Recent tax revenue trends

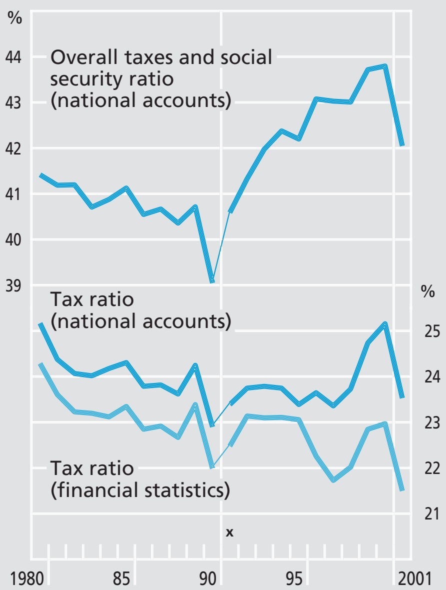
Following a period of strong growth between 1998 and 2000, tax receipts fell considerably from 2001 onwards owing to large shortfalls in the wake of the tax reform and the more unfavourable economic climate; this was the main reason for the steep rise in the general government deficit in Germany. Whereas the direct tax burden has recently been eased noticeably, the relative weight of indirect taxes has tended to increase. This reflects the measures aimed, on the one hand, at lightening the tax load on incomes and, on the other, at increasing the tax charge on consumption – primarily of energy – with a view to providing additional government grants to the statutory pension insurance fund so as to curb non-wage labour costs. With a growing share of pensions now financed out of general taxation, the taxes and social security ratio was of late much lower than in 1997. In 2003, however, the levy burden will increase again significantly as a result of the rise in social security contributions and the announced tax measures.

Underlying trends

Different phases of revenue development

The tax revenue trend in the last four years may be divided into two distinct phases. In the period between 1998 and 2000 tax receipts recovered noticeably after being well below expectations for several years prior to

Taxes and social security ratio *



* Revenue from taxes and social security contributions as a percentage of nominal GDP. — x New territorial definition as of 1991.

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1998.[1] The increase in revenue exceeded nominal economic growth, which also strengthened; this was attributable to a high revenue inflow from profit-related taxes – in part due to a tightening of tax concessions for the promotion of investment in eastern Germany – and the rise in indirect taxes. Since 2001, by contrast, tax receipts have declined noticeably. Besides the large tax shortfalls in the wake of the tax reform, this mirrors the worsened overall economic situation. The revenue trend has been additionally depressed, of late, by structural effects and declining back payments in respect of earlier years, whereas previously it was buoyed by favourable assessment outturns.

Tax ratio trend

Total tax receipts – as defined in the government's financial statistics – grew in the last four years at an average rate of only 2¼%, which was somewhat weaker than nominal GDP (+2½% per annum). The overall tax ratio – ie the ratio of tax receipts to nominal GDP – fell substantially in 2001 after recording a significant rise up to 2000 (see chart on this page). In 2001 the tax ratio, as defined in the government's financial statistics, amounted to 21.5% – somewhat less than in 1997 (21.8%) – and consequently recorded its lowest level since the late 1950s. However, according to the definition used in the national accounts, the overall tax ratio marginally increased (by 0.2 percentage point to 23.6%) in the period under review.[2] This shows growing discrepancies compared with the ratio as defined in the financial statistics, which to an increasing extent understates the tax burden in Germany through the deduction of transfers – such as child benefit and the grant to home buyers. In this sense, the tax ratio as defined in the national accounts is also more meaningful when comparing tax burdens at an international level. However, over time its development is likewise distorted somewhat by certain substitution processes.[3]

Lower taxes and social security ratio

As defined in the national accounts, the overall levy ratio (ie including social security contribu-

1 See Deutsche Bundesbank, Recent tax revenue trends, *Monthly Report,* August 1997, p 83-103.
2 This is based on the definition chosen by the European System of Central Banks, which, contrary to ESA 95, fully includes the tax shares paid to the EU in national tax revenue because from an economic viewpoint these tax levies, like other tax receipts, are to be regarded as a burden on the tax payers of the country concerned. This approach has the additional advantage that the tax ratio trend is not distorted upwards over time by the shifts in the method of financing the EU from VAT to GNP resources.
3 This is especially the case for the grant to home buyers, which was introduced in 1996 in place of the previous tax-deductible allowance.

tions) in 2001 amounted to 42.1% and – unlike the tax ratio – fell below its level in 1997 by 1 percentage point. In 2000, by contrast, it had reached a high of 43.9%. The ratio of social security contributions to GDP was reduced significantly by the greater co-financing of pensions out of general taxation; it came to 18.5% in 2001, compared with 19.7% in 1997. Although the German tax ratio is relatively low by international standards, since in other countries (such as the UK and some Scandinavian countries) social benefits are financed to a greater extent out of tax revenue (see table on this page), the overall taxes and social security ratio in Germany, despite its marked decline in 2001, was only marginally below the EU average and was still well above the figures for the United States and Japan.

International comparison of the tax and social security burden

In %

Country	Taxes and social security ratio		*of which* tax ratio	
	1997	2001	1997	2001
Sweden	51.5	54.3	36.5	38.0
Denmark	50.6	49.8	48.0	46.6
Austria	46.7	47.9	29.3	30.8
Belgium	47.4	47.6	30.9	31.2
France	46.5	46.6	26.2	28.4
Finland	46.7	45.6	33.3	33.1
Italy	44.3	42.9	29.0	30.2
Luxembourg	42.5	42.6	31.0	30.1
Germany	43.1	42.1	23.4	23.6
Netherlands	41.5	40.7	24.9	25.4
United Kingdom	36.6	38.7	29.2	31.0
Greece	36.0	38.6	22.7	25.1
Portugal	35.9	36.5	24.8	24.5
Spain	34.8	36.0	21.7	22.5
Ireland	32.4	30.1	28.3	25.7
EU overall	42.5	42.4	27.0	28.0
Memo item				
USA	29.3	29.7	22.3	22.5
Japan	27.7	27.5	17.5	16.9

Source: ESCB (for EU member states), OECD (for the USA and Japan). Whereas the ESCB's data are based on the ESA 1995 classification (plus the EU shares in tax revenue), the OECD figures are based on different concepts. The figures for the EU member states and those for the USA and Japan are therefore not fully comparable.

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Positive revenue trend between 1998 and 2000

In 1998, partial amendments to tax legislation ...

After the tax reform concept of the previous government coalition foundered in the Bundesrat (upper house of parliament) in autumn 1997, tax policy was limited, at first, to partial taxation and tax relief measures which broadly balanced out. Thus trade capital tax was abolished at the beginning of 1998, confining the levying of trade tax to income and earnings. The associated relief for enterprises was, however, offset by tightening the regulations governing the determination of profit. In addition, the solidarity surcharge on income tax and corporation tax was also lowered at the beginning of 1998 by 2 percentage points (to 5.5%). Conversely, the standard rate of turnover tax was raised on 1 April 1998 by 1 percentage point (to 16%) to enable the Federal Government to make an additional grant to the statutory pension insurance fund, instead of having to increase the contribution rate.

... alongside notable growth in revenue

Tax receipts went up by 4½% in 1998 in the context of stronger economic growth. Although the rise in nominal GDP in 1998 by just over 3% was still somewhat lower than expected (based on the comparable official estimate from autumn 1997), tax receipts exceeded this figure by €5 billion. The main reason for this was the favourable development of profit-related taxes which resulted – partly with a considerable time-lag – from the improved profitability of enterprises and was also supported by the reduction of tax concessions for the promotion of investment in eastern Germany.

New reform projects following the change of government

Following the change of government in autumn 1998, new tax reform projects were initiated. Besides new arrangements concerning low-paid part-time work, these projects comprised an "ecological tax reform" and a reform of income taxation. Under the "ecological tax reform", the existing tax on energy consumption was increased further from spring 1999 and supplemented by a new electricity tax, which – like the tax on motor fuel – was raised in stages over the subsequent years. One of the aims was to introduce an environment policy steering function, although the producing sector was broadly exempted on the grounds of international competitiveness. The other aim was to boost employment by using the revenue from the additional taxation of energy consumption to lower the contribution rate to the statutory pension insurance scheme and simultaneously reduce non-wage labour costs. The income tax reform envisaged raising child benefit, gradually reducing income tax rates up to 2002 (to a bottom rate of under 20% and a top rate of 48.5%) and lowering the corporation tax rate applying to retained profits to 40% (as from 1999). However, since the rules for determining profits were severely tightened, the first stage of the reform had virtually no impact on overall revenue and, in fact, resulted in considerable extra burdens on the corporate sector.

Accelerated rise in revenue in 1999

Although nominal GDP growth slackened somewhat in 1999, tax revenue went up even more sharply (by 6½%) than in 1998, mainly as a result of the rises in consumption taxes and a stronger concentration of economic growth on domestic demand, which yields greater tax revenue than external activities. In addition, profit-related taxes continued to develop favourably, partly thanks to declining shortfalls resulting from tax concessions for the promotion of investment in eastern Germany. The upshot was that revenue expectations were exceeded by an even greater margin than in 1998, namely by €6½ billion.

Dampening effects in 2000

In 2000 the income tax rates were lowered further and child benefit – following a ruling by the Federal Constitutional Court – was increased again. Revenue from energy taxation also grew far less than in 1999 – despite further increases in the tax rates – as a result of marked consumer restraint in response to the rise in oil prices. Furthermore, the weaker growth of private consumption dampened the increase of turnover tax receipts. By contrast, profit-related taxes, for the most part, still produced abundant receipts owing to continuing robust profitability, the broadening of the tax assessment base and high back payments in respect of earlier years. Total tax revenue exceeded the previous year's level by just over 3% and was again noticeably higher (by almost €4 billion) than the expectations, even though nominal economic growth was lower than expected.

Steep decline in revenue in 2001 in the wake of the tax reform

"Tax reform 2000": structure…

Sizeable tax relief measures came into force in 2001 in the wake of the "Tax reform 2000" which was adopted in the previous year. As a result of this reform, the lowering

Trends in tax revenue *

Period	Total tax revenue	Direct taxes [1]	*of which*					Indirect taxes [2]	*of which*	
			Wage tax	Assessed income tax	Non-assessed taxes on earnings	Corpora-tion tax	Trade tax		Turnover tax	Mineral oil tax and (as of 1999) electri-city tax
	DM billion									
1970	154.2	82.6	35.1	16.0	2.0	8.7	12.1	71.7	38.1	11.5
1975	242.1	142.3	71.2	28.0	2.2	10.1	20.9	99.7	54.1	17.1
1980	365.0	213.4	111.6	36.8	4.2	21.3	28.0	151.6	93.4	21.4
1985	437.2	258.2	147.6	28.6	6.2	31.8	30.8	179.0	109.8	24.5
1990	549.7	311.9	177.6	36.5	10.8	30.1	38.8	237.8	147.6	34.6
1991	661.9	369.9	214.2	41.5	11.4	31.7	41.3	292.0	179.7	47.3
1995	814.2	438.0	282.7	14.0	16.9	18.1	42.2	376.2	234.6	64.9
1996	800.0	417.5	251.3	11.6	13.3	29.5	45.9	382.5	237.2	68.3
1997	797.2	409.6	248.7	5.8	14.7	33.3	48.6	387.5	240.9	66.0
1998	833.0	433.4	258.3	11.1	22.7	36.2	50.5	399.6	250.2	66.7
1999	886.1	459.6	261.7	21.3	22.1	43.7	52.9	426.6	268.3	74.8
	€ billion									
1999	453.1	235.0	133.8	10.9	11.3	22.4	27.1	218.1	137.2	38.3
2000	467.2	243.5	135.7	12.2	13.5	23.6	27.0	223.7	140.9	41.2
2001	446.2	218.9	132.6	8.8	20.9	– 0.4	24.5	227.4	138.9	45.0
	Percentage share of total tax revenue									
1970	100	53.5	22.7	10.4	1.3	5.7	7.9	46.5	24.7	7.5
1975	100	58.8	29.4	11.6	0.9	4.2	8.6	41.2	22.3	7.1
1980	100	58.5	30.6	10.1	1.1	5.8	7.7	41.5	25.6	5.8
1985	100	59.1	33.8	6.5	1.4	7.3	7.0	40.9	25.1	5.6
1990	100	56.7	32.3	6.6	2.0	5.5	7.1	43.3	26.8	6.3
1991	100	55.9	32.4	6.3	1.7	4.8	6.2	44.1	27.1	7.1
1995	100	53.8	34.7	1.7	2.1	2.2	5.2	46.2	28.8	8.0
1996	100	52.2	31.4	1.5	1.7	3.7	5.7	47.8	29.7	8.5
1997	100	51.4	31.2	0.7	1.8	4.2	6.1	48.6	30.2	8.3
1998	100	52.0	31.0	1.3	2.7	4.3	6.1	48.0	30.0	8.0
1999	100	51.9	29.5	2.4	2.5	4.9	6.0	48.1	30.3	8.4
2000	100	52.1	29.0	2.6	2.9	5.0	5.8	47.9	30.1	8.8
2001	100	49.0	29.7	2.0	4.7	– 0.1	5.5	51.0	31.1	10.1

* Up to and including 1990, in the former Federal area; as of 1991, in Germany as a whole. — **1** As defined in the financial statistics of the Federal Ministry of Finance which, unlike the national accounts, classify above all trade tax and real property taxes as taxes on income, wealth etc and as such assign them to direct taxes. The same is the case for inheritance tax. — **2** Taxes on uses of income and from property transactions (with the exception of inheritance tax).

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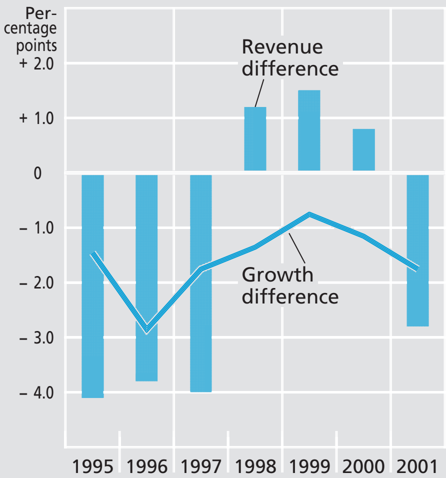
Deviations in tax revenue and economic growth compared with original expectations*



* As percentage points of tax revenue or nominal economic growth according to the official tax estimate made in the autumn of the previous year (on which the budget plans are largely based).

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of the income tax rates, which was initially envisaged for 2002, was brought forward by one year and supplemented by further declines in tax rates planned for 2003 and 2005; this should significantly reduce marginal tax rates, particularly at the bottom and top end of the income scale (in the final stage to 15% and 42%, respectively, excluding the solidarity surcharge). Enterprises were also given considerable relief by a cut in the corporation tax rate to a uniform 25% at the beginning of 2001 and the introduction of a facility which allows non-corporations to partly offset trade tax against their income tax liability. This largely abolished the previous additional tax burden relating to the profits of non-corporations resulting from this levy.[4] In addition, the corporation tax regime underwent a systemic change from the previous imputation system to a system of income tax relief on dividends, which included, as from 2002, tax exemption for corporations on capital gains from the sale of domestic participating interests. However, tax depreciation rules were concurrently made much more restrictive.

... and effects

On balance, the reform to this extent improved the macroeconomic framework in Germany, since it reduced the existing locational disadvantages for enterprises and created additional performance incentives by lowering tax rates and introducing the partial trade tax offsetting facility.[5] Furthermore, the tax exemption granted to corporations for capital gains from the sale of participating interests encouraged restructuring in the corporate sector. However, the marked deterioration in the tax depreciation rules made domestic fixed capital formation less attractive, including vis-à-vis financial investments. Also, the sharp lowering of the corporation tax rate and the changeover to a system of income tax relief on dividends reinforced the tax bias in favour of profit retention over distribution – which already existed in the previous imputation system – for shareholders with high marginal tax rates and tended to weaken the allocation function of capital markets. Bearing in mind that the distributed profits of corporations are taxed far more heavily, they ultimately fare little better after the reform than non-corporations charged with the top tax rate. However, the latter have the disad-

4 This specific burden had previously been mitigated for higher trade earnings by a capping of income tax rates.
5 For an assessment of the tax reform, see Deutsche Bundesbank, *Monthly Report,* August 2000, especially p 57-61.

vantage that most of the income tax cuts will not come into force until a later date and that their tax relief from restructuring is lower than the corresponding relief granted to corporations.

Slump in revenue in 2001

The overall tax ratio went down by 1½ percentage points in 2001, mainly as a result of large revenue shortfalls (of just over 1% of GDP) ensuing from the first stage of the tax reform. Furthermore, tax receipts, which declined by 4½%, also fell well short of the expectations for the first time since 1997 (by almost €13 billion). This was mainly attributable to the worsened economic situation. Profit-related taxes were additionally affected by the turnaround on the stock markets, which led to high write-downs. Furthermore, structural factors also had an impact on turnover tax, while profit-related taxes were adversely affected by smaller retrospective payments in respect of earlier years as well as temporary influences caused by the tax reform (for details, see page 23).

Further decline in the importance of direct taxes

Tax policy stance…

Receipts from direct taxes[6] have grown over the last four years by little more than 1% on average, thus continuing the decline – which began at the beginning of the 1990s – in the share of this tax category in overall tax revenue. In 2001 direct taxes constituted 49% of total tax receipts, compared with 51½% in 1997 and around 56% in 1991. Besides a policy-induced rebalancing of the relative weights, this development was also attributable to the fact that receipts from direct taxes were increasingly depressed by offsetting transfers.

… in favour of lower direct tax burden

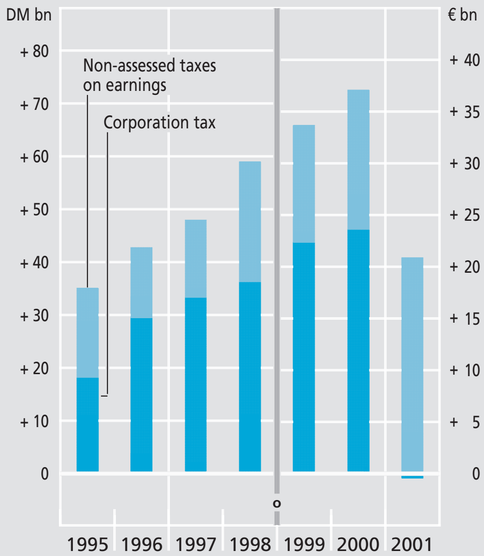
In relation to income, too, the overall direct tax burden fell somewhat in the last four years. If the sum of gross wages and salaries, plus civil servants' pensions, entrepreneurial income and investment income are taken as a rough indicator of aggregate income, direct taxes amounted to just over 16% of that sum last year, compared with just under 17% in 1997. Solely on account of the in part considerable time lags between the generation of income and the resulting tax payments, this general ratio is not, however, identical to the effective tax burden from direct taxes, to which income was subject on average. Moreover, with regard to the marginal tax burden, income is subject in some cases to tax rates that are still relatively high.

Weak growth of wage tax revenue

Revenue from wage tax – which is by far the most important direct tax – grew only by an average of 1% in the last four years. This was, however, partly attributable to the fact that child benefit, which is booked against wage tax receipts, was raised twice during this period. But even before deducting child benefit, wage tax receipts still grew far more slowly, at an annual average rate of 1¾%, than gross wages and salaries and civil servants' pensions (+2½% per annum), from which wage tax is deducted at source. The main reason for this was the increasing im-

6 This analysis is based on the system of classification used in the financial statistics, as defined by the Federal Ministry of Finance, in which – in contrast to the national accounts – direct taxes notably include trade tax, taxes on land and buildings and inheritance tax.

Revenue from corporation tax and non-assessed taxes on earnings



o As of 1999, data in euro.

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pact of tax relief measures, particularly in the past two years. If tax legislation had not been amended, wage tax receipts would have gone up by around 4½% on average between 1998 and 2001, ie almost twice as fast as the underlying income base. This mirrors the high revenue elasticity of this tax, deriving from the progressive tax scale.[7] In the individual years the revenue trend of wage tax was also distorted, at times, by the postponed payment of Christmas bonuses for tax reasons. In 2001 this somewhat moderated the fall in revenue brought about by the tax reform.

Sharp pick-up in assessed income tax

Assessed income tax picked up markedly from 1998 onwards after revenue from this tax had fallen sharply in the years prior to 1998, not least owing to extensive tax concessions for the promotion of investment in eastern Germany. Receipts from this statistical "residual", which primarily reflects the difference between the final tax liability and the tax receipts that are deducted at source (in the case of wage tax, corporation tax and investment income tax), quadrupled by 2000 (to just over €12 billion), compared with the low they had reached in 1997. However, they fell again considerably in 2001 as a result of the more unfavourable economic climate and the tax reform. The level of revenue from this tax was increasingly dampened by the fact that the method of promoting home ownership was changed in 1996 from a tax-deductible facility – which, for the most part, had depressed wage tax – to a grant which is offset against assessed income tax. On the other hand, revenue from assessed income tax was no longer reduced by growing refunds to employees, which had been the case between 1992 and 1996. This was attributable to income tax rate cuts and declining tax allowances, not least in connection with the promotion of investment in eastern Germany. Gross revenue from assessed income tax – before deducting refunds, the grant to home buyers and investment grants – nonetheless amounted to just over €38 billion last year, which was nearly 1½ times as high as in 1997 (see chart on this page) despite the recent decline.

7 This elasticity has even tended to increase somewhat with the latest adjustments to the tax regime because, on the one hand, the basic tax-free allowance was progressively raised, thereby lowering the average burden and, on the other, the marginal tax rate in the lower income bracket now increases more rapidly than before.

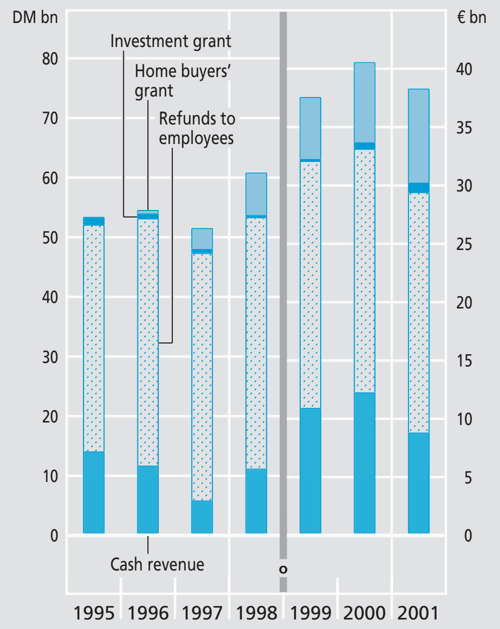
Greater yield from the tax on interest income

Revenue from tax on interest income rose steeply from 2000 after developing rather weakly prior to that; it reached €9 billion in 2001 – just over 1½ times as high as in 1997. Firstly, savers' tax-free allowance was halved at the beginning of 2000, which, owing to the delay in collecting this tax, also had an impact at the beginning of 2001 vis-à-vis the same period in the previous year. Secondly, the massive portfolio shifts in favour of mainly short-term interest-bearing investments, such as money market paper, also played a role following the sharp decline of share prices since spring 2000.

Zero contribution from corporation tax of late ...

Revenue from corporation tax grew steeply between 1998 and 2000 (to €23½ billion, compared with €17 billion in 1997) as a result of improved corporate profitability and tighter regulations governing the determination of profit. In 2001, however, receipts collapsed to zero; in fact, refunds actually somewhat exceeded tax payments. This result stemmed from various causes. Owing to the steep cut in the corporation tax rate and a more unfavourable profit situation, firms made far smaller advance payments than before, and retrospective payments also fell markedly. In addition, several exceptional factors resulting from the tax reform also had a major impact. For example, it was the last chance for enterprises to claim tax write-downs on their participating interests before the tax exemption of capital gains from the sale of equity stakes came into force.[8] Moreover, under the transitional arrangements pending the changeover to the new system, firms could reduce their tax burden by distributing profits retained in earlier years that had incurred a higher corporation tax rate. Since the associated tax refund claim (compared with the old distribution rate of 30%) was partly restricted at the turn of 2001-02, there was a strong incentive for firms to quickly claim this tax credit. All in all, profit distributions further depressed corporation tax receipts in 2001 by an estimated €21 billion, following almost €14 billion in 2000 and a more or less normal level – based on the previous split corporation tax schedule

Assessed income tax
– gross revenue versus net revenue –



o As of 1999, data in euro.

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8 Although capital gains from foreign participating interests – unlike domestic participating interests – had been tax-free for quite some time, it was still possible until the assessment year 2000 to claim tax write-downs on such participating interests, too. Furthermore, losses arising from the sale of domestic participating interests were tax-deductible only until 2001 and the imputation system could likewise be used for intra-group netting only up to 2001.

Reduction in tax bill ensuing from a distribution of earnings retained in past years

Under the imputation system which prevailed prior to the tax reform, profits earned and retained by corporations were initially taxed at the rate applicable to retained earnings. Upon distribution, such earnings were taxed at the lower corporation tax rate applying to distributed earnings (corporation tax reduction). Furthermore, the tax already paid – along with the investment income tax levied in addition – was offset in full against the income tax liability of (domestic) shareholders, for which the tax already paid constituted an advance tax payment. This meant that the distributed profit was ultimately always taxed at the personal rate of income tax applicable at the time of distribution.

The tax reform replaced that imputation system (for shareholders) by a system of income tax relief on dividends in which the now uniform corporation tax rate applicable to both retained and distributed earnings has a definitive character; as a quid pro quo, only half of the dividend is liable to the shareholder's personal income tax rate. The "tax credit" vis-à-vis the distribution tax rate which accumulated at the enterprise level prior to the change in the tax regime can be claimed by firms for the next 15 years upon a distribution of earnings retained in past years.

If government were to refuse to accept such a reduction of tax liability in respect of tax payments already made, this would be questionable on both tax-systematic and constitutional grounds, as enterprises and shareholders would be "misappropriated" in the amount of the foregone tax credit and the distributed profit would ultimately be overtaxed because, on top of the high rate of corporation tax levied on the retained earnings, the shareholder's personal income tax rate would be additionally charged on half of the dividend. This would also be problematical because in the past firms sometimes deliberately refrained from neutralising profit distributions through a simultaneous capital increase as they could rely on the fact that the taxes already paid on retained earnings would yield a tax credit upon distribution owing to the lower applicable tax rate; their faith in this ongoing possibility thus needed to be respected by government.

Hence the transitional arrangement for the change of tax regime regarding the distribution of profits retained in earlier years is quite appropriate. Moreover, it leads to no (or only very small) revenue shortfalls if all tax categories are considered together. Thus although corporation tax receipts are thereby reduced sharply, more revenue will be received (at least from domestic shareholders) in the form of investment income tax and possibly – given correspondingly high income tax rates – slightly more revenue from assessed income tax. Even if some tax shortfalls should result on balance, this would be due to the fact that the rate of corporation tax paid in the past on retained earnings was higher than the personal income tax rate of the shareholder (until 2001) or the marginal overall tax rate payable on the dividend (as from 2002). This would then likewise be quite appropriate.

The aforementioned situation may be summarised in the following table (which for the sake of simplicity omits trade tax and the solidarity surcharge):

Item	Distribution of EK 45 in 2001	Distribution of EK 40 in 2002
Gross profit	100.00	100.00
Corporation tax already paid in the past	45.00	40.00
Corporation tax reduction upon distribution	– 15.00	– 10.00
Investment income tax (25% or 20%, respectively) on a distribution of 70 CU	17.50	14.00
(Residual) assessed income tax		
at 48.5% (top rate)	1.00	3.00
at 35%	– 12.50	– 1.75

For a distribution of "EK 45" in 2001 the tax office sustains a loss in corporation tax revenue of 15 units of currency (CU) on a gross profit of 100 CU as a negative offsetting item to the 45 CU of corporation tax received in the past. But it gains an extra 17.50 CU in investment income tax. Similarly, the claiming of the tax credit resulting from the "EK 40" in 2002 leaves the tax office with a positive balance in the year of distribution from investment income tax and the corporation tax reduction. Whether and to what extent this balance remains positive after taking account of the (residual) assessed income tax depends on the individual income tax rate of the (domestic) shareholders. However, this revenue effect occurs only at the assessment stage and thus later.

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– of around €12 billion in 1999.[9] The transitional arrangements were, however, justified both on systemic and constitutional grounds and had only a very small influence on overall tax revenue (see box on page 24).

... and a record outturn for non-assessed taxes on earnings

Conversely, the corporation tax shortfalls related to these high one-off profit distributions were largely counterbalanced by considerable additional revenue from investment income tax on dividends (see chart on page 23). Thanks to these extraordinary dividends, a record outturn of nearly €21 billion was recorded in 2001 for non-assessed taxes on earnings, after considerable revenue growth (by one-fifth to €13½ billion) had already been recorded in 2000, when the tax reform was adopted. Revenue from this tax category almost tripled vis-à-vis the level in 1997. The combined revenue from corporation tax and non-assessed taxes on earnings declined in 2001 by €16½ billion to €20½ billion; around half of this drop was attributable to the corporation tax rate cut.

Sharply fluctuating trade tax receipts

Trade tax receipts rose strongly until 1999, even though since the beginning of 1998 this tax has only been levied on trade earnings and no longer on trade capital. Besides back payments in respect of earlier years, the tighter regulations governing the determination of profit and the improved profitability of enterprises also had an impact. This rising tendency was, however, superseded by a stagnation in 2000 and a steep decline in revenue (of just over 9%) one year later. The main reason for this was declining tax receipts for earlier years as well as a marked fall in advance tax payments in 2001 as a result of the deteriorated earnings situation. Besides the worsened macroeconomic setting, tax write-downs on participating interests and restructuring measures in the corporate sector – such as the increased formation of interdependent corporate groups *(Organschaften)* to facilitate the intercompany offsetting of losses – likewise led to considerable revenue shortfalls, which were also associated with severe distortions between individual local authorities. Of late, trade tax revenue, at €24½ billion, fell marginally below the level of 1997.

Other direct taxes

Of the other direct taxes, wealth tax recorded only a small residual amount of revenue after this tax ceased to be levied as from 1997. By contrast, receipts from inheritance tax went up considerably, mainly because of the tax increases adopted to compensate for the lost wealth tax.[10] Receipts from taxes on land and buildings, which are levied at the local level, increased relatively steadily, not least as a result of higher collection multiplication factors.

Indirect taxes characterised by tax increases

Various tax increases

In the past four years indirect taxes recorded revenue growth of 3½% on an annual aver-

9 Such revenue distortions resulting from disbursements had also occurred to a somewhat smaller extent in connection with the previous tax rate cuts in earlier years during the corresponding transitional period. The years 1994 and 1998, in particular, were characterised by such special factors ("EK 56" and "EK 50" distribution effects).
10 These tax increases – which also affected the tax on the acquisition of land and buildings – came about, like the abolition of wealth tax, in response to a ruling of the Federal Constitutional Court in June 1995 calling for uniform valuations of the tax base and, in the case of inheritance tax, led to an upward valuation of land and buildings for tax purposes.

age in the wake of various tax increases. Consequently, their share in overall tax revenue rose. Turnover tax and taxes on energy consumption, in particular, were raised with the objective of limiting the contribution rate to the statutory pension insurance fund through additional Federal grants to that fund.

Weak trend in turnover tax, particularly of late

Receipts from turnover tax increased at an annual average rate of 3% between 1998 and 2001; this was ½ percentage point more than the growth of nominal GDP and domestic demand, which is more relevant for tax revenue purposes. Without the rise in the standard rate which came into force on 1 April 1998, turnover tax receipts would not, however, have kept pace with nominal economic growth. Although the flow of revenue accelerated until 1999, in part owing to the stronger growth of domestic demand, revenue developed considerably less favourably than domestic demand in the last two years under review – particularly in 2001, when it declined by 1½% (see box on pages 28 and 29). This was partly due to the fact that tax-free components of private consumption (such as housing rents and financial services) grew disproportionately strongly. In addition, consumers have been spending an increasing proportion of their income on food (which is subject to a lower rate of VAT), not least because of the rise in prices in the wake of BSE and foot-and-mouth disease. Other factors that had an impact in 2001 were the strained liquidity situation of some enterprises and the increased number of insolvencies. Yet these factors do not per se fully explain the recent disappointing revenue trend. It appears rather implausible that the extent of turnover tax fraud surged under a legal framework which remained broadly unchanged until 2001.

Revenue effects of the "ecological tax reform"

Among excise taxes, the receipts from the taxes on energy consumption – ie mineral oil tax and the new electricity tax – have grown steeply since 1999 as a result of the multi-stage "ecological tax reform". Receipts from energy taxes reached €45 billion in 2001, compared with just under €34 billion in 1997. The revenue level of these taxes was, however, depressed somewhat by the consumer restraint in response to the tax increases and the rise in the price of crude oil. This was actually consistent with the policy goal of curbing energy consumption. Non-wage labour costs, too, were simultaneously reduced a little. Even so, the "double dividend" which was hoped for from the "ecological tax reform" is likely to have been very modest. Moreover, the use of these tax receipts to finance the statutory pension insurance fund tended to conceal the fund's need for adjustment.

Other indirect taxes

Receipts from the other indirect taxes only increased by an annual average of 1½% in the last four years. The decline in revenue from some excise taxes was offset by partly sharp growth in motor vehicle tax, real estate transfer tax and tobacco tax as a result of (or in anticipation of) tax increases.

Revenue trend in 2002 and the further outlook

Tax revenue declined further in 2002, so that the original expectations have again been ser-

Further decline in revenue in 2002

iously undershot. Tax receipts (excluding receipts from local government taxes, which are not recorded monthly) between January and October were 2½% lower than the corresponding level in 2001. According to the latest official estimate, a shortfall of 1½% vis-à-vis 2001 is anticipated for 2002 as a whole. Tax revenue will consequently be €27 billion down on the estimate from autumn 2001, on which the budgets were largely based; this corresponds to 1¼% of GDP. One reason for these huge shortfalls is that the cyclical slowdown, which has persisted for longer than expected, is having a surprisingly strong impact on profit-related taxes and has also resulted in sizeable write-downs. Furthermore, turnover tax receipts are still developing unfavourably, mainly due to the decline in retail trade turnover. In addition, considerable wage tax shortfalls have ensued from the smaller growth in gross wages and salaries. Although the rises in excise taxes (energy taxes, tobacco tax and insurance tax), which were introduced at the beginning of 2002, have outweighed the additional tax relief granted in the form of child benefit, the overall tax ratio, according to the recent official estimate, will show another marked drop of 0.8 percentage point (as defined in the government's financial statistics) to 20.8%.

Tax ratio set to rise in 2003

Conversely, a bigger inflow of revenue is anticipated in 2003 in the light of the expected upturn in economic growth as well as the further tax increases and measures designed to close special tax loopholes. According to the latest tax estimate, a revenue increase of just over 4% is expected for 2003, given nominal economic growth of 3½% and real growth of 1½%, which would push up the tax ratio to 21% (and to just over 22½% before deducting child benefit). These figures include the tax measures adopted to finance aid to the flood victims, ie postponing the next stage of the tax reform to 2004 and temporarily raising the corporation tax rate to 26.5%. However, they exclude the tax package adopted by the Federal Government after the German general election – which envisages revenue improvements of €5 billion for 2003[11] growing considerably in subsequent years (to just over €18 billion or around ¾% of GDP in 2006).

Planned tax package merits differentiated assessment

The planned tax measures comprise curtailing existing turnover tax and energy tax privileges, axing subsidies, extending the taxation of private capital gains and introducing restrictive measures in the enterprise sector, which will primarily reduce firms' ability to offset losses and further lessen the scope for claiming tax depreciation allowances (see box on page 31). The envisaged measures merit a differentiated assessment. From a tax systemic and macroeconomic perspective, the efforts to reduce or eliminate some privileges – such as the grant to home buyers and various turnover tax reductions which are also contained in the Subsidy Report – are to be welcomed. The planned extension of the taxation of private capital gains – which is much more moderate compared with the original

11 Furthermore, in the social security funds the income ceiling for contributions is being raised and the contribution rates to the statutory pension insurance scheme and the health insurance fund are being increased. Taken together, these fiscal measures will cause the burden of taxes and social security contributions (judging from the present perspective) to rise by around 1 percentage point vis-à-vis 2002.

Development of turnover tax receipts vis-à-vis the national VAT assessment base

The national VAT assessment base may be approximately deduced from the national accounts using the subtractive or additive procedure. According to the subtractive method – which, with the aid of certain assumptions about the future expenditure structure of GDP, is also used for the official tax estimates – the most important tax-free components (net exports, business investments resulting in a tax credit to VAT, including changes in inventories) are deducted from nominal GDP. Turnover tax receipts are then estimated based on the remaining "modified domestic expenditure". A comparison of the correlation between these two variables for the past shows, however, that the growth of turnover tax receipts – adjusted for the increase of the standard rate in 1998 – has remained lower than the growth of this rough approximation for the national VAT assessment base almost continuously since the mid-1990s.

This may suggest an erosion of turnover tax receipts in relation to the national VAT assessment base that is tending to grow over the longer term. Such a presumption is, however, not confirmed by the following derivation based on the additive method, which – despite the estimation errors[1] contained therein – constitutes a better approximation for the VAT assessment base thanks to its greater disaggregation.

Turnover tax in relation to the national VAT assessment base in accordance with the subtractive approach

€ billion

Item	1995	1996	1997	1998	1999	2000	2001
A Turnover tax revenue	120.0	121.3	123.2	127.9	137.2	140.9	138.9
Change from previous year in %	– 0.5	+ 1.1	+ 1.6	+ 3.9	+ 7.2	+ 2.7	– 1.4
Phasing shifts							
– January estimation year	10.2	10.5	10.6	10.2	11.5	12.4	11.8
+ January subsequent year	10.5	10.6	10.2	11.5	12.4	11.8	12.1
– Amendments to tax legislation		– 0.3	0.1	0.1	1.6	2.2	2.2
= Adjusted revenue	120.3	121.7	122.6	129.2	136.4	138.0	136.9
Change from previous year in %	+ 0.0	+ 1.2	+ 0.8	+ 5.3	+ 5.6	+ 1.2	– 0.8
: 0.1304 (up to 1997), 0.136 (1998) and 0.1379 (as from 1999) *							
= Notional assessment base	922.4	933.1	940.3	949.6	988.9	1,001.0	993.1
B Nominal GDP	1,801.3	1,833.7	1,871.6	1,929.4	1,978.6	2,030.0	2,071.2
Change from previous year in %	+ 3.8	+ 1.8	+ 2.1	+ 3.1	+ 2.6	+ 2.6	+ 2.0
– Net exports	11.6	19.1	25.7	28.8	16.3	7.8	38.6
= Domestic expenditure	1,789.7	1,814.6	1,845.9	1,900.6	1,962.3	2,022.2	2,032.6
Change from previous year in %	+ 3.5	+ 1.4	+ 1.7	+ 3.0	+ 3.3	+ 3.0	+ 0.5
– Changes in inventories	3.9	– 2.5	0.6	7.2	0.9	5.2	– 9.4
– Gross fixed capital formation by enterprises excluding residential construction	222.0	219.3	224.4	235.4	244.9	261.6	250.1
Change from previous year in %	+ 1.7	– 1.2	+ 2.4	+ 4.9	+ 4.0	+ 6.8	– 4.4
= Modified domestic expenditure	1,563.9	1,597.9	1,620.9	1,658.0	1,716.5	1,755.3	1,791.9
Change from previous year in %	+ 3.5	+ 2.2	+ 1.4	+ 2.3	+ 3.5	+ 2.3	+ 2.1
C Notional assessment base as a % of modified domestic expenditure	59.0	58.4	58.0	57.3	57.6	57.0	55.4

* The increase in the VAT standard rate from 15% to 16% on 1 April 1998 is reflected in the development of this factor.

In contrast to the subtractive method, this approach shows a broadly constant ratio until 2000 between the actual revenue from turnover tax and the "arithmetical" VAT revenue calculated from the assessment base. This pattern is punctured sharply in 2001, which shows a sharp decline. This trend,

1 Statistical inaccuracies arise, firstly, from the rough disaggregation of the figures in the national accounts. Secondly, for the sake of simplicity this calculation ignores the implicit taxes which burden tax-free components of private consumption where there is no tax credit for intermediate consumption or the associated investments. For a

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Turnover tax in relation to the national VAT assessment base in accordance with the additive approach

€ billion, partly estimated

Item	1995	1996	1997	1998	1999	2000	2001
A Turnover tax revenue	120.0	121.3	123.2	127.9	137.2	140.9	138.9
Change from previous year in %	– 0.5	+ 1.1	+ 1.6	+ 3.9	+ 7.2	+ 2.7	– 1.4
Phasing shifts							
– January estimation year	10.2	10.5	10.6	10.2	11.5	12.4	11.8
+ January subsequent year	10.5	10.6	10.2	11.5	12.4	11.8	12.1
– Amendments to tax legislation		– 0.3	0.1	0.1	1.6	2.2	2.2
= Adjusted revenue	120.3	121.7	122.6	129.2	136.4	138.0	136.9
Change from previous year in %	+ 0.0	+ 1.2	+ 0.8	+ 5.3	+ 5.6	+ 1.2	– 0.8
B Consumer spending by households in Germany	972.4	997.8	1,023.8	1,051.8	1,090.9	1,122.4	1,162.6
Change from previous year in %	.	+ 2.6	+ 2.6	+ 2.7	+ 3.7	+ 2.9	+ 3.6
of which							
Components exempted from VAT, total	237.1	248.3	260.3	268.6	278.8	291.6	300.6
Change from previous year in %	.	+ 4.7	+ 4.8	+ 3.2	+ 3.8	+ 4.6	+ 3.1
Housing rents (including notional payments)	161.4	171.3	179.0	184.8	191.1	198.1	204.5
Out-patient and in-patient health services	26.8	26.3	27.9	27.7	27.9	29.4	30.2
Education	6.9	7.1	7.5	7.6	7.9	8.3	8.4
Social services	5.9	6.0	6.4	7.1	7.6	7.9	8.2
Insurance and financial services	36.1	37.7	39.5	41.4	44.3	47.9	49.3
Components subject to a lower rate of VAT, total	143.0	145.3	148.7	152.3	157.6	162.5	172.9
Change from previous year in %	.	+ 1.7	+ 2.3	+ 2.4	+ 3.5	+ 3.1	+ 6.4
Food	109.3	110.1	111.9	114.1	116.4	119.7	128.3
Newspapers, books and stationery	20.1	21.1	22.0	22.5	24.4	25.5	26.0
Recreational and cultural amenities (50 %)	13.6	14.1	14.8	15.7	16.8	17.3	18.7
Components subject to the standard rate of VAT, total	592.4	604.1	614.8	631.0	654.6	668.3	689.1
Change from previous year in %	.	+ 2.0	+ 1.8	+ 2.6	+ 3.7	+ 2.1	+ 3.1
Consumer spending by government subject to VAT	117.7	119.9	117.6	121.1	125.7	130.5	135.5
Change from previous year in %	.	+ 1.9	– 1.9	+ 3.0	+ 3.8	+ 3.8	+ 3.9
Social benefits in kind subject to tax	44.5	46.9	45.9	47.4	48.8	52.0	53.9
Intermediate consumption	73.2	72.9	71.7	73.7	76.9	78.5	81.6
Investments subject to VAT, total	192.9	190.0	187.1	188.0	191.1	187.0	176.3
Change from previous year in %	.	– 1.5	– 1.5	+ 0.5	+ 1.6	– 2.1	– 5.7
Investment in residential construction	142.0	141.7	142.1	142.4	144.2	140.9	131.2
Government fixed capital formation (excluding residential construction)	40.3	38.2	34.6	34.9	37.0	36.2	35.0
Fixed capital formation of the credit and insurance sector	10.6	10.1	10.4	10.7	9.8	9.8	10.1
Arithmetical turnover tax amount derived therefrom, total	127.1	128.7	129.6	137.8	144.3	146.6	149.3
Change from previous year in %	.	+ 1.2	+ 0.7	+ 6.3	+ 4.7	+ 1.6	+ 1.9
From components of private consumption subject to a lower rate of VAT	9.4	9.5	9.7	10.0	10.3	10.6	11.3
From components of private consumption subject to the standard rate of VAT	77.3	78.8	80.2	85.8	90.3	92.2	95.0
From government consumption subject to VAT	15.3	15.6	15.3	16.5	17.3	18.0	18.7
From investments subject to VAT	25.2	24.8	24.4	25.6	26.3	25.8	24.3
C Adjusted revenue as % of the derived arithmetical amount	94.6	94.6	94.6	93.7	94.5	94.2	91.7

which deviates from the subtractive outturn, is mainly attributable to the relatively strong growth of tax-free components of private consumption which – like those components subject to a lower rate of VAT – are not considered separately in the subtractive derivation approach. Nonetheless, it cannot be inferred from this that there is no significant turnover tax fraud because tax evasion can also have an impact on the national VAT assessment base.

more detailed analysis of these relationships, see A Boss (1997), *Untersuchungen zur Bemessungsgrundlage und zum kassenmäßigen Aufkommen der Steuern vom Umsatz*, Kiel Working Paper No 844 of the Kiel Institute of World Economics, Kiel.

proposals – can be justified systemically within the framework of a comprehensive income taxation approach, in accordance with the principle of taxing all accretions to wealth. However, there is a danger that this may adversely affect domestic capital formation and, if applied retroactively, public confidence in the stability of the overall taxation regime. Furthermore, the package largely exempts privileges relating to employee compensation.

The package of measures also encroaches on areas which rightfully form part of the tax system as an integral whole. The envisaged curtailing of firms' ability to offset losses against profits will tend to weaken entrepreneurial risk propensity and dampen the investment climate. In a neutral tax system government should participate equally – ie on a full and timely basis – in both profits and losses. Investment risks for residential construction and the overall economy will also ensue from the planned reduction of depreciation allowances for buildings, which would worsen the investment conditions for enterprises at an international level, too. In addition, the planned restrictions on intercompany netting would make Germany less attractive as a location for group holding companies, after its locational attractiveness had been enhanced by the tax reform 2000, which granted tax exemption to corporations' capital gains from the sale of participating interests. Hence, some elements of the tax package are problematic under longer-term growth and employment aspects. Moreover, the changes will also make German tax legislation more complicated.

Reform of municipal finance

Further tax policy reforms are planned for the coming years in the areas of municipal finance and the taxation of retirement income. The reform of local authority finance primarily concerns trade earnings tax, which is problematic both at the municipal level (because of its high elasticity to cyclical developments) and for tax systemic reasons (owing to the disadvantage imposed on a specific type of income and the resulting distortions). It is essential to replace this tax with a source of income which – without entailing macroeconomic drawbacks – would again provide local authorities with a steadier revenue trend. There are two conceivable approaches in this context: firstly, broadening the trade tax assessment base by including elements that are independent of earnings and extending it to free-lance professions and, secondly, completely abolishing this tax and compensating the local authorities through a municipal multiplier or add-on facility on income tax and corporation tax as well as possibly giving them a larger share of turnover tax. From a tax systemic and macroeconomic perspective, the second approach is preferable.[12] Abolishing trade tax would make the taxation system much less complicated and would bring about a more even taxation of different types of income. "Revitalising" trade tax by including elements which are independent of earnings would, by contrast, represent a return to taxing firms' capital reserves and would thus partly cancel some earlier reform steps.

12 So as not to handicap cities vis-à-vis their rural catchment area, income tax could in future be coupled partly to the place of employment instead of the place of residence.

Financial implications of the envisaged package of taxation measures (Draft Act to Reduce Tax Subsidies and the Act Continuing the Ecological Tax Reform, which has already been passed by the Bundestag) *

Increase (+) or decrease (–) in receipts in € billion

Measure	Accounting year			
	2003	2004	2005	2006
I. Income tax measures, total	+ 0.6	+ 2.5	+ 4.0	+ 5.1
of which Lowering straight-line depreciation of buildings to 2% per year and abolition of declining-balance depreciation of buildings	–	+ 0.3	+ 0.7	+ 1.0
Limiting the home buyers' grant to a basic family allowance of €1,000 and an allowance per child of €800 for families and single parents and simultaneously reducing the eligible income ceiling to €70,000 for single persons (and twice that amount for married couples) plus €20,000 per child in the relevant two-year tax period	+ 0.2	+ 0.8	+ 1.4	+ 2.0
Flat-rate taxation of private capital gains from the sale of securities and rented property at a rate of 15% and verification via bank notifications	–	+ 0.3	+ 0.7	+ 0.7
Verification of investment income for taxation purposes via bank notifications	–	+ 0.6	+ 0.8	+ 1.0
Increase in the flat-rate tax on the private use of company cars to monthly 1.5% of the listed price	+ 0.4	+ 0.5	+ 0.5	+ 0.5
II. Business tax measures, total	+ 1.5	+ 6.2	+ 8.9	+ 9.4
of which Limitation of the deductible loss to half of the overall income or profit from business operations (for income tax, corporation tax and trade tax purposes)	+ 0.7	+ 1.8	+ 1.6	+ 1.2
Abolition of intercompany netting for trade tax purposes and its limitation for corporation tax purposes	+ 0.2	+ 0.6	+ 0.8	+ 0.9
Non-recognition of intercompany offsetting in the case of multiple parent companies also for corporation tax purposes	–	+ 0.7	+ 1.5	+ 1.9
Reduction of offsettable tax credits from earnings retained in past years	+ 0.3	+ 0.7	+ 0.4	+ 0.2
Creation of new documentation requirements for internal transfer prices	–	+ 0.1	+ 0.4	+ 0.8
Abolition of the simplified depreciation rule	+ 0.3	+ 1.2	+ 1.8	+ 2.2
Non-recognition of the formation of provisions for anniversary bonuses and the reversal of existing anniversary provisions over three years	–	+ 0.6	+ 1.5	+ 1.1
III. Turnover tax measures, total	+ 1.5	+ 2.0	+ 2.2	+ 2.2
of which Abolishing the turnover tax reduction for agricultural primary products and lowering the flat rate of average taxation of agricultural enterprises	+ 0.5	+ 0.7	+ 0.7	+ 0.8
Abolition of turnover tax reduction for dental technician services	+ 0.3	+ 0.4	+ 0.4	+ 0.4
Abolition of other turnover tax relief measures (horticultural products, animal breeding etc)	+ 0.4	+ 0.5	+ 0.5	+ 0.6
Abolition of turnover tax exemption for cross-border passenger flights	+ 0.3	+ 0.5	+ 0.5	+ 0.5
IV. Energy tax measures, total	+ 1.4	+ 1.4	+ 1.5	+ 1.5
of which Increase in mineral oil tax rates for natural gas, liquid gas and heavy heating oil	+ 1.0	+ 1.0	+ 1.0	+ 1.0
Limitation of the tax breaks for the producing industry as well as for farmers and foresters	+ 0.4	+ 0.4	+ 0.4	+ 0.4
All tax measures, total	+ 5.0	+ 12.1	+ 16.5	+ 18.2
of which: central government	+ 3.0	+ 5.8	+ 7.5	+ 8.1
state government	+ 1.5	+ 4.2	+ 5.9	+ 6.5
local government	+ 0.6	+ 2.1	+ 3.2	+ 3.6

* According to estimates of the Federal Ministry of Finance.

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New method of taxing retirement income

Following a constitutional ruling, a new method has to be found for taxing retirement income, since the present practice of taxing only the notional accrued interest component of normal pensions represents an unfair advantage with respect to the taxation of civil servants' pensions. The ruling made in March could be seized as an opportunity to change over to taxing general pensions, too, at the benefit rather than the contribution stage. Given the problems of double taxation and of revenue shortfalls which would stem from a progressive tax exemption of contributions, the transition will have to be phased, however, over a longer period. The reform should also be used to harmonise the tax treatment of different old-age provision instruments; various privileges should also be reviewed in this context.

Further need for reform

Further reforms are required to make the tax system less complicated, more neutral from a macroeconomic point of view and, ultimately, more geared to performance incentives. A key need is to further lower the marginal tax rates on the factor labour, which are also high by international standards. This would necessitate additionally lowering the tax rates for medium incomes, too, while at the same time reducing existing tax breaks for employees. Significant tax cuts can, however, only be made after the government budgets have been consolidated. Moreover, the marginal rates of tax and social security contributions on labour income can only be reduced lastingly if the social security systems, too, are thoroughly reformed.

Annex

Major tax policy measures since 1998

Act to Continue the Business Tax Reform *(Gesetz zur Fortsetzung der Unternehmenssteuerreform)* of October 1997

This Act abolished trade capital tax at the beginning of 1998 and stipulated that, in eastern Germany, it was also not to be levied in 1997. The net annual shortfalls in tax revenue of around €2 billion which resulted from the abolition of this tax were financed predominantly by stipulating that,- from 1997, tax provisions for anticipated losses from uncompleted transactions were no longer to be set up and that existing provisions were to be reversed within six years, thus boosting the disclosed profit. The Act further put an end to abusive practices with regard to carrying forward losses and reduced the previous tax concession for extraordinary income. From 1998, local authorities were given a share of just over 2% of turnover tax revenue as a substitute for trade capital tax.

Act to Lower the Solidarity Surcharge *(Gesetz zur Senkung des Solidaritätszuschlags)* of November 1997

The surcharge on income tax and corporation tax introduced in 1995 as a supplementary tax accruing solely to the Federal Government was lowered by 2 percentage points to 5.5% at the beginning of 1998 (causing tax revenue losses of just over €3½ billion per year).

Act concerning the Financing of an Additional Federal Grant to the Statutory Pension Insurance Scheme *(Gesetz zur Finanzierung eines zusätzlichen Bundeszuschusses zur gesetzlichen Rentenversicherung)* of December 1997

To avoid raising the contribution rate to the statutory pension insurance scheme, an additional Federal grant to this social security fund was introduced in 1998 and financed by raising the standard rate of turnover tax by 1 percentage point to 16% (with an unaltered reduced rate of 7%) as of 1 April 1998. The expected revenue increase from this source was just under €5 billion for 1998 and rose to €8 billion in 1999.

Tax Relief Act 1999 *(Steuerentlastungsgesetz 1999)* of December 1998 and Tax Relief Act 1999/2000/2002 *(Steuerentlastungsgesetz 1999/2000/2002)* of March 1999

These Acts, which were passed following the German parliamentary election of 1998, initiated a reform of the income tax regime in three stages between 1999 and 2002. In its first year, the reform granted gross tax relief totalling around €27 billion, of which almost €17 billion was to be financed by widening the tax assessment base. The first two stages were designed to have virtually no effect on revenue. The tax relief consisted, above all, of an increase in child benefit in 1999 of DM30 per month to DM250 per month for the first and second child and a gradual lowering of income tax rates up to 2002 to a bottom rate of 19.9% and a top rate of 48.5%, coupled with an increase in the basic tax-free allowance to around DM14,000 per year. Furthermore, the top rate of income tax for business earnings was reduced from 47% to 45% in 1999 and to 43% in 2000, while the corporation tax rate applicable to retained earnings was lowered by 5 percentage points to 40% at the beginning of 1999. The widening of the assessment base focused primarily on tightening the tax regulations governing the determination of profits by restricting existing facilities to set up provisions, to write down assets to their going-concern value (with the simultaneous introduction of a requirement to reinstate original values) and to transfer hidden reserves. The tax package also restricted the possibility of offsetting losses between various types of income and of carrying back losses, abolished the tax rate reduction for extraordinary income, halved savers' tax-free allowance (as of 2000) and extended the applicable "speculation period" for taxing private capital gains to one year for securities and ten years for rented property.

Act Revising the Arrangements for Low-Paid Part-Time Workers *(Gesetz zur Neuregelung der geringfügigen Beschäftigungsverhältnisse)* of March 1999

The tax exemption ceiling for low-paid part-time workers was set at DM630 per month for both western and eastern Germany as of 1 April 1999 and not increased thereafter. In addition, a compulsory contribution was introduced for these part-time low-paid jobs consisting of a basic employers' contribution of 12% of the wage to be paid to the statutory pension insurance scheme and 10% of the wage to be paid to the statutory health insurance scheme. Earnings of employees receiving income solely from one part-time low-paid job were exempted from tax (whereas previously wage tax had been imposed at a flat rate of 20%).

Act Initiating the Ecological Tax Reform *(Gesetz zum Einstieg in die ökologische Steuerreform)* of March 1999

The first stage of the "ecological tax reform" – which sought, on the one hand, to curb statutory non-wage labour costs and, on the other, to make energy consumption dearer – was introduced on 1 April 1999. It increased the existing mineral oil tax by 6 pfennigs/l for petrol and diesel, by 4 pfennigs/l for heating oil and by 0.32 pfennigs/kWh for natural gas, and introduced a new electricity tax of 2 pfennigs/kWh. The tax increase was moderated in the case of the producing sector, the farming sector and the railways. The expected additional revenue of just over €4 billion in 1999 was earmarked to finance the simultaneous lowering of the contribution rate to the statutory pension insurance scheme by 0.8 percentage point.

Act Continuing the Ecological Tax Reform *(Gesetz zur Fortführung der ökologischen Steuerreform)* of December 1999

This Act encompassed further increases in mineral oil tax on fuel of 6 pfennigs/l per year as well as a rise in electricity tax of 0.5 pfennig/kWh per year for the years 2000 to 2003. The resulting additional revenue, which was forecast to grow from €2½ billion in 2000 to almost €11 billion in 2003, was earmarked to finance a further increase in the Federal grant to the statutory pension insurance scheme.

Family Assistance Act *(Gesetz zur Familienförderung)* of December 1999

The minimum subsistence level for children, below which tax exemption applies, was substantially boosted in line with a ruling of the Federal Constitutional Court. In the first stage, which came into effect at the beginning of 2000, the revised family assistance arrangements included the introduction of a child-minding allowance of DM3,024 per child (under 16 years of age) and a further increase in child benefit of DM20 per month to DM270 per month for the first and second child. The resulting shortfalls in tax revenue amount to almost €3 billion per year.

1999 Tax Adjustment Act *(Steuerbereinigungsgesetz 1999)* of December 1999

This Act, which entailed annual shortfalls in tax revenue of around €1½ billion, was designed *inter alia* to adjust several counterfinancing measures concerning the business sector laid down in the Tax Relief Act 1999/2000/2002.

Act Amending the Housing Allowance Act and other Acts *(Gesetz zur Änderung des Wohngeldgesetzes und anderer Gesetze)* of December 1999

This Act lowered the income ceiling for entitlement to the home buyer's grant at the beginning of 2000 from DM240,000 to DM160,000 for single persons (double amount for married couples) in the relevant two-year tax period. The new income ceilings are raised by DM60,000 for each child.

Tax Reduction Act *(Steuersenkungsgesetz)* of October 2000 and Supplementary Tax Reduction Act *(Steuersenkungsergänzungsgesetz)* of December 2000

These Acts, which entail additional tax relief totalling €32 billion up to 2005, involve a further reduction in income tax rates and a reform of business taxation. The reduction in income tax rates planned for 2002 was brought forward by one year; income tax rates are to be reduced further in the years 2003 and 2005 (to a starting rate of 15% and a top rate of 42%), with a simultaneous raising of the basic tax allowance to DM15,000. The reform of business taxation lowered the corporation tax rate to a uniform 25% at the beginning of 2001. Moreover, the existing imputation system for corporation tax was replaced by a system of income tax relief on dividends, and corporations' capital gains from selling domestic equity stakes were exempted from tax as of 2002. Income tax for non-corporations was reduced from 2001 by 1.8 times the trade tax assessment base. Furthermore, the halving of the tax rate upon giving up the business was reintroduced (as of the age of 55) and the tax-free amount on selling the business was raised from DM60,000 to DM100,000. The counterfinancing measures focused on lowering the declining-balance depreciation rate for investment in machinery and equipment from 30% to 20% per year, cutting the straight-line depreciation rate for commercial buildings from 4% to 3% per year and adjusting the official depreciation tables to "more realistic" write-off periods (the latter by administrative regulation).

Act Introducing a Standard Travel Allowance *(Gesetz zur Einführung einer Entfernungspauschale)* of December 2000

At the beginning of 2001, in response to the steep increase in crude oil prices on the world markets, the existing petrol allowance of 70 pfennigs per kilometre claimable by commuters was converted into a standard travel allowance independent of the means of transport used and increased to 80 pfennigs per kilometre for that part of the distance between a commuter's home and his/her place of work which exceeds 10 kilometres (resulting in annual shortfalls in tax revenue of around €½ billion).

Act Promoting Private Pension Plans *(Altersvermögensgesetz)* of June 2001

This second part of the pension reform constituted a first step towards funded pensions by promoting certain forms of supplementary old-age provision through grants and tax allowances from 2002. Up to 2008, the Act lays down the progressive introduction of a basic grant of €154, plus a supplementary grant of €185 per child, for contributions to private pension plans that meet certain criteria. Instead of the grant, a tax allowance can be claimed which will increase in stages to a maximum amount of €2,100 in 2008. The later pension payments resulting from these tax-free savings will be taxed in full (taxation of benefits). The tax environment for company pension schemes was likewise improved. The Act entailed shortfalls in tax revenue which will increase progressively from around €½ billion in 2002 to over €10 billion as of 2009.

Second Family Assistance Act *(Zweites Gesetz zur Familienförderung)* of August 2001

This Act – which entails annual shortfalls in tax revenue of around €2½ billion from 2002 – is the second step in fulfilling the Federal Constitutional Court's stipulations of 1998 concerning extended tax exemption up to the minimum subsistence level for children. For this purpose, the child benefit granted for the first and second child was increased at the beginning of 2002 from DM270 to €154 per month for each child and the tax allowance for children was raised to €3,648. Furthermore, a child-rearing component was added to the existing child-minding allowance of DM3,024, as a result of which the aggregate allowance has been €2,160 since 2002. Moreover, a deduction for proven employment-induced child-minding costs was introduced for children under 14 years of age up to a ceiling of €1,500 per child where such costs exceed the existing child-minding allowance. On the other hand, the household allowance is being reduced gradually and the special allowance for household employment was abolished.

Act to Curb Illegal Employment in the Construction Industry *(Gesetz zur Eindämmung illegaler Betätigung im Baugewerbe)* of August 2001

In order to curb illegal employment in the construction industry, awarders of construction contracts are required to deduct 15% of payments to contractors above a certain threshold as a withholding tax and to transfer this to the tax authorities if the contractor in question does not have an exemption certificate (this is expected to yield additional revenue of around €¼ billion as of 2002).

Act on Financing Activities to Combat Terrorism *(Gesetz zur Finanzierung der Terrorbekämpfung)* of December 2001

In order to finance the additional expenditure on internal and external security amounting to €1½ billion, this Act increased tobacco tax in two stages (by 1 cent per cigarette at the beginning of both 2002 and 2003) and insurance tax (by 1 percentage point to 16% at the beginning of 2002).

Act for the Further Development of Business Tax Law *(Gesetz zur Fortentwicklung des Unternehmenssteuerrechts)* of December 2001

This Act, which has little effect on revenue, is designed primarily to facilitate the restructuring of non-corporations and, secondly, to end certain accounting options in respect of trade tax with a view to improving the financial position of local authorities.

Act to Combat Tax Evasion *(Steuerverkürzungsbekämpfungsgesetz)* of December 2001

This Act is designed to curb turnover tax fraud through improved monitoring procedures (this is expected to yield additional revenue of around €2½ billion per year as of 2002).

Flood Victim Solidarity Act *(Flutopfersolidaritätsgesetz)* of September 2002

The costs of overcoming the flood damage caused predominantly in eastern Germany are being financed by postponing the income tax relief planned for 2003 by one year and by temporarily raising the corporation tax rate by 1.5 percentage points to 26.5% in 2003 (this is expected to yield additional revenue of around €6½ billion in 2003).