. 105 and 106 GG). Thus, any time the federal government's coalition in the Bundestag is in the minority in the Bundesrat, reforms can easily be blocked.

Second, the German tax system is characterised by a high degree of revenue sharing between the different levels of government (*Bund, Länder, Gemeinden*) (BMF 2002). For example, with respect to the income tax, currently the federal government and the Länder as a whole each receive 42.5 percent of the revenue and the local communities receive the remaining 15 percent. There is also a large amount of redistribution from richer Länder to poorer Länder under the so-called *Länderfinanzausgleich* (LFA). Until recent reforms, the states with the lowest tax revenues were guaranteed up to 99.5% of the average tax revenues of all German states. States that generated by far more tax revenue than the national average could retain only up to about 103% of that average and had to pass on the rest to poorer states.<sup>2</sup> Thus, with the exception of the local trade tax (*Gewerbesteuer*) and the local land tax (*Grundsteuer*), there is hardly any tax competition. High redistribution and revenue sharing means that almost no tax reforms affect the revenue of just one level of government.

Third, the German constitutional court (*Bunerverfassungsgericht*) has always had a very strong influence on tax policy. As will be detailed below, many tax changes in recent years have become necessary because a verdict by the court had called the existing tax law as unconstitutional. Many observers increasingly suggested the court exceeded its competence when giving very detailed prescriptions for future tax laws (Böckenförde 1999; Höffe 1999).

Fourth, Germany still has to overcome the fiscal problems of unification (Priewe 2002a; Bach/Vesper 2000). Huge transfers from the West to the East – averaging more than three

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<sup>2</sup> Differences in tax revenues between the Länder result from different economic conditions or income differences among the Länder's inhabitants, not, however from differences in tax rates, as these are uniform across the country.

percent of German GDP (Flassbeck 1999) – were needed in order to finance the transition to a market economy in the New Länder. After the 1990 and 1991 unification boom, with growth rates of more than 5 percent induced mainly by deficit-financed public expenditure, Bundesbank monetary policy initiated a recession in order to contain inflation. After that, the economy never really recovered and grew at an average annual rate of only 1.2 percent from 1991 to 1997, with unemployment rising from 5.4 percent to 9.5 percent in the same period (see Table 2).

**Table 2: GDP growth and unemployment in Germany (1992-1997).**

	1992	1993	1994	1995	1996	1997	1998
GDP-growth rate (%)	2.2	-1.1	2.4	1.7	0.8	1.4	2.0
Unemployment-rate (%)	6.4	7.6	8.1	7.9	8.5	9.4	8.9

Source: OECD (2002).

Fifth, Germany's fiscal policy is restricted by the Maastricht Treaty (MT) and even further by the Stability and Growth Pact (SGP) signed as prerequisites of European Monetary Union (EMU). The 1992 MT limits the participating countries' government deficit to 3 percent of GDP. The 1997 SGP calls for balanced budgets or even budget surpluses in the medium term. The red-green government had projected to reach a balanced budget for total government budget by 2004 (BMF 2000). Compliance with the MT and SGP is monitored by the European Commission, and violation may be punished by severe fines. These restrictions placed severe limitations on the new government's room for maneuver, a fact that soon spilled over into the headlines. In March 1999, after only five months in office, Finance Minister Oskar Lafontaine resigned, and Hans Eichel became his successor. Lafontaine and his economic advisors were Keynesians and explicitly took into account the macroeconomic aspects of economic policy. Eichel has a much stronger supply-side orientation and soon put consolidation of the budget at the top of his agenda while at the same time pushing tax cuts.

## 4. Important Tax Reforms enacted 1999-2001

### 4.1 Income Taxation (Households and Families)

Personal income tax reform proceeded in several steps (see table 3) with the last two steps still to come in 2003<sup>3</sup> and 2005 (BMF 2000a; 2002a; Seidel 2001). After some smaller changes in 1999, the government implemented two major tax laws, the *Steuerentlastungsgesetz* (Tax Relief Act) 1999/2000/2002 in 1999 and the *Steuerreform* (Tax Reform) 2000 in 2000. The first contained a three step lowering of income tax rates that was only partly compensated by a broadening of the tax base. The top rate decreased from 53 to 48.5 % and the basic tax rate from 25.9 to 19.9 %, with the basic personal allowance increasing significantly. Altogether, gross projected annual tax relief was € 18.4 billion, and after broadening the tax base, there remained a net relief of € 12.4 billion (BMF 2000a). At the end of 1999, Eichel surprised the public with plans for even more ambitious tax cuts, this time without any major broadening of the tax base. The Bundestag consented in 2000 and by granting some further tax relief for business and high income earners the government succeeded in getting the Bundesrat's consent, a serious defeat for the opposition CDU/CSU in the Bundestag. The plan foresaw the basic tax rate decreasing to 15 % and the top rate to 42 % by 2005. Total projected annual tax relief amounted to a further € 16.7 billion or 4% of total 1998 tax revenue (BMF 2000a). Table 3 gives figures on personal and child allowances plus tax rates for the period 1998-2005 (projected).

**Table 3: Important changes in personal income and family taxation 1998 to 2005.**

	1998	1999	2000	2001	2002	2003	2004	2005
basic personal allowance	6,322	6,681	6,902	7,206	7,206	7,426	7,426	7,664
basic tax rate (%)	25.9	23.9	22.9	19.9	19.9	17.0	17.0	15.0
top rate (%)	53.0	53.0	51.0	48.5	48.5	47.0	47.0	42.0
child benefits 1 <sup>st</sup> and 2 <sup>nd</sup>	113	128	138	138	154	154	154	154

<sup>3</sup> In the meantime, the tax cut in 2003 has been postponed to 2004 (see section 6 below).

child each (€/month)								
child allowance (€/year)	3,534	3,534	5,080	5,080	5,808	5,808	5,808	5,808
child allowance for single parents (€/year)	2,045	2,045	0	0	0	0	0	0
child care allowance for single parents (€/year)	2,871	2,871	2,871	2,871	2,340	1,180	1,180	0

Source: BMF (2000a); BMF (2002b).

Germany has a dual system of child benefits and child allowances. Parents automatically receive *either* the benefits or the allowance; up to a certain income, the child benefits are larger than the tax allowance, but above that income, benefits are smaller, and the allowance is granted. Thus, high income families actually receive more support per child, which many regard as unjust. The government's policy was strongly influenced by a 1998 verdict from the constitutional court that declared unconstitutional that single parents were granted additional allowances and that there were no allowances for child care and education for married parents (Dingeldey 2001). The government then had to abolish the special allowances for single parents. At the same time, child care and educational allowances for all parents have been introduced in two steps. As these would have favoured high income families, the government also increased the child benefits in three steps. All in all the projected relief for families amounted to € 8 billion or 1.9 % of total 1998 tax revenue (BMF 2000a).<sup>4</sup>

## 4.2 Corporate Income and Business Taxation

More complicated changes have taken place with respect to corporate income and business taxation (Bach 2001; BMF 2000a; 2002a). The major reform came in 2001 and led to drastically lower rates and a complete switch in the system of corporate income taxation. Before

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<sup>4</sup> Plans to formally reduce tax splitting for married couples were not realized, though there is some de facto reduction due to the lower rate. Many argue that the constitutional court might ban attempts to reduce splitting and will not allow splitting to be abolished completely.

the reform, retained profits and distributed profits (dividends) were taxed at different rates: The retained profits were taxed at 40 % (before 1999: 45%), and dividends were taxed at the stakeholders' personal income tax rate. After the reform, tax rates are uniform at only 25%. Dividends are still subject to personal income tax, but to avoid full double taxation, only one half of the dividends is taxed.

Most German companies are unincorporated with profits subject to their owners' personal income tax. Thus, lowering corporate tax rates did not help unincorporated companies, yet it was clear that a similarly drastic lowering of the personal income tax rate was not sustainable. One alternative – to tax profits at a lower rate – was banned by the constitutional court. Therefore, in addition to the lower tax rates due to the reform of the personal income tax, unincorporated companies' local trade tax is credited in a standardized manner against their income tax liabilities, thereby further reducing their tax burdens.

The projected gross tax relief for companies from these reforms amounted to € 36 billion, but there was a substantial broadening of the tax base (mainly reduced depreciation). Still, projected annual net tax relief amounted to more than € 14 billion (BMF 2000a). Even a summary of the very controversial discussion on the costs and benefits of the reform is too complicated to include here. However, one largely unexpected result of the reform must be noted, namely the dramatic revenue losses from the corporation tax: Whereas the corporation tax used to produce an annual revenue of more than € 20 billion before the reform (€ 23.6 billion in 2000), it produced a negative revenue of € –0.5 billion in 2001 and will probably yield not much more in 2002 (BMF 2002c). Though the revenue losses can partly be explained by low growth since 2001, a substantial part (one third to one half) of the losses stem from a problem in the reform: During a fifteen year transition period to the new system, corporations can distribute retained profits from earlier years and receive the difference between the old (higher) tax rate

and the new one from the revenue authorities (SVR 2002: 221-224). Corporations have done so to an unexpected extent in 2001 and 2002. It is hoped that in future years this effect will diminish. The effect on total revenue is softened a little, since the distributed profits are subject to income taxation, but the net revenue effect is still negative.

### **4.3 Ecological Tax Reform**

One of the core tax reform projects promoted by the Green Party was the ecological tax reform (Truger 2001b). During the 1990s, detailed plans had been developed, and when the red-green coalition formed the government in 1998, it was clear that something would be done. The ecological tax reform implemented is revenue-neutral, which means the revenue from the new or increased taxes on fossil fuels and electricity were transferred to the public pension system in order to lower social security contributions. The switch had two purposes: On the one hand, taxes were to be used as market based instruments of environmental policy to induce energy and climate protecting changes in both production and consumption. On the other hand, the lower social security contributions were to reduce the comparatively high tax burden on labour and thus promote employment. Table 4 shows the changes in the regular tax rates induced by the reform. In order to secure international competitiveness, there are important special allowances for industry and agricultural. Companies in these sectors pay only 20 % of the new tax on electricity and of the increases light heating oil and methane taxes. Industrial firms also get refunded the part of their eco-tax payments that exceeds 120 % of the compensating reduction of social security contributions. Even after the increases, German energy tax rates remained well below the EU's highest (Truger 2000).

**Table 4: Important tax rates/changes within the ecological tax reform (1998-2003).**

	1998	1999	2000	2001	2002	2003
Petrol (unleaded) (€/1000 l)	501.07	531.74	562.42	593.10	623.80	654.50
Diesel (€/1000 l)	317.00	347.68	378.36	409.03	439.70	470.40
Methane (€/ MWh)	1.84	3.48	3.48	3.48	3.48	3.48
Light heating oil (€/1000 l)	40.90	61.35	61.35	61.35	61.35	61.35
Electricity (€/MWh)	-	10.20	12.78	15.34	17.90	20.50
Coal (€/1000 kg)	-	-	-	-	-	-
Heavy heating oil (€/1000 l)	15.34	15.34	17.89	17.89	17.89	17.89
Revenue (billion €)	-	4.2	8.7	11.2	13.8	16.4

Source: BMF 2001, author calculations.

From an ecological point of view, the reform has been welcomed by many as an important first step. On the other hand, several criticisms remain: The tax rates are rather unsystematic and not in line with energy/CO<sub>2</sub>-content; they are still too low to induce strong ecological effects; and there are too many special allowances for industry. The revenue shift has only been a partial success, as the intended reduction of 1.8 percentage points of the social security rates for 2003 has been missed by 0.7 percentage points.<sup>5</sup>

#### 4.4 Property Taxation

As can be seen from Table 1, the revenue from property related taxes in Germany, at 0.9 % of GDP, is very low. There has been a steady decline over the decades, and during the 1990s two property taxes, the annual wealth tax and the property related element within the local trade tax (*Gewerbesteuer*), were abolished (Loeffelholz 2001; Schratzenstaller 2002). The abolition as well as some changes in the inheritance and gift tax and the tax on land acquisition (*Gründerwerbsteuer*) had taken place since a 1995 verdict from the constitutional court had judged the unequal taxation of financial property (higher) and real estate property (lower) to be unconstitutional. In addition, the court judged the annual wealth tax to be justified only under the

condition that the total tax burden of the estimated yield from property through the income tax and the wealth tax together did not substantially exceed 50 percent of that yield (*Halbteilungsgrundsatz*). This latter prescription contributed mightily to the court's reputation as the "secret legislator" of German tax policy.

From a distributional point of view, one possible task for the red-green government would have been to find legal ways to revive the wealth tax. Though there was the danger of provoking problems with the constitutional court, there was certainly some room for that, even accepting the arbitrary aspects of the *Halbteilungsgrundsatz*. A less risky alternative would have been to raise the inheritance tax, which had to be reformed before the end of 2001 anyway. However, as part of its tax-cutting strategy, the government chose not to do anything about property taxation, apart from appointing a commission to find ways to implement a more equal treatment of financial and real estate property within the inheritance and gift tax (Commission 2000). After that, the proposal of the commission which would have produced very little extra revenue (less than € 1 billion) was ignored and the existing laws were extended until 2004.

#### **4.5 Communal Tax Reform**

The central problem of Germany's local tax system is the trade tax, which is levied on local companies' profits and which allows for considerable tax rate variability across the communities (see Zimmermann 1999). Providing about 11 per cent of total communal revenue, the trade tax is the communities' most important independent revenue source. Most communal revenue comes from state grants, user fees, and a 15 % share of the income tax. The trade tax has been criticized for more than 30 years, but there still has not been a major reform. The most

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<sup>5</sup> This was mainly due to rising unemployment due to the slowdown of the world economy (see section 6 below).

serious problem is its extreme dependence on the business cycle: In economic upswings, the revenue increases in a disproportionately strong manner, and vice versa in recessions. Since communities' ability to take on debt are very limited, fluctuating revenue leads to cyclical local expenditures. And since communities make up about two thirds of German total public investment, and since investment expenditure is their most discretionary category, communities increase investment in boom times and decrease investment during recessions. Thus, trade tax serves as built in macroeconomic destabiliser.

The red-green government, like previous ones, has not reformed the trade tax, though it might well be that from a macroeconomic point of view, this might even have been more important than the reform of company taxation. The Tax Relief Act and the Tax Reform 2000 have only added to the communities' fiscal problems, as they are affected by the revenue losses because of revenue sharing (Karrenberg 2001). When in 2001 the economy slowed (see section 6 below), communities' financial problems worsened and communal tax reform was back on the agenda (Bach/Vesper 2002). The government has appointed a reform commission in 2002, but this remains an area in which reform is needed.

#### **4.6 Tax Equalization**

German unification had forced some hard choices about the LFA system (Renzsch 1991, 1994; Burchardt 1992; Hüther 1993; and Hickel 1992). If the five East German states had simply joined the LFA system under the existing rules, redistribution would have had to rise from 3.5 billion DM<sup>6</sup> per annum to about 20 billion DM. Indeed, if the LFA were to remain unreformed, *every* West German state but Bremen would have become a net payer. In response, Bonn and

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<sup>6</sup> One € is 1.95583 Deutsche Mark.

the Western states had agreed to put off admitting the new states to the LFA until 1995. Instead, they set up and financed the Fund for German Unity (*Fond Deutscher Einheit*). Then as the public finance misery of the Eastern states became more apparent, Bonn responded with a new program, *Aufschwung Ost*, which provided about 24 billion DM in 1991 and 1992 for investment and employment in Eastern Germany (Sally and Weber 1994). In 1995, Bonn then footed the bill for extending the by-now staggeringly expensive LFA to the five new states. “Vertical redistribution” from Bonn jumped almost 500% between 1990 and 1995 (from less than 5 billion DM per year in the early 1990s to around 25 billion DM from 1995 (Jacoby 2002: 14). Because Chancellor Kohl had made such a commitment to the Fund for German Unity, he could not accept a breakdown of the system that paid for it and was thus in a difficult bargaining position vis-à-vis the states.

The pattern of minor concessions by current recipients coupled with increased federal payments was repeated in negotiations in June 2001. Even though only five states now paid into the LFA (while eleven are beneficiaries), the sides extended the LFA system from 2005 through 2019. Two institutional factors shaped the deal: first, the constitutional court had ordered the parties to find a more just system in response to a suit brought by Bavaria, Baden-Württemberg, and Hesse. Second, if the state governments could not broker a unanimous deal, maneuvering would shift to the Bundestag, where more parties would be involved, and a plurality would suffice. Given the implicit backing of the court, the richer states did well in this deal, achieving a new rule allowing them to keep the first 12% of revenues over the national average plus a cap on their total contribution. Bavaria will gain an estimated 400 million DM per year from these new arrangements. Yet, the poorer states of Western and Eastern Germany did not lose the benefits they had won during the 1995 negotiations. Instead, when negotiations seemed in trouble, Schröder stepped in with 13 billion DM to compensate the poorer states for the funds the richer

would be allowed to retain. Thus, even a poor state such as Bremen will get an additional 70 million DM per year more than under the prior system. All in all, this was an expensive accord for the federal government.<sup>7</sup>

## 5. A Brief Evaluation of the Reforms

To come to some general evaluation of the reforms one can use as yardsticks both traditional tax theory and the German tax reform debate of the 1990s. The first considers only the effects of the reforms actually implemented, whereas the second also considers which of the proposed reforms have been enacted and which have been neglected. Traditional tax theory distinguishes between a tax reform's effects on allocation (incentives and efficiency), (re-) distribution, and economic stabilisation (Musgrave 1959; Rosen 1998: part 4 and 5). From the point of view of incentives and efficiency, the changes have certainly brought some improvements. This is particularly true for the *tax-cuts-cum-base-broadening* elements in the income tax reform, which have certainly reduced excess burdens and raised incentives to work, save and invest. It is also true – with some qualifications – for the ecological tax reform, which provides incentives to economise on fossil fuels and contributes to relieve the tax burden on labour. Economists disagree, however, about whether the reform of the corporate income tax has improved incentives. Since tax rates have been lowered substantially, it can be argued that international competitiveness has increased. From an efficiency point of view, however, the reforms have certainly failed to reduce the complexity and administrative cost of the tax system.

With respect to redistribution, the measures have a slight bias in favour of high income households. The government pursued a balanced income tax reform by substantially raising the

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<sup>7</sup> The parties also agreed to fund the *Aufbau Ost* program with 306 billion DM over the same period. Thus, the LFA, *Aufbau Ost*, and Fund for German Unity will all run until 2019 under the June 2001 deal.

basic tax free allowance, yet the substantial lowering of the top marginal rate still leads to less redistribution (Wagenhals 2000). It also seems that corporations and companies gained relatively more than households.<sup>8</sup> And since high income households own more company shares, this also will add to the bias in their favour. Families with children gained substantially through higher child allowances and child benefits, with high income families gaining absolutely and sometimes relatively more than lower income families. All in all then, income disparity can be expected to increase.

With respect to stabilisation policy, automatic stabilisers may be slightly weakened as tax progression for high income earners has been reduced, and there has been a shift to indirect taxes through the ecological tax reform. As to discretionary stabilisation, the tax cuts naturally have expansionary effects, though the tax-side must not be seen in isolation from the expenditure-side of the budget to obtain fiscal policy's total effect (see section 6 below). The timing of the steps so far has been arbitrary in relation to the economy's output gap since in 1999 and 2000, the tax cuts came pro-cyclically as the economy was recovering, while in 2001, they helped stabilise the economy in a counter-cyclical way. All in all then, from a tax-theoretical point of view, the evaluation of the reforms depends on the weights that are attached to efficiency, distribution and stabilisation. Here, some efficiency gains have to be weighed against losses in distribution and stabilisation.

Taking the German tax reform debate of the 1990s as a yardstick, several elements of the debate are reflected in the government's reforms, whereas some others clearly have been neglected. The general pattern points to the characterisation of the reforms as mainly supply-side and/or "*Standort*"-oriented with some distributional and ecological influence (Truger 2001a).

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<sup>8</sup> This, of course, is only a first-round-effect since taxes ultimately are always borne by individuals, not by companies.

The government has clearly stressed cuts in income and corporate taxation to promote private incentives and international competitiveness. This is obvious from the government's rhetoric – “less taxes, higher investment, more competitiveness, more jobs, higher private consumption” (BMF 2000a) – as well as from the measures taken: The substantially lower tax rates were only partially compensated by broader tax bases. The projected annual tax relief for households and companies up to 2005 as compared to 1998 is the largest in the history of the Federal Republic, amounting to more than € 48 billion (BMF 2000a). This figure is 2.6 percent of Germany's GDP in 1998 and 11.8 percent of total 1998 tax revenue (excluding social security contributions). At the same time, there have been no increases in other taxes since the ecological tax reform is revenue-neutral and attempts to revive the annual wealth tax or raise the inheritance tax have been blocked by the government. Indeed, because of its many loopholes, the ecological tax turned into a de facto subsidy for German industry. Moreover no serious attempt has been made to make capital income taxation more effective or to touch banker's secrecy laws. In sum then, the “high-tax” and the “*Standort-Deutschland*” arguments, which had already dominated the tax reform debate, have to a great extent been translated into red-green tax policy, whereas more traditional redistributive and more ambitious ecological goals obviously have not.

## **6. Broadening the Perspective: Effects on Fiscal Policy, Growth and Employment**

As Chancellor of the first red-green government, Gerhard Schröder famously asked voters to judge him on the country's economic performance. Accordingly, the stakes for sparking growth and reducing unemployment seemed very high. As can be seen in table 5, however, the significant reforms detailed above have not led to positive trends in growth. And while the unemployment rate did decline, the Chancellor could not come close to keeping his promise to

cut the ranks of the unemployed below 3.5 million.<sup>9</sup> What went wrong? For some, the answers would lie largely in monetary policy, wage policy or labor market regulation, and we would not deny the importance of either of those policy domains.

**Table 5: Macroeconomic Indicators for Germany (1997-2003).**

	1997	1998	1999	2000	2001	2002	2003
GDP-growth rate (%)	1.4	2.0	1.9	3.0	0.6	0.4	0.9-1.4 <sup>1</sup>
Unemployment-rate (%)	9.5	8.9	8.2	7.5	7.4	7.8	-
Deficit-GDP ratio (%)	2.7	2.2	1.6	1.4	2.7	3.2-3.7 <sup>2</sup>	1.9-3.3 <sup>2</sup>

<sup>1</sup> estimate by Institute (2002);

<sup>2</sup> estimate by Institute (2002) (first value) and SVR (2002) (second value).

Source: OECD (2002); Institute (2002); SVR (2002).

As we have seen, however, the impetus behind significant changes in tax policy was always the argument that economic improvements would result from lower (and simpler) taxes. There are at least two ways in which cutting taxes might lead to more growth and employment. First, some argue that cutting taxes and decreasing government spending – for example, on the welfare state – may unleash market forces in the long run. In general, the empirical evidence for this claim is unimpressive (see Atkinson 1993;1999), but in the case of Germany in the 1990s it is simply doubtful that liberal orthodoxy about cutting government expenditure made much political sense (Flassbeck 1999). It would have seemed counterintuitive to dismantle the welfare state just when it was needed most, e.g. in the aftermath of unification. Moreover, it seems odd to cut government spending just when massive public infrastructure investments in the East are called for (Vesper 2001). As a result, the lower tax/lower spending regimen was never fully applied. German total government spending actually rose as a percentage of GDP in the 1990s compared to 1989 by about 2.5 percentage points, and this was primarily a result of growing

<sup>9</sup> In fact, the number was above 4 million at the time of the election.

unemployment and the investment needs of German unification. If the first proposition is to gain any credence from the German case, clearly this was not the right period in which to test it out.<sup>10</sup>

Thus, the more plausible argument for cutting taxes in Germany applies to the short run. Cutting taxes can stimulate the economy via demand side effects (Blanchard 2000: 92, 357, 518). The logic is that lower taxes lead to higher disposable incomes. If at least part of this income is spent for consumption or investment, higher growth and employment eventually results. From this point of view, expansionary fiscal policy in the form of lowering taxes certainly made sense at the end of the 1990s after several years of low growth and rising unemployment. However, in order to really stimulate the economy via tax policy, it is essential that the expansionary effects of lower taxes are not (over-)compensated by restrictive measures on the expenditure side of the budget. In other words, when cutting taxes it is essential that one is willing to temporarily accept a higher government deficit. This higher deficit need not be permanent and may well be part of a medium-term consolidation process. Once economic growth is restored, tax revenues will eventually rise again, and if expenditure growth is limited, consolidation will result.

Yet in the late 1990s no such deficits were possible in Germany since the MT and the SGP mandated keeping the deficit below three per cent of GDP and running a balanced budget in the near term. Hans Eichel took over the Finance Ministry in 1999 and made budget consolidation his top priority, initiating an austerity programme that substantially diminished the expansionary effects of the tax cuts (Bartsch et al. 1999). Still, the economy recovered, and in 2000 it grew at three per cent due mostly to a booming world economy. Everything might have turned out well if nothing unexpected occurred. But something did: After several years of robust growth, in 2001 the US economy slowed, and Germany found itself on the verge of recession

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<sup>10</sup> The classic supply side argument is that a permanent tax cut might increase labor supply as a consequence of falling marginal tax rates. While labor supply may become a long-term problem for the German welfare state, the

(see table 5). The 2001 reform step contained substantial tax relief that was not counteracted by further expenditure cuts, and it helped stabilize the economy and prevented negative growth rates. But this planned step was too weak to do more, especially since it was not sufficiently flanked by either an eased European monetary policy or more expansive wage policy (Truger/Hein 2002).

In combination with revenue losses from the drop in economic activity, the cut also brought the German deficit very close to the three percent limit. An important part of the revenue losses resulted from the reform of the corporate income tax, which as noted earlier, actually produced negative revenue in 2001. With no convincing signs of recovery for 2002, the government saw no room for fiscal stimulation, and overall fiscal policy remained restrictive. In order to avoid a formal EU warning, the government committed to further austerity for 2003 and 2004. However, low growth kept tax revenues falling, and it became clear it would be difficult to stay below the three per cent limit in 2002 and also balance the budget after further planned tax cuts in 2003 and 2005. When floods devastated parts of Eastern Germany and Bavaria in August 2002, the government used the population's feelings of solidarity as cover for postponing the 2003 tax cut until 2004 and levying a 1.5% surcharge on the corporate income tax in order to finance a € 7.1 billion recovery program for 2003 (BMF 2002d). Under the circumstances, the opposition chose not to try to block this in the Bundesrat. As of this writing (December 2002), the re-elected government faces tax projections that show a complete mess (BMF 2002c). The deficit will exceed the three per cent limit in 2002, which has already led to the start of the formal "excessive deficit procedure" of the MT by the EU Commission. This process could result in fines if the government cannot contain the deficit. Prospects for recovery in 2003 are poor (SVR 2002 and Institute 2002), so that in order to meet the Maastricht criteria, the

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high numbers currently unemployed diminish the need for a mechanism to increase labor supply.

government will once again have to run an austerity program in the face of an economic slowdown.

What could have been done to avoid the problems? Obviously, had the Maastricht criteria and the SGP not existed, the problems would have been much less severe (Priewe 2002). Clearly, the combination forced the EMU member countries into restrictive fiscal policies that significantly limited counter-cyclical options during economic slowdowns in the 1990s (Truger 2002). Without the SGP, Germany could have accepted the temporarily higher deficits due to the combination of lower growth and tax cuts and let automatic stabilisers and expansionary fiscal policy work. As demonstrated by the experience from the beginning of the 1990s in the United States – where deficit to GDP ratios ran to six percent – there is nothing fatal about a deficit ratio temporarily above three per cent (Priewe 2001).

If one accepts MT and SGP, which the red-green government certainly did, the alternative would have been to provide less generous tax cuts (especially Tax Reform 2000 and corporate income tax cuts) and include some of the redistributive proposals that it ignored in the German tax reform debate, such as increasing the inheritance tax or reintroducing the wealth tax early in 1999 or 2000. With the help of such measures, the deficit to GDP ratio could easily be a full percentage point lower now. It is, of course, difficult to blame the government for not having foreseen the economic slowdown when the official economic experts did not do so either. But even ignoring the revenue side, there were good reasons for such measures from the point of view of increasing the distributive justice of the tax system alone. Of course, such alternative measures would have had to pass through the Bundesrat, and pursuing them would have meant challenging the dominant views in the German tax debate. They would not have been easy to achieve; the point here is that the government did not even try them.

## 7. Perspectives for Future Tax Policy

It is very difficult to predict future changes in tax policy because the government's post-election reaction to the budget problems has been chaotic with new proposals or revisions presented almost daily. Finally, the cabinet decided to cut spending by about € 8 billion, increase taxes by about € 5 billion, and social security contributions by about €7.5 billion in order to keep the deficit ratio below three per cent in 2003 and come closer to balancing the budget in the following years (BMF 2002e, 2002f). When the tax increases are fully realized, the projected extra revenue will amount to € 17.3 billion. Though both higher taxes and lower spending will have adverse effects on growth and employment, the projected tax changes do include some of the measures that had been called for from the distributive and ecological points of view but had not previously been taken up by the government. As reactions from the media and the public have been furious, the original plans have been softened to an extent, but still they include a capital gains tax, loosening of the banker's secrecy, a minimum tax on corporate profits, a slight strengthening of the local trade tax, tax increases on fossil fuels that are more in line with energy usage, and reduced special exemptions for industry in the existing eco-taxes (BMF 2002). In addition, the SPD Länder are preparing an initiative to revive the annual wealth tax (Handelsblatt 2002).

It is, of course, still uncertain whether the concept will pass the Bundesrat. If it does, the red-green tax reforms will substantially improve on the German tax system both from an efficiency and a distributive point of view. Ironically, however, their main intended goal, increasing growth and employment, will almost certainly be missed since the reforms have been ill-timed and not been embedded in a coherent fiscal policy. With binding deficit constraints like the SGP, it is very risky to cut taxes generously, because the expansionary effects from the tax side are always in danger of being (over)compensated by destabilising cuts on the expenditure

side. Unfortunately, since the high-tax-complaints remain dominant, no political forces in Germany have both the insight and the courage to recognize this enduring structural dilemma. Instead, when Germany sees the next iteration of the “high-tax-debate” (as it surely will), that debate, if translated into policy, will likely produce a growth and employment result as disappointing as the last one.

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