Efficient, Fair and Simple: An Integrated System of Income Taxes and Social Security Contributions in Germany

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Recent Policy Debate I

- Germany implemented several major policy reforms in the early 2000s
  - Income tax system (tax base and schedule, "Tax Reform 2000")
  - Labor market policy ("Hartz I, II and III")
  - Unemployment and social assistance ("Hartz IV")
- However, ongoing debate on the need for further reforms
  - Income taxation is too complex and insufficiently transparent
  - High tax burdens for middle income earners
  - Negative work incentives for secondary earners
- Similar problems in other European countries.

Recent Policy Debate II

- Several proposed policy reforms (mainly concentrated on tax schedule)
- But: Conflicting goals
  - Positive employment effects (higher employment rate)
  - Positive distributional effects (lower income inequality)
  - Neutral or positive budget effects (no revenue losses)
- None of the proposals met all of these goals.
- Main problem: Most reform proposals neglect the importance of social security contributions and the interaction between SSC and income taxation in Germany.

Reform Proposal

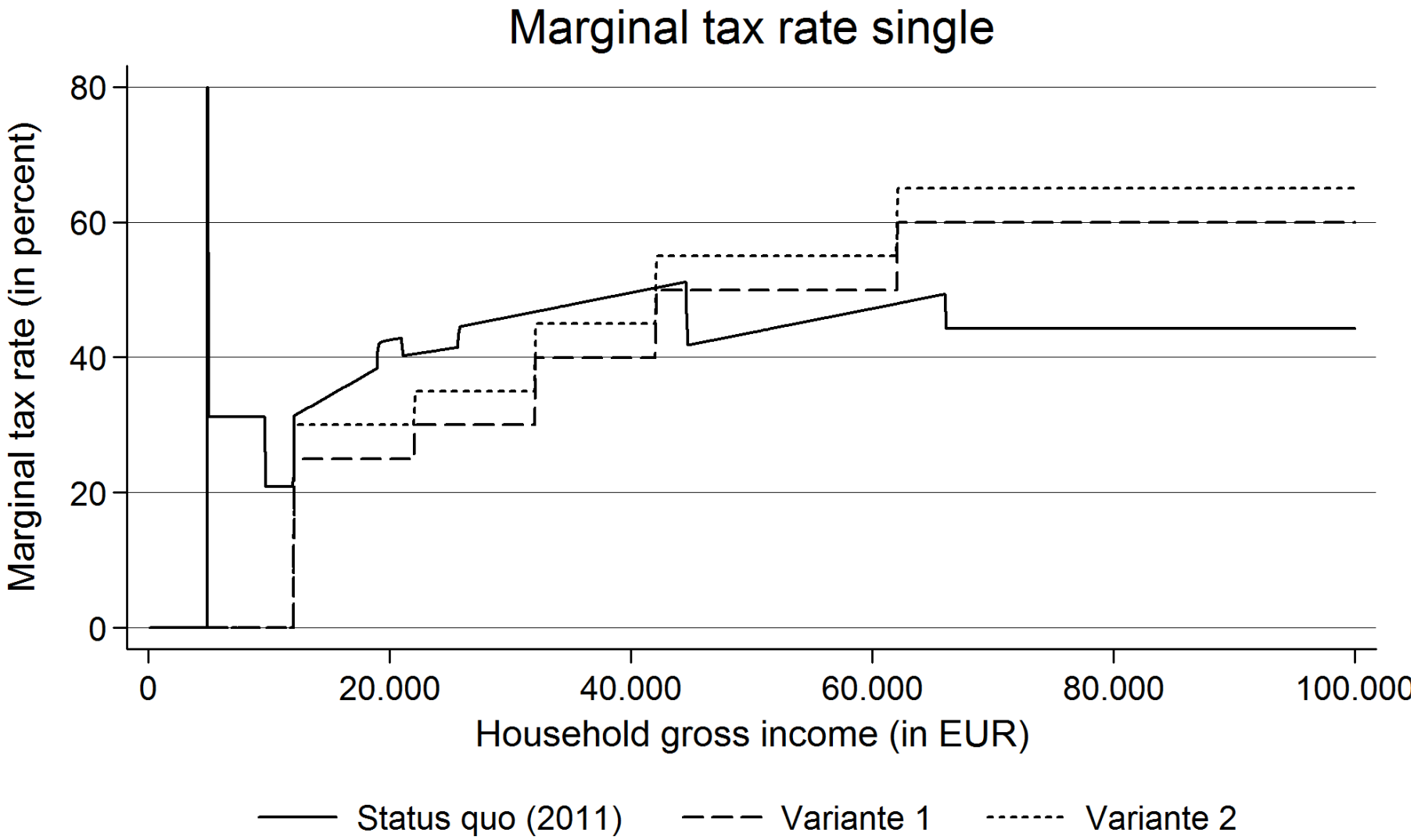
- Much broader definition of income (e.g., we reduce tax deductions and include capital income, pensions and imputed rents of owner-occupied housing).
- Individual instead of joint taxation for married couples.
- Integration of social security contributions into the income tax system.
  - Will possibly create new entitlements to benefits.
  - We address this issue in "Variante 2".
- Benefit rules, transfer payments and corporate taxes remain unchanged.

Tax Schedule

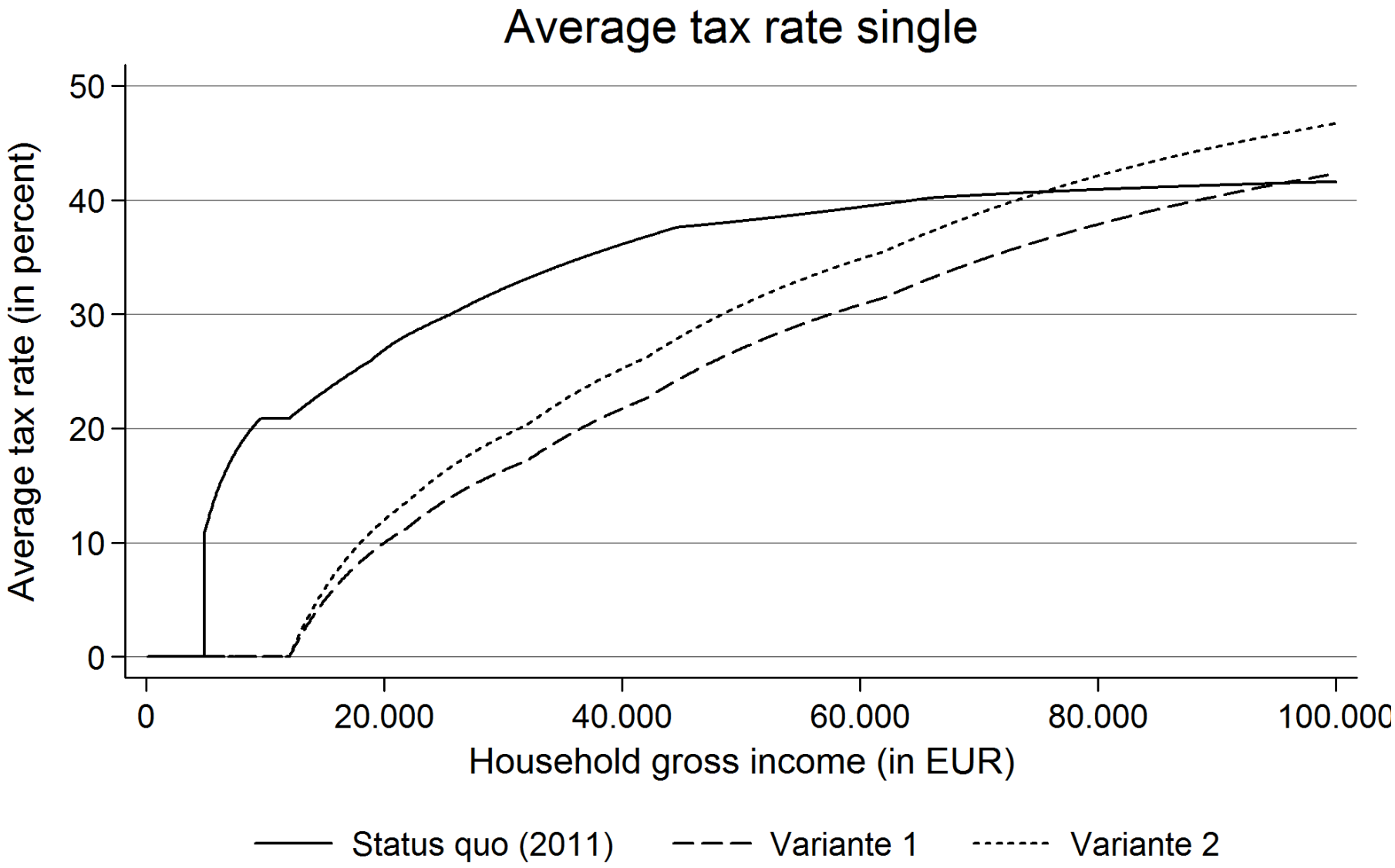
Household Income	Marginal Tax Rates	
	Variante 1	Variante 2*
0 EUR ... 20,000 EUR	25 %	30 %
20,000 EUR ... 30,000 EUR	30 %	35 %
30,000 EUR ... 40,000 EUR	40 %	45 %
40,000 EUR ... 60,000 EUR	50 %	55 %
60,000 EUR ...	60 %	65 %

* Higher revenue for potential additional benefit entitlements.

- But: Non-deductible tax credit of 10,000 EUR and 2,000 EUR tax allowance for wage earnings.



Note: Cut-off at 80%.


Average tax rate single
Average tax rate (in percent)
50
40
30
20
10
0
0
20.000
40.000
60.000
80.000
100.000
Household gross income (in EUR)
Status quo (2011)
Variante 1
Variante 2

Public Revenue (in billion €)

	Variante 1			Variante 2		
	Morning After	Labor Supply	Labor Demand	Morning After	Labor Supply	Labor Demand
Taxes	160.5	157.6	157.0	208.8	203.4	202.9
SSC	-155.2	-152.5	-153.4	-155.2	-153.2	-154.0
Transfers	-0.6	1.9	1.0	-0.8	1.4	0.7
Total	4.1	6.5	4.1	52.1	51.0	49.0

Source: Own Calculations with IZAΨMOD.

Labor Supply and Employment

	Variante 1		Variante 2	
	Labor Supply	Labor Demand	Labor Supply	Labor Demand
Full-time equivalents (in 1,000)	837.4	525.5	672.0	422.9
Participation (in 1,000)	771.2	497.0	755.6	537.5
Participation rate (in %-points)	2.1	1.3	2.0	1.4

Source: Own Calculations with IZAΨMOD.

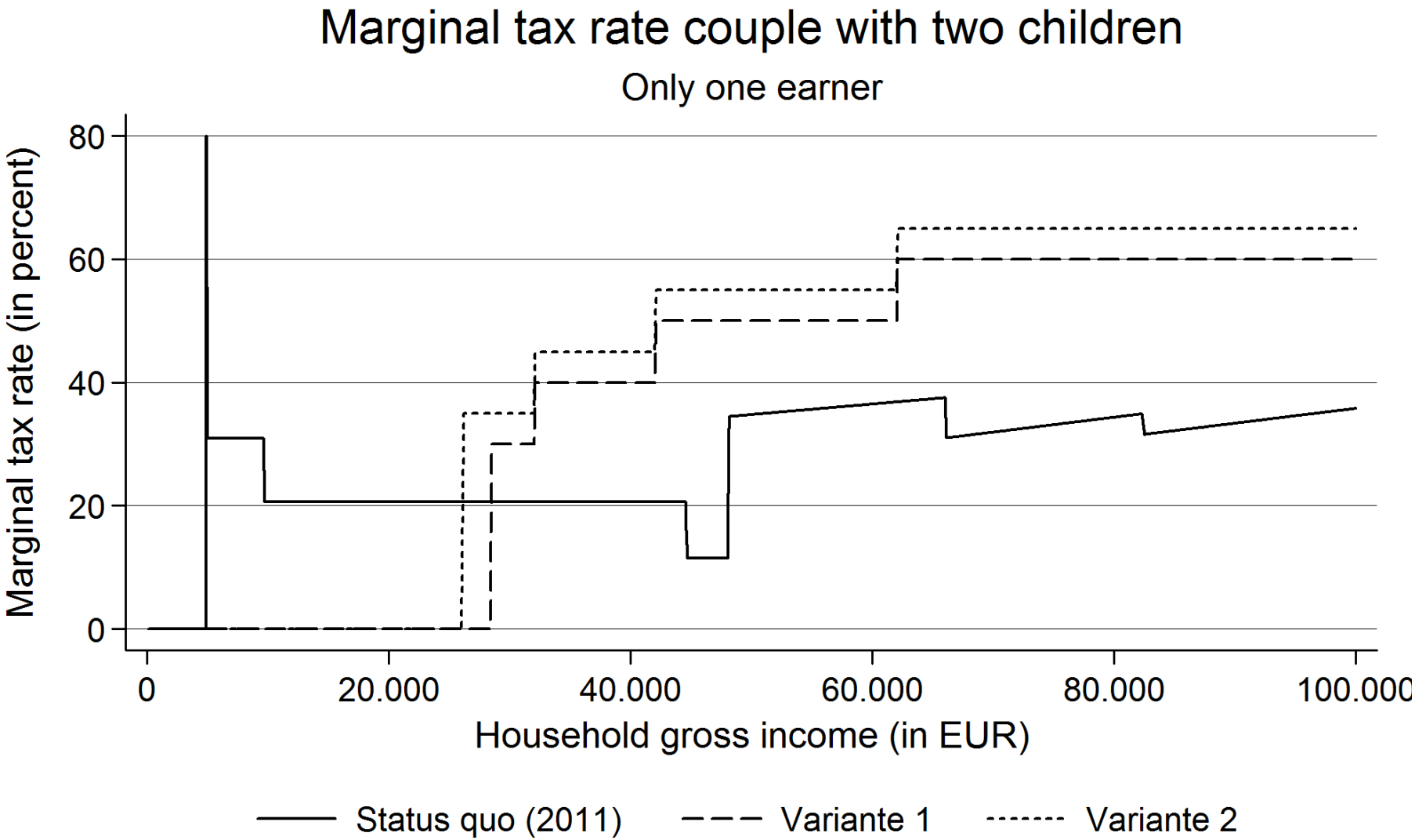
Distributional Effects (in %-points) I

	Relative to mean income			Difference	
	Status quo	Var. 1	Var. 2	Var. 1	Var. 2
Poorest 10 %	40.2	41.5	43.1	1.3	2.8
Decile 2	51.1	52.5	54.2	1.4	3.1
Decile 3	60.2	62.7	64.1	2.5	3.8
Decile 4	70.2	72.9	73.9	2.7	3.7
Decile 5	79.5	82.8	83.7	3.3	4.3
Decile 6	91.0	95.1	95.8	4.1	4.9
Decile 7	104.4	110.2	110.5	5.8	6.1
Decile 8	120.8	125.0	124.9	4.2	4.1
Decile 9	145.1	146.7	145.5	1.6	0.4
Richest 10 %	246.8	219.7	213.0	-27.1	-33.8

Source: Own Calculations with IZAΨMOD.

Conclusion

- There is a need for further reforms in Germany. But: Not only with respect to the tax schedule.
- We propose a comprehensive reform and an integrated system of income taxation and social security contributions, which meets all three goals:
  - Higher Employment
  - Lower income inequality
  - Neutral effect on public revenues
- However:
  - Huge reform
  - Marginal tax rates above 50 %?
  - Proposal shows the direction



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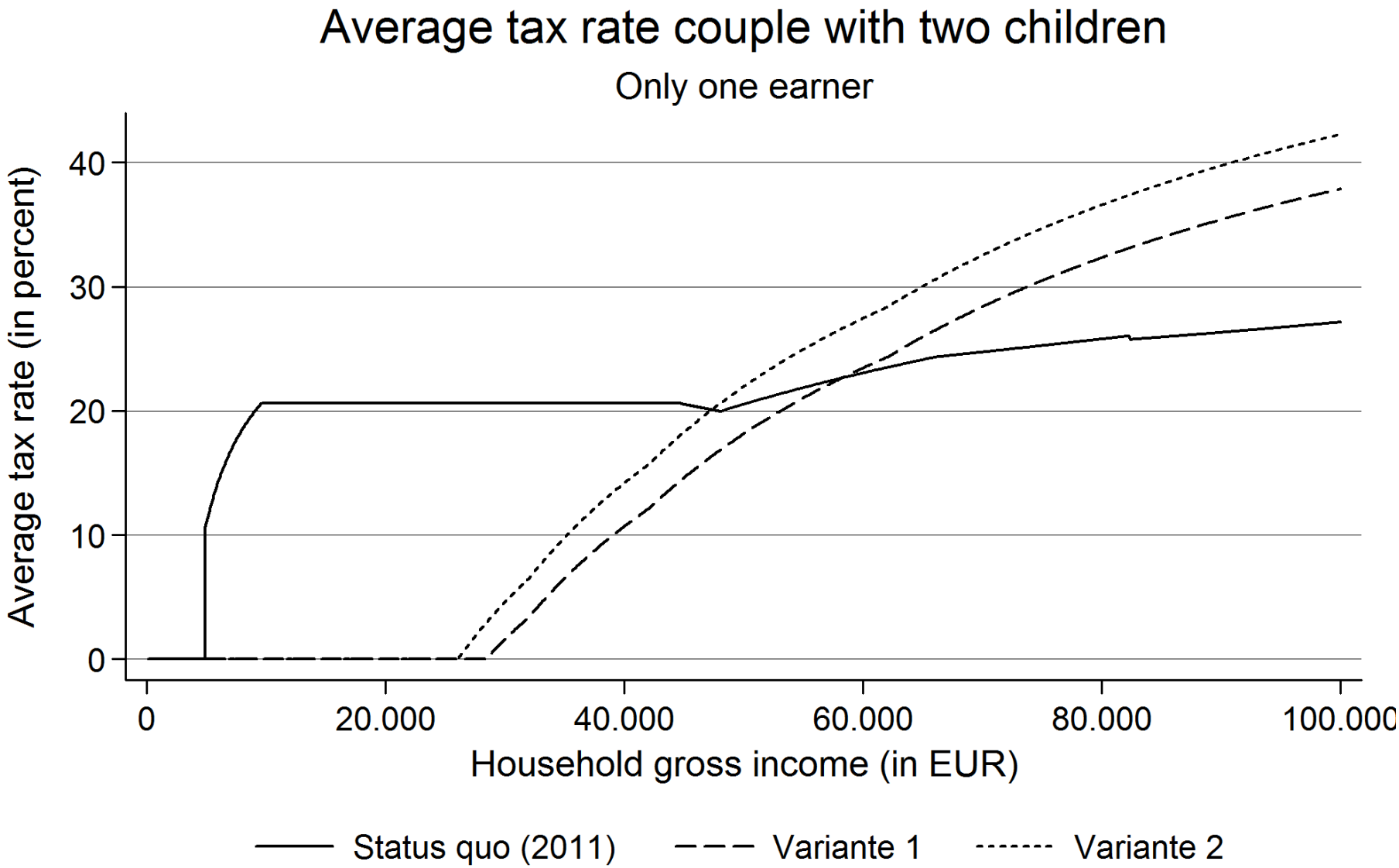
Average tax rate couple with two children
Only one earner
Average tax rate (in percent)
0
10
20
30
40
0
20.000
40.000
60.000
80.000
100.000
Household gross income (in EUR)
Status quo (2011)
Variante 1
Variante 2

Distributional Effects II

	Income Inequality			Difference	
	Status quo	Var. 1	Var. 2	Var. 1	Var. 2
Gini	0.300	0.285	0.275	-0.015	-0.025
P90/P10	3.531	3.570	3.391	0.040	-0.140
P90/P50	1.938	1.907	1.862	-0.031	-0.076
P50/P10	1.822	1.872	1.821	0.051	-0.001

Source: Own Calculations with IZAΨMOD.