

THE ROLE OF TAX POLICY IN THE COURSE OF ECONOMIC DEVELOPMENT: THE GERMAN CASE

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I. Introduction

It is recognized that taxation has an impact on the economic development and that tax policy is advised to take this into account. Moreover I would like to say, that measures of taxation directed to revenue-sharing, distribution-, stabilization- and allocation aspects - as commonly differentiated in the theoretical literature - affected each one on its own the economic development.

What we do not know exactly is how the economic development is affected in terms of intensity and direction of each one of the policies measures and in their joint-impact.

There are plenty of theoretical analysis around which support this or other argument¹. But who wants decide what is the correct model for a concrete situation and who is willing derivate from statistical figures the correctness of one or another theoretical model.

Just in order to avoid this discussion my presentation is limited on general remarks without pretending that there is any clear correlation between tax policy measures and economic development.

Nevertheless my task to describe the role of tax policy in Germany is still difficult enough since Germany is in the moment in a transitional period. The creation of a single market in Europe in 1993 and the unification will bring further significant changes in the tax system although the latest tax reform goes back only two years.

In the following I will first describe the general conditions under which tax policy and tax management operate in Germany (II). Then various areas of tax intervention - already mentioned above - will be dealt with in the context of tax policy

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practice in Germany (III)², before I will discuss the latest issues of taxation with respect to the creation of a single market in Europe and the unification of Germany (IV). The paper will conclude with a few general remarks on the topic of tax policy and economic development, drawing general lessons for developing countries when reforming their tax systems (V).

II. Tax policy and tax management in Germany: General conditions

Taxes constitute the basic source of government revenue in Germany³. This is true for all levels of government within the federative structure of Germany.

The level of taxation is thus decisive for all major public expenditure programs - services, transfers and investments in public infrastructure. It also constrains public borrowing, since the servicing of debts has to be born out of the regular tax revenue.

This revenue-raising aspect, the fiscal-function, played not only a major role in the beginning of taxation in general, but it also remains the centerpiece of public policies in Germany today.

Especially in the context of this policy function it has to be considered, that tax policy and tax management operate on a specific cultural background - especially the compliance to pay taxes.

With respect to this compliance there is now in Germany a widespread recognition that paying taxes is necessary in general.

This might be due to the attitude that it is worthwhile to hand over part of one's income in return for services provided for by the state: Such as an improved infrastructure, social security, a reliable judicial system and the provision of a varied cultural life as well as the financing of scientific progress.

The willingness of taxpayers has furthermore increased with their ability to take legal actions against the tax office. Independent courts of finance have proven to be a necessary precondition for the functioning of the German tax system. With them, the citizen's and taxpayer's voice has been put on equal terms with that of the state. This fact in turn has increased the general willingness to obey the tax laws and the said courts are increasingly being used by taxpayers.

Also the so-called tax secret plays an important role in explaining the German taxpaying morality. Anyone who discloses his financial situation to the tax office can rely on that this information will be treated highly confidential. Even within the walls of the tax office itself, this information can be passed on only if there are substantial practical reasons for it. Any violation of this rule is subject to the court of law and will be prosecuted.

Finally tax policy, tax management and taxpayers are furthermore assisted by the help and constructive criticism of the profession of tax consultants as well as of the teaching profession at law schools. Not only do both groups stabilize the existing tax system, they also give an impetus for its further development.

Under these circumstances we are confident that the taxpaying morality in the new federal states of former East-Germany will reach the west-german standard very quickly.

Thus we expect that the recently applied measures in order to meet the costs of unification will not end up in higher tax evasion. To finance the unification a new law has been passed increasing taxes on petrol and introducing for a limited period a so-called solidarity surcharge on top of income tax.

III. Areas of tax intervention

However, as we already know, it is not the sole purpose of tax policy and tax laws to fulfill the states financial needs. Tax policy also serves as a tool for public intervention.

The fact that wherever taxes are applied, taxpayers tend to react in order to avoid or reduce the tax burden in the meantime led to the recognition, that taxation can be used to change this behaviour into desired directions.⁴ The economist now typically assigns the effects of taxation to three facts of public intervention: a) Distribution policies, b) stabilization policies and c) allocation policies.

During the history of taxation the emphasis has been shifting between these policy objectives. I will now deal with this various areas of tax intervention in the context of tax policy practice over the past forty years in Germany.

3.1 The distribution function of taxation

At the beginning of a deliberate interventionist approach to taxation, the emphasis was on social justice or fairness, hence on distribution policies. It had become clear, that "simple" taxes, like a polltax or excise taxes, totally disregard the ability to pay of the person bearing the tax.

Like everywhere in the Western world, also in Germany the first two decades in the post-world-war-II history of taxation were the heydays of redistributive taxes. As the history of redistributive tax policies is intrinsically related to the development of modern income taxation a system of progressive income taxation was established on the basis of the fundamental philosophy: Personal taxation should reflect the ability to pay taxes; and this ability to pay is at least proportional to the command over resources as expressed in the income accruing to the individual taxpayers.

In Germany progressive taxation has been realized into two ways: indirectly by leaving a basic allowance tax-free and directly by applying a progressive tax schedule onto taxable income.

However, as in the course of time in Germany - as in other Western countries - progressivity became more and more acute, and a mounting share of taxpayers was consistently moving into the progressive scale of the tax schedule the German government had to react.

And it did so the last time in the tax reform of 1987 to 1990 by increasing the amount of tax reductions notably for families with children and by mitigating the progression of the tax rate schedule. The latter effects were particularly visible for middle-income earners whereas the top rate was lowered only marginally from 56 to 53 per cent.

However, the increase in tax reductions was not found to be adequate with regard to the monetary equivalent of minimal living conditions as defined in the official poverty-line in social-security-legislation by the constitution court. The latter has asked the government to further increase these deductions in order to bring them up to this monetary equivalent.

3.2 The stabilization function of taxation

A new dimension of taxation has been discovered in the 60's which thrilled politicians all over the world: the stabilization function of taxation.

This policy function relates to the philosophy of Keynesian demand management. The basic idea is quite simple: Government should aim at stabilizing aggregated demand in order to avoid recessions or inflation. Taxes may play a decisive role here. If, for instance, an economy is over-heating, because of excessive demand for goods and services, government should raise taxes in order to skim-off parts of the excess purchasing power. Alternatively, if economic development are sluggish -due to faltering demand-, government should lower taxes in order to support private net incomes and, hence, demand.⁵

Although German politicians for a long time were reluctant to embark on this road, in order to assure steady and adequate growth path for economic development since the policy recommendations had too much of an interventionist flavour which smacked like central planned economies, finally a more active role for tax policies - discretionary fiscal policies- was accepted and applied.

Another reason for this was also, that stabilization without any government intervention through so called "built-in-stabilizers", in particular progressive income taxation -were thought to be insufficient during the 60's.⁶

The Stability and Growth Act of 1967 allows the government, inter alia, to levy a surcharge or to give a rebate on income and corporate taxes of up to 10 percent of tax revenues on the condition "that there is, or about to occur, a disturbance of overall economic equilibrium ..." Discretionary variations of tax rates can thus play an important role for the management of aggregate demand.

Ironically, once the legal basis for a more active stabilization function of taxation was established, demand-management policies became unfashionable not only in Germany, but throughout the world.

The theoretical foundations of Keynesian policies had been punctured, for long, by academics like Milton Friedman and the Chicago school. Yet stabilization policies, where they were applied, were also soon discredited empirically: During the 70s, they proved to be unable to cope with mounting pressures in the labour market as a consequence of the break-down of the old fixed-exchange regime as well as the two oil crises.

The presence of high unemployment and high inflation - an impossibility for an unreconstructed Keynesian - shed doubts on the basic prescriptions of stabilization policies. Where they were applied despite these doubts, they led to instantaneous public sector deficits with little visible impact on employment. Thus, the 70s saw the victory of Chicago monetarists and the demise of Keynesian stabilization policies.

However, this does not mean, that demand management through tax policy does no longer play a role in actual policies for economic development. On the contrary: The massive expansion of government expenditures combined with fiscal restraint in the US not only led to unprecedented budget deficits; it also constituted an enormous employment program, with large repercussions on the world economy.

A particular case of stabilization through taxation is Germany after unification.

The federal government's response to this challenge was therefore a strong one: In 1991, an amount of 105 bill. DM in public monies will be transferred from the West to the East - representing about 80 percent of GNP of the ex-GDR. It is the equivalent of almost twice the amount the whole North gives to the South in terms of official development aid.

It is obvious that this, possibly, largest regional stabilization and redistribution program in the history of mankind is only made possible by taxing the relatively high economic potential in the West and, temporarily, by tapping capital markets through government loans.

3.3 The allocation function of taxation

The 80s were the decade of mounting concern for unfavorable tax-induced supply reactions and thus became the impetus, for major reforms throughout the world - and in West Germany.

Therefore does not come as a surprise that also in Germany the major concerns in this context, relate to a) the deficiency of savings and capital formation, b) the tax-induced structure of capital formation and c) possibly negative tax incentives on the supply of labour have been presently discussed.

The first issue related to the deficiency of savings and capital formation is theoretically attributed in Germany to negative incentives embedded in the system of income taxation: Double-taxation of income and of the proceeds from income invested - interests and dividends - which tend to discourage capital formation to the benefit of consumption.

The possible answer appears to lie in the substitution of a personal consumption tax for the income tax and, at the company level - where no personal consumption occurs - a corporate cashflow tax. This is not only considered to be more efficient; it is also expected to be more equitable - according to Kaldor's simple formula declaring it unfair to tax those who put something "into the pot", rather than who take something out of it.

For this, however, no practical solution has been found yet. Research on the personal consumption tax remains still on the agenda of academic circles and the policy implications of this alternative to income taxation may become relevant only in the longer run.⁷

However, possibly this solution finds additional proponents among politicians after only recently the Constitutional Court has ruled the existing practice of taxation of interest earnings unconstitutional and illegal since it violates the basic principle of equity. Although someone who files a tax return, has to declare interest he earns and the tax administration in turn has the right and even the duty to carry out random checks of the correctness of these details, the reality was different. Tax politicians were not interested in enforcing the taxation of interest earnings too rigidly, since they feared that it would promote capital flight. Therefore tax management had to issue the so called "bank-secrecy-decree" which prohibited the checking of bank accounts of taxpayers by the tax administration. The obvious result was that only those who voluntarily informed the tax office about their interest earnings had to pay taxes. Whoever chose to withhold information on interest earnings did not have to fear prosecution.

The second concern already mentioned relates to the tax-induced structure of capital formation. Capital income taxation in Germany has led to a very uneven development of effective tax rates for different types of assets. Apart from specific tax concessions and subsidies, effective tax rates vary across industries as a consequence of the different rules governing depreciation allowances, the evaluation of stocks and risks, the treatment of capital gains and losses - to name just the major aspects.

As a consequence, the allocation of capital could be expected to be severely distorted by tax rules. Capital, seeking the highest after-tax-return, is derouted to those investments where tax concessions are largest - not to those where economic returns are highest. This behaviour must lead to inefficiencies and the loss of productive potential.

The policy implications of this problem are also clear: The tax law had to be cut short and simplified in order to do away with unwarranted tax concession, subsidies and existing loopholes. The broader the tax as a consequence of this tax trimming would be, the more efficient the tax system would become through the narrowing of effective tax rates. In addition, the tax system would become more equitable. This idea - the broadening of the tax base became the centrepiece of the US Tax Reform Act of 1986 and had a great impact on the tax reform in Western countries.

Tax-base broadening together with the reduction of marginal tax rates were therefore also a characteristic of the German tax reform - although generally the German approach was much more cautious than in the United States. For instance the taxation of minor fringe-benefits given to workers of the automobile industry.

The third issue related to possible tax disincentives on the supply of labour⁴ are reflected in concrete results of the German tax reform, as well. The reduction in the marginal tax rate was very substantial for the second earner of a married couple - usually the women. It can therefore be expected that the tax reform of 1990 has contributed to increase the female part in labour supply.

A special case of allocation invention is related to environmental policies.

It has long been argued that, sometimes, markets may fail to convey the appropriate messages for the optimisation of resource allocation. If, for instance, prices do not reflect the full costs of producing products - including social costs and damages done to the environment - there may be over-production of those goods in combination with excessive demand and long-term negative impact for economic development.

As we know one answer to the problem could be the definition of legal property rights combined with a polluters-pay principle. Another answer could be that government may try to "internalize" the costs occuring to society or to the environment

by levying taxes (so-called Pigou-tax) on polluting activities that correspond - more or less - to the cost of removing the damage or to society's willingness to live with the hazard done.

This would increase the costs of polluting activities, lead to substituting "softer" production techniques for existing ones, and it would curtail the demand for goods the production of which puts a heavy burden on the environment.

In Germany the mineral oil tax had been already applied with great success in order to control pollution and expansion of individual traffic. And the motor vehicle tax had been restructured in recent years in order to stress ecological objectives. For instance rebates were given for cars running on unleaded petrol.

IV. Medium-term agenda for a tax policy in the united Germany

Apart from all measures already mentioned above the prevailing tax system has been under attack by academic economists, as well as economic experts of various interest groups before, during and after their implementation. And this critical discussion has become even more intensive with the unification and the near realization of the single market in Europe.

It is now recognized that a medium-term agenda for a tax policy in the united Germany has to face at least three main issues.

4.1 Business taxation

The united Germany's tax system must not discriminate against German competitors in the Internal European Market. Inefficiencies and higher tax burdens put at risk expected national welfare gains from European integration and from economic globalization.

It is argued, that effective tax rates in Germany are less favorable compared to other countries because double taxation of corporate taxes put a higher tax burden on the average investor than in other EC countries.

In order to render the German economy more attractive to national and international investors and to enhance the German international competitiveness proposals are made to reduce more and equalize the top rate on personal and corporate income below 50 percent, extend corporate income integration to retained earnings, replace the business tax by a neutral communal tax on value added, or abolish the net wealth tax.

4.2 Tax harmonization

If tax systems are allowed to compete in a single market in Europe, there is the danger of a beggar-my-neighbor (or tax-induced rent-seeking) policy where governments try to stimulate international demand for their regional products or to attract capital by the lowering of the tax rates. This would enlarge their employment as well as their tax base at expense of other regions. If all regions would adopt such tax strategies, this would lead to a ruinous reduction of tax rates with -in the end- a smaller and suboptimal size of the combined public sector. It would also jeopardize the role of government in the context of international stabilization and economic development policies.

The problem is particularly acute with regard to value-added taxation (VAT) and to the taxation of capital as the latter becomes increasingly mobile internationally. Whereas the issue has basically been resolved for European VAT System -governments agreed on a minimum tax rate of 15 percent that cannot be undercut- the issue remains totally unresolved with regard to the taxation of international capital.⁹

Here a response could be to set up administrative systems that allow the monitoring of international capital flows, and to coordinate tax policies through multilateral double-taxation agreements, international cooperation among tax administrations and the cross-checking of tax-returns at the European-scale.

4.3 Fiscal federalism

The financial needs of regional and local governments will exhibit higher dispersion in the united Germany, as long as major gaps in public infrastructure and social goods provision prevail between the eastern and western parts.

This will not only guide the elaboration of a new mechanism of intergovernmental transfers, it will also raise the issue of allocating tax responsibilities in the united Germany.

It is recommended to restructure the present distribution of tax responsibilities and to share not only tax revenues but also the power to tax between the central and regional levels. Examples of other nations suggest an introduction of regional or local surtaxes on personal and corporate income.

Summarizing now the general tendencies in international taxation and particularly in Germany I would like to stress the following points:

1. Tax policy in Germany is more and more influenced by international policy-coordination and cooperation. This is notably true for the member states of the European community where governments are committed to a greater degree of cooperation in the field of taxation.

2. Distributive objectives are being realized increasingly via direct redistributive measures rather than taxation. For instance direct subsidies for housing rather than through tax concessions. At the regional level this entails a greater fiscal autonomy for the regions and communities rather than intergovernmental transfers of resources.
3. Selective tax measures in order to stimulate growth have come to be discredited in recent years (for instance investments tax credits, or tax expenditures given to certain industries) and the German government has consistently moved towards a more general form of taxation and forwards improving the general political, legal and institutional preconditions for development within a market-oriented framework.

V. Tax policy and economic development

As already mentioned taxation has an impact on the economy and policy is advised to take this into account - directly or indirectly. However the state-of-the-art in taxation is also influenced by economic developments. In other words: tax systems also reflect the level and the quality of economic activities as well as the evolution of society and last not least the quality of the tax administration. Tax systems hinge on a given state of development; they cannot readily be transferred from one society to another.

More mature economies have produced complex forms of taxation that require highly developed administrative procedures and even international tax coordination. Progressing societies have discovered new problems that were ignored before - like the effects of international tax arbitrage on the taxation of capital income - and they have identified new policy objectives - like controlling the environment. Typically, taxation in developing countries still is indirect, selective and pragmatic: Taxes are levied where taxable objects and activities can be defined and administered most easily.

In reforming their systems of taxation, developing countries should, however, learn from more recent experiences made in industrialized countries, and avoid some of their mistakes made in the past. The lessons would, perhaps, be the following:

- They should no longer continue selective taxation. Selective taxation distorts price relativities and thus entails inefficiencies in the production and consumption of goods and services. It may also lead to inequities among different social groups. This is especially true for taxes on foreign trade.

From the stability viewpoint, it may be said that a large percentage of taxes on exports make the development of the state's finances highly dependent on external factors which cannot be influenced by the country in question, such as, for example:

the development of import prices, the prices of raw materials, the demands for exports or the rate of exchange of important currencies.

With regards to allocation, the actual protection of the domestic economy, caused by foreign trade taxation, protects sectors that tend to be inefficient, by granting them short-term protection, but inhibiting the potential for long-term growth.

Instead, in the longer term, developing countries should start utilizing the full potential of broad-based taxes in their economies. But it should be noted that this may require social and political adjustments - a more democratic society, for instance, or the decentralization of decision-making in the public sector, and the strengthening of federal structures of municipal government. It also requires a stable economic environment including manageable inflation rates, because taxation under inflationary conditions is bound to induce inequities and inefficiencies.

- As to the income tax, there should be a considerable simplification of rate schedules and a reduction of top rates. The complexities which have characterized income tax schedules in the past rarely served the purposes intended.¹⁰

It would be an irony if developing countries would start to engage in redistribution tax policies with progressive taxes when OECD countries have already started to revert this trend which has been acknowledge to entail greater inequities and inefficiencies.

- It should be worthwhile for developing countries, as well, to consider some of the more recent tax proposals made in OECD countries - notably in the area of "eco"- taxation. The carbon tax in particular would seem to suit the needs of lesser developed regions since it is relatively easy to administer, its revenue potentials are substantial and its effect on carbon emissions through the change in relative prices will help to control severe problems of local traffic in the developing countries as well as to solve the more general environmental questions of mankind.
- At last, tax policy has to concern itself more with questions of tax administration. As we know, the role of tax management lies in the correct, comprehensive and timely application of the tax laws.¹¹ If the tax laws are not enforced correctly and equitably in their complexity, the citizens over time will no longer be convinced that paying one's taxes is necessary.

If tax policy measures and their results are to correspond to the intentions of politicians those have to take care that elementary task of tax administration can also be met. On the one hand this can be done by adjusting the existing techniques of existing taxation to the respective objectives of tax policies and vice versa.

On the other hand by improving the material and qualitative working conditions. By controlling investment in the administration, both in form of personnel and capital, policy makers can influence the administration's ability to function effectively.

- ¹ For instance, one may remain that in the demand model by Keynes positive economic growth effects may be possible through a tax policy induced redistribution because of the different marginal propensities to consume of different income classes. On the other hand we know, that excessive and steeply taxation of increasing income earned after a certain point may lead taxpayers to reduce their working hours.
- ² It is, of course, somewhat artificial to split the history of taxation into different phases of concern in accordance with the emphasis laid onto distribution, stabilization and allocation policies. In fact policy-makers tend to consider all functions in conjunction. Undeniably, however, there are policy "fashions", as in other domains of social life, and the account given on taxation in the Western world does reflect such fashions.
- ³ Tax revenues in the former FRG followed the characteristic pattern of a developed market economy. Personal income taxes (42, 9%) and a general sales tax (25, 3%) account for more than two thirds of total tax revenues. Another fifth of tax revenue is derived from corporate income tax, local business tax, and two major excises on tobacco and petrol.
- ⁴ This understanding is not naturally and required a change in the philosophy of taxation which took place with the economist's approach to investigate into taxpayer's reactions and then design an optimal tax system taking these reactions into account. A first response to the disliked tax avoidance induced by taxpayer's reactions was -and still frequently is- to disallow those reactions by law. Smuggling, for instance, as an attempt to avoid taxes on foreign trade -was rendered a criminal offence in many countries. The extreme outcome of this lawyer's approach may then be overregulation of an economy that starts suffering under too heavy a burden of legal and administrative rules, and that requires an ever increasing amount of resources in order to feed an unproductive bureaucracy.
- ⁵ Demand management policies are, of course, much more complex and policy instruments more sophisticated than would be indicated by this simple illustration -because demand management is not simply a matter of taxation, and the respective policies are intertwined with monetary aspects-, yet the basic prescriptions for stabilizing tax policies are indeed relatively straightforward.
- ⁶ It is obvious that an expansion of income would automatically induce additional tax yield. If taxation is progressive, the additional yield is higher than proportional. Similarly, taxes would fall more than proportionally following a general contraction of income. Thus a strongly expanding economy is automatically restrained through the more than proportional increase of taxes. Similarly, a weakening economy is supported by the more than proportional decrease of the tax burden. This property of the tax system provides another strong argument in favour of progressive taxation -besides the redistributive considerations relating to the ability-to-pay argument.

7 Proposals for a personal consumption tax had been advanced in the US, in Great Britain and in Sweden during the mid-70s. Notably the so called Meade-Report for the UK - with its detailed recommendations for a change of the basic tax paradigm - deserves particular mentioning.

However, these proposals had very little influence on actual policy making and tax legislation. Politicians always shy away from major overhauls of existing systems with their unknown political, legal and administrative consequences, and with formidable transition problems. The only empirical evidence on the functioning of a personal expenditure tax still rests on the experiment undertaken - on the recommendation of Lord Kaldor - in India and Ceylon - with, unfortunately, negative administrative results.

8 The basic idea, again, is very simple and can be expressed by Laffer's reasoning: You can raise tax revenue by increasing tax rates on wages and other forms of income up to a certain point. Yet beyond that point, workers (as well as other income earners) start reacting by working less. As the tax rates approach 100 per cent, total work effort approaches 0 per cent; and 99 per cent of nothing is still nothing.

9 There are large discrepancies in the structure of personal and corporate income taxation among OECD countries that may compete for internationally mobile portfolio investment. With modern technologies for transferring capital at the world scale advancing, differences in transaction costs - including taxes - will become more and more important.

10 The present law of income tax alone fills in Germany a book with more than 350 pages. The law has 130 sections of which over 70 are again subdivided into countless supplementary sections. Partly, these laws are so complicated that, in order for them to be applied, over 1000 guidelines and other administrative orders have to be issued every year.

11 It is not responsibility of tax management to determine the total tax yield of the state. The latter has to be the direct result of the tax laws provided that tax management enforces these laws effectively.