



Talking point



Flat tax – still an interesting reform option for Germany

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Politically, it was dead in the water at the latest after the 2005 general election. The attempt by the CDU in the run-up to the election to clear the way for a comprehensive income tax reform on the back of the so-called Kirchhof model, a type of flat tax named after a former constitutional judge, was anything but a success. The tax proposal took such a pummeling in the populist sparring that resuscitating it can only be recommended to incorrigible optimists.

Lately, though, more and more voices have been calling for a new stab at wide-ranging reform of income tax during the next parliament (from 2009). So far, however, no concrete proposals have been made. Debate focuses primarily on the “usual” message of raising the basic personal allowance (necessary anyway in light of the fiscal drag of “cold progression”) and lowering the bottom tax rate. Nonetheless, this is scarcely more than a cosmetic correction of the existing income tax schedule. Therefore, this cannot be called a reform, let alone a fundamental change of the income tax regime. It would, however, be worthwhile to devote more thought to precisely this matter.

Such reform considerations should also include concepts that, on the one hand, cover income as completely as possible, while on the other hand ensuring that this income is subjected to a comparatively low, uniform tax rate and that it is also eligible for substantial personal allowances. Tax regimes of this type have long been the subject of political debate under the heading of “flat tax”. Nine countries of Central and Eastern Europe alone have already introduced a flat tax over the past few years (the latest one to do so being the Czech Republic at the start of this year). The issue is under discussion in other countries, too.

Of course, not all flat taxes are the same. Rather, the designation is an umbrella term for a string of variously modelled single-rate taxes. For example, in some countries the rate of income tax differs from that of corporation tax. Usually, though, a flat tax is not really “flat”. After all, as a rule the flat rate is applied in combination with a basic personal allowance. Even though the marginal tax rate is then constant, a flat tax is nevertheless progressive in character (contrary to frequently made claims), since the average tax rate increases as income rises. Unlike the current tax schedule in Germany which features direct progression (i.e. it also has an increasing marginal tax rate), a flat tax regime features indirect progression.

The higher the basic personal allowance, the more pronounced is this indirect progression. This and the size of the tax rate are therefore the main parameters for finetuning a flat tax. Their final shape and form have a major impact on the efficiency and distribution effects of such a tax. If, for instance, a large exemption is combined with a high tax rate, the redistribution aspect of an income tax is emphasised more strongly. If the focus is concentrated more heavily on redistribution, the labour market is likely to feel a negative impact, since the willingness to offer labour would decline accordingly.

The uniform rate of a flat tax has a raft of advantages. One thing is that it broadens the scope to tax income at the source. In addition, the tax benefit for married couples and wage tax categories would become superfluous. There would be huge potential for simplifying the tax system and reducing bureaucracy for all involved – private individuals, business and government – i.e., it is likely that the overall costs of collection could be slashed. Above all, though, the uniform rate reduces tax incentives to allocate income to specific periods or persons. Moreover, it would also ensure extensive legal and financing neutrality in the area of corporate taxation, which – especially in the wake of the recent reform – is lacking even more. The generally excessive attempts at present to find a just solution to satisfy every individual case, which has created a virtual jungle of regulations (without having achieved greater justice), might cease to be necessary.

The biggest obstacle to reforging Germany’s tax system in this way lies in the required but politically difficult task of doing away with direct progression. Direct progression is generally understood to reflect a “socially just” tax policy which compels higher-earning people to shoulder a larger share of the burden of financing state tasks. In

this respect, two things are overlooked: first, indirect progression is quite effective (owing to the basic personal allowance) and, second, broadening the tax base eliminates many exceptions and much of the scope for tax optimisation from which particularly the higher-earning parties benefit. Without doubt it would be possible, and advantageous, to achieve a more comprehensive picture of income generation and thus of the tax base also in the existing system; however, there seems to be a lack of political will to do so. Finally, it has to be borne in mind that in every tax schedule – also the existing one – those who earn incomes that exceed the highest tax bracket are subject to a constant marginal tax rate.

True, the balance between distribution and efficiency can be steered with a flat tax largely by means of the tax rate selected and the allowances granted. In the end, however, this concept is not able to completely reconcile the conflicting objectives of distribution and efficiency either.

Moreover, the income tax must not be viewed in isolation. Rather, reform attempts must take account of the entire system – i.e. also social contributions and the level of indirect taxation. Studies show that in some countries the social security systems were reformed (with contributions in some cases being lowered) at the same time as indirect taxes were raised. The effects of a flat tax may therefore differ considerably. In Germany, a reform of this type would particularly need to ensure that those in the medium-income bracket were not again obliged to carry a disproportionately large share of the tax burden.



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