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Petersen, Hans-Georg

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The German tax and transfer system: a problem oriented overview

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The German Tax and Transfer System: A Problem Oriented Overview

von

Hans-Georg Petersen

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Herausgeber:

Prof. Dr. Hans-Georg Petersen
Universität Potsdam
Wirtschafts- und Sozialwissenschaftliche Fakultät
Lehrstuhl für Finanzwissenschaft
Postfach 900 327
D - 14439 Potsdam
Tel. +49 331 977-3394
Fax: +49 331 977-3392
Email: lsfiwi@rz.uni-potsdam.de

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The German Tax and Transfer System: A Problem Oriented Overview

Hans-Georg Petersen

University of Potsdam, Faculty of Economics and Social Sciences, August-Bebel-Str. 89, D-14482 Potsdam. Email: lsfiwi@rz.uni-potsdam.de

The state is like a cow which is fed
in heaven but milked on earth
(Puviani)

I Introduction

The main purpose of this paper is to give a brief overview of the German tax and transfer system. Bearing in mind the enormous complexity of the system, it is obvious that only the most basic components can be explained here. Emphasis will be placed on the current institutional framework, the single tax and transfer basis and the schedule structures, as well as the basic principles which have determined the character of both systems. Additionally some concise information on the revenue and transfer structures is given.

With regard to the historical development it should be mentioned that both systems have developed more or less independently. While the social security system was announced in the 'Emperor's Message' of 1881 and implemented in the following decade, the 'modern' tax system was introduced by the Erzberger tax reform of 1920. Despite the changes which have since been made, the basic legal characteristics of both systems have remained almost unchanged, whereas changes in social structures, values and behaviour have led to an expansion far beyond the original target groups of tax payers and transfer recipients.

In the German tradition the transfer system was developed under the heading of the 'social state' *(Sozialstaat)*, a principle which is fundamentally different from the British 'welfare state' *(Wohlfahrtsstaat)*.[1] While the Beveridgian approach is a model of redistribution and

[1] For more details see Koslowski (1997, p. 113).

socialist welfare, the Bismarckian model is one of minimalist social insurance, originally aimed at solidarity in times of need. In its evolution, and as a result of numerous political interventions into the social insurance system, the principle characteristics have become blurred. The minimalist approach was substituted by paternalistic views and the erosion of the insurance myth was accompanied by the introduction of extensive measures for interpersonal or intergenerative redistribution, which in turn has arguably had an adverse impact on income distribution. The social aid system, which follows the subsidiary principle, came into existence in the 1920s and was further developed after World War II.

It was particularly with the Erzberg tax reform that a modern income tax system was introduced at the federal level. The income tax base was broadly defined by pragmatic income assessment criteria, and due to the ability-to-pay principle, the tax schedule was highly progressive. Additionally, the progressive marginal rate structure had the important function of redistributing income from the rich to the poor, a target which – as just mentioned – was not part of the original social insurance system but was obviously introduced as part of the later social aid system. As in any democratic setting after World War II, the increasing influence of many interest groups meant the income tax system faced an ongoing erosion of the tax base because of tax concessions and loopholes. In connection with long-term fixed income brackets, and as a consequence of inflation, income growth in the lower and middle income groups caused a marked increase of marginal tax rates for these groups. At the same time, a large number of tax payers in the higher income groups could take advantage of the permanently increasing tax concessions, thereby effecting a sharp decline in effective average marginal tax rates. The originally intended redistribution was partly turned in the opposite direction, with the consequence that nowadays the bulk of the tax burden is laid on the middle income classes, with follow-on effects on incentive schemes. Tax evasion has been as often deplored as the growth of the shadow economy.[2]

In Chapter II, a short description of the tax and revenue structures will be presented, while Chapter III gives corresponding information for the ‘transfer’ or social security system. Chapter IV elucidates the basic underlying principles and benefit structures, as well as the scope of the marginal tax and transfer rates, which are important for further discussion. In Chapter V, a basic security concept is juxtaposed against the current status quo; Chapter VI concentrates on possible further political development patterns and Chapter VII gives a brief summary of the arguments.

II The Tax System

The German tax system is similar to other European systems, and consists of about 40 different single taxes. The most important of these are presented in Figure 1. In addition, the revenue for 1997 is shown, both in billion DM as well as in per cent of total tax revenue. The most important tax of both direct and indirect taxes is income tax, which comprises wage tax and assessed income tax. The second most relevant direct tax is corporation tax. Property tax was abolished in 1996, while the tax base of inheritance tax has been broadened, a move which will lead to a higher tax revenue in the future.

The value added tax (VAT) is the most important indirect tax, and forms the second largest source of revenue in the German system. With respect to specific indirect taxes, the tax on gasoline predominates, and this will gain even more importance as it forms part of the new ecological tax program.[3] April 1999 has seen, along with the new coalition's tax reform, the implementation of an ecological tax system which also consists of a specific energy tax (on electric inputs or consumption).

Within the German fiscal equalization system the tax system is partly regulated under the legal sovereignty of the federal state (especially the indirect taxes) and partly by the conjunction of the Federation and the States (*Länder*). In relation to revenue sovereignty (see Figure 2), revenue sharing is overwhelmingly regulated under the German Constitution (*Grundgesetz*), and most specific indirect taxes are also Federal taxes. Income tax and value added tax are common taxes, that is, shared by the Federation (*Bund*) and the States (*Länder*), with the distribution of VAT being negotiable between the two jurisdictions.

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[2] See Schneider (1999).

[3] For the effects of an increasing gasoline tax and corresponding reductions within the income tax see Müller, Nagel & Petersen (1997).

Figure 1: *Tax System – Tax Revenue in 1997*

Tax System
Tax Revenue 1997

direct taxes		% of total tax revenue	**indirect taxes**		
• **income tax**	**306.5**	**38.3**	• **value added tax**	**240.9**	**30.2**
			• **specific indirect taxes**		
- wage tax	248.7	31.2	- tobacco tax	21.2	2.7
- assessed income tax	5.8	0.7	- Tax on gasoline	66.0	8.3
- source tax on interest payments	11.4	1.4	- tax on alcoholic beverages	4.7	0.6
- solidarity surcharge	25.9	3.2	- beer tax	1.7	0.2
• **property tax**	**1.8**	**0.2**			
• **inheritance and gift tax**	**4.1**	**0.5**			
• **corporation tax**	**33.3**	**4.2**			

Source: Institut Finanzen und Steuern (1998)

Figure 2: *Tax System – Classification by Revenue Sovereignty*

Tax System
Classification by Revenue Sovereignty

Common taxes	**Federal taxes**	**State taxes**	**Local taxes**
• wage tax	• tax on gasoline	• automobile tax	• firms profit tax
• assessed income tax	• tobacco tax	• inheritance and gift tax	• land tax
• firms profit tax apportion	• tax on alcoholic beverages	• beer tax	• other Local taxes
• corporation tax	• insurance tax	• other State taxes	
• capital income tax	• tariffs (imposed for the EU)		
• value added tax	• solidarity surcharge		
• source tax on interest payments	• other Federal taxes		

The States have no autonomy over tax rates and levy only minor taxes. They are thus heavily dependent on the common taxes, their share of which they can influence via negotiations between the Federal Parliament and the second chamber (*Bundesrat*). At the community level there is limited autonomy with regard to firms' profit tax and land tax and here the local tax rate can be influenced by a rate multiplier. The sharing rules for 1997 are depicted in Figure 3.

The structure of the fiscal administration reflects the hierarchical federal system and the legal sovereignties; administration is carried out by the Federal and the State ministries which both have departments within the revenue directorates (see Figure 4). The directorates then have control over the custom and revenue offices; the revenue offices then work in co-operation with the local revenue offices to determine local taxes.

Table 1 gives an overview of tax revenue and the revenue sharing amongst the German jurisdictions for selected years. As has already been mentioned, the proportion of taxes commonly shared predominates (almost 70 per cent in 1997). The Federal taxes comprise 17.8 per cent, while Local taxes, at 8.4 per cent, are almost twice as much as State taxes – a clear indicator that the '*Länder*' are strongly dependent on the Common tax revenue.

Figure 3: *Revenue Sharing amongst the German Jurisdictions 1997*

	Share of the Federal Government	**Share of the States**	**Share of the Communities**
wage tax	42.5%	42.5%	15%
assessed income tax	42.5%	42.5%	15%
corporation tax	50%	50%	
capital income tax	50%	50%	
value added tax*	56%	44%	
source tax on interest payments	44%	44%	12%
firms profit tax	5%	5%	90%

* since 1998 the communities participate at the rate of 2.2% in VAT revenue

Figure 4: *Fiscal Administration Structures*

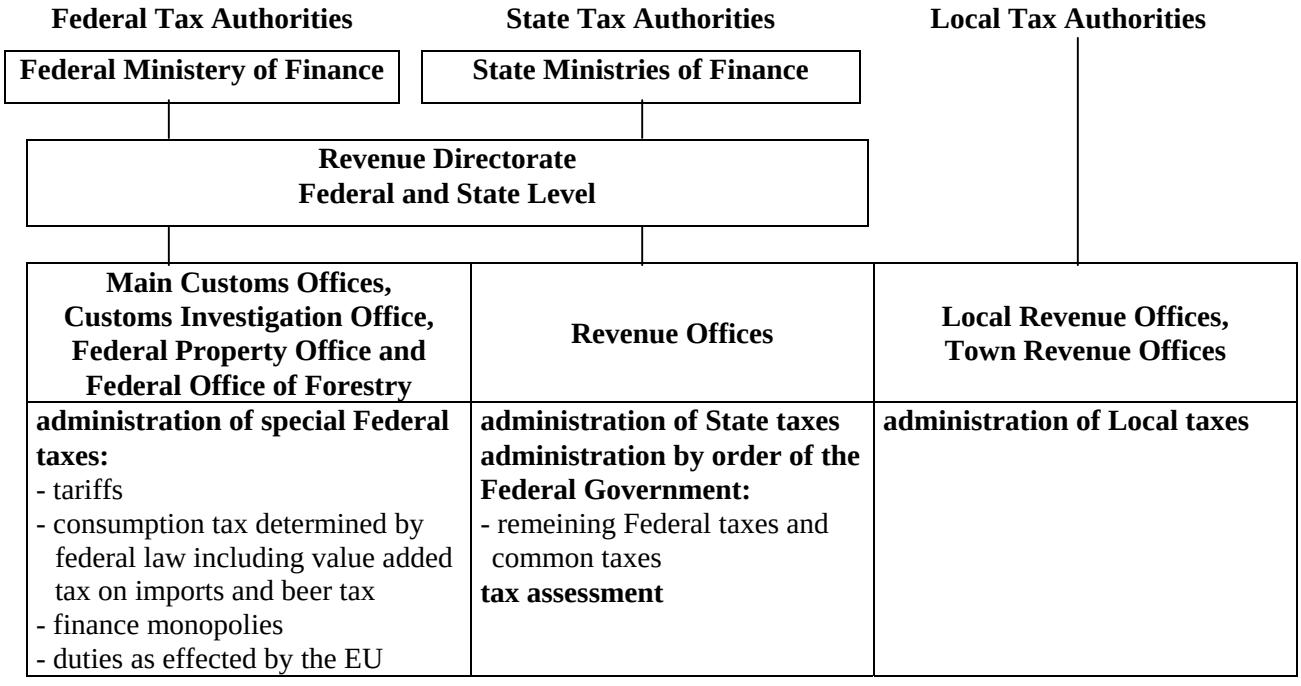

Table 1: *Tax Revenue of the German Jurisdictions*

	1986		**1990**		**1995**		**1997**	
	in billion DM	in % of total tax revenue	in billion DM	in % of total tax revenue	in billion DM	in % of total tax revenue	in billion DM	in % of total tax revenue
Common taxes	333.7	73.8%	416.4	73.4%	579.2	71.1%	554.7	69.6%
wage tax	152.2	33.6%	181.1	31.9%	282.7	34.7%	248.7	31.2%
assessed income tax	29.9	6.6%	36.5	6.4%	14	1.7%	5.8	0.7%
corporation tax	32.3	7.1%	30.1	5.3%	18.1	2.2%	33.3	4.2%
capital income tax	8.1	1.8%	10.8	1.9%	16.9	2.1%	14.7	1.8%
value added tax	58.6	13.0%	84.6	14.9%	198.5	24.4%	199.9	25.1%
value added tax on imports	52.6	11.6%	69.9	12.3%	36.1	4.4%	41	5.1%
source tax on interest payments					12.8	1.6%	11.4	1.4%
Federal taxes	56.4	12.5%	76.4	13.5%	141.2	17.3%	142.2	17.8%
tax on gasoline	25.6	5.7%	36.6	6.5%	64.9	8.0%	66	8.3%
tobacco tax	14.5	3.2%	18.3	3.2%	20.6	2.5%	21.2	2.7%
tax on alcoholic beverages	4.1	0.9%	4.5	0.8%	4.8	0.6%	4.7	0.6%
insurance tax	4.2	0.9%	6.4	1.1%	14.1	1.7%	14.1	1.8%
tariffs	5.2	1.1%	7.2	1.3%	7.1	0.9%	6.9	0.9%
solidarity surcharge					26.3	3.2%	25.9	3.2%
other Federal taxes	2.7	0.6%	3.4	0.6%	3.3	0.4%	3.4	0.4%

Table 1 continued

	1986		1990		1995		1997	
	in billion DM	in % of total tax revenue	in billion DM	in % of total tax revenue	in billion DM	in % of total tax revenue	in billion DM	in % of total tax revenue
State taxes	21.3	4.7%	25.4	4.5%	36.6	4.5%	34.7	4.4%
property tax *	4.4	1.0%	6.3	1.1%	7.9	1.0%	1.8	0.2%
automobile tax	9.4	2.1%	8.3	1.5%	13.8	1.7%	14.4	1.8%
inheritance and gift tax	1.9	0.4%	3	0.5%	3.5	0.4%	4.1	0.5%
beer tax	1.3	0.3%	1.4	0.2%	1.8	0.2%	1.7	0.2%
other state taxes	4.3	1.0%	6.4	1.1%	9.6	1.2%	12.7	1.6%
Local taxes	41.2	9.1%	48.6	8.6%	57.2	7.0%	65.6	8.2%
firms profit tax **	32	7.1%	38.8	6.8%	42.1	5.2%	48.6	6.1%
land tax	7.6	1.7%	8.7	1.6%	13.7	1.7%	15.5	1.9%
other local taxes	1.5	0.3%	1.1	0.2%	1.4	0.2%	1.5	0.2%
total tax revenue	452.4	100.0%	567.3	100.0%	814.2	100.0%	797.2	100.0%

* until 1997
** until 1997 incl. firms capital tax

Source: Institut Finanzen und Steuern (1998)

In addition to the structural information, some details on tax bases as schedules are given for the two most important taxes, namely income and value added tax. As previously noted, the tax base of German income tax is pragmatically and not synthetically defined; there are seven different kind of income sources. Since 1999 a distinction has been made between active and passive income sources. Income from agricultural activities, self-employment, business, and wages belong to the former, while rents and leasing, capital income (especially interest payments and dividends) as well as other means of income (e.g., pension payments) belong to the latter. Considerable tax exemptions and concessions distinguish gross from taxable income, structures partly determined by different income sources. As a consequence, taxable income is often substantially reduced, so that the gap between the scheduled tax rates (average and marginal) and the effective tax rates (related to gross income) is remarkably high. This gap expresses the above-mentioned erosion, which in the post-war period has led to an increasing deviation from the concept of a comprehensive tax base.

Because of general budgetary pressures, there was a need for income tax revenue, which could only be secured by a comparatively progressive marginal rate structure. Notwithstanding this, tax brackets, basic tax exemptions, allowances, tax credits and so on have not been adequately adjusted to take inflation into account, while both high marginal rates and long-term constant exemptions have created disincentives. Furthermore, behavioural adaptations have shifted the income tax burden to the middle income classes. In a crucial ruling of the German Constitutional Court in 1992, the Federal Parliament was obliged to fix the basic exemption within the income tax schedule to the minimum income guaranteed by the social aid system, a figure which is to be adapted every year.[4] Increasing inefficiency and intensified public discussion of an ever-rising equity gap then led to a political strategy which seeks to abolish at least some specific exemptions, whereas others which are especially important for large groups of voters (such as pensioners dependent on social retirement insurance) have been excluded.[5]

The basic idea was thus to lower marginal rates, and to compensate the revenue losses by an increase of taxable income. The old coalition envisaged a marginal rate structure between 15 per cent for low incomes and 39 per cent for high incomes. The new coalition, fearing serious revenue losses, seems to be much less courageous and more dependent on their specific

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[4] See *Bundesverfassungsgericht* (1992). Another important ruling was recently made by the Constitutional Court with regard to the family equalization system; the revenue losses of this ruling might be much higher than the losses connected with the tax reforms of 1999 to 2002.

[5] For details, see eg Petersen & Bork (1997).

political clientele. Consequently they will reduce the highest marginal rate only to 48.5 per cent for wages and passive incomes by 2002, while for business income the highest marginal rate will be reduced to 35 per cent. The current tax schedule (1999) has a marginal rate structure between 23.9 and 53 per cent.

Due to innumerable specific regulations, tax law and the accompanying income tax instructions and directives have become highly complex. This complexity is clearly expressed within the different commentaries on income tax law, some of which fill over ten thousand pages. This flood of information has made the tax system a profitable field for tax consultants – their number would be an excellent proxy measure for the inefficiencies of the system; it has also created dubious redistributive effects. The system may have become exploitable for the informed, but it is the uninformed, the average tax payer, who has to foot the bill.

Similar developments have taken place with regard to the value added tax (VAT) – the commentaries of which are also quite extensive. Introduced in 1967 as a comparatively simple and efficient tax, the VAT tax law has since become more and more complex, especially due to the modifications which have been necessary as part of European integration. The VAT system is a consumption tax and the basis is the net turn-over for goods and services; the tax credit method is applied. The turn-over due to other transaction taxes and housing rents is exempt and there is also an exemption for small turn-overs. The tax rate is proportional, with a standard rate of 16 per cent and a reduced rate of 7 per cent for goods and services which are basic needs (eg food, books, newspapers). The tax-free rents and reduced rate were introduced to diminish the regressive effects of the VAT system. Empirical estimates have shown that such reduction is in fact observable, while slight regressive effects remain.[6] We do not have any precise empirical information about the total re-distributive effect of the German tax system, but in view of the numerous concessions and loopholes, the whole system appears to be more proportional than progressive.[7]

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[6] See, eg Nagel & Müller (1992).

[7] The regressive effect depends heavily on the tax base and the chosen time horizon; what is regressive in an annual perspective may not be regressive if considered in terms of a life-time. Annual market income is less equally distributed than annual consumption, and life-time consumption is more equally distributed than life-time market income; for details see Metcalf (1994) and Petersen (1996).

III The Transfer System

The German transfer system is too complex to represent the hierarchical order in a simple table. There are over 40 institutions with more than 90 general regulations and laws involved in German social policy, not to mention thousands of guidelines for its administrative execution. There is neither enough space nor time to describe this in detail. However, unlike tax systems with no comprehensive tax code, in the social security system a code of the social law has been developed.

The institutions are roughly grouped in Figure 5 (detailed interrelations omitted). The Federal and State authorities have legal sovereignty over almost all of the institutions mentioned, partly on a competitive basis. The main tasks of the ministries should be mentioned. The Ministry for Finance is responsible for the family equalization system, which is mainly included within the income tax system, while the Ministry for the Interior decides on the pension systems for the government employees. The Ministry for Employment and Social Order has power over some social insurance institutions, such as Social Unemployment and Accident Insurance, in addition to regulating the Social Aid System, (administered by the Local Social Offices and predominantly financed by the communities). The Social Health Insurance is administered by the Ministry for Health; the Ministry for Transport and Housing is responsible for social rent and housing support. Specific social programs are organized by the Ministry for Family, Senior Citizens, Women and Youth, while the Ministry of Education administers the parent-dependent educational assistance system.

Figure 5: *Social Security Institutions in Germany*

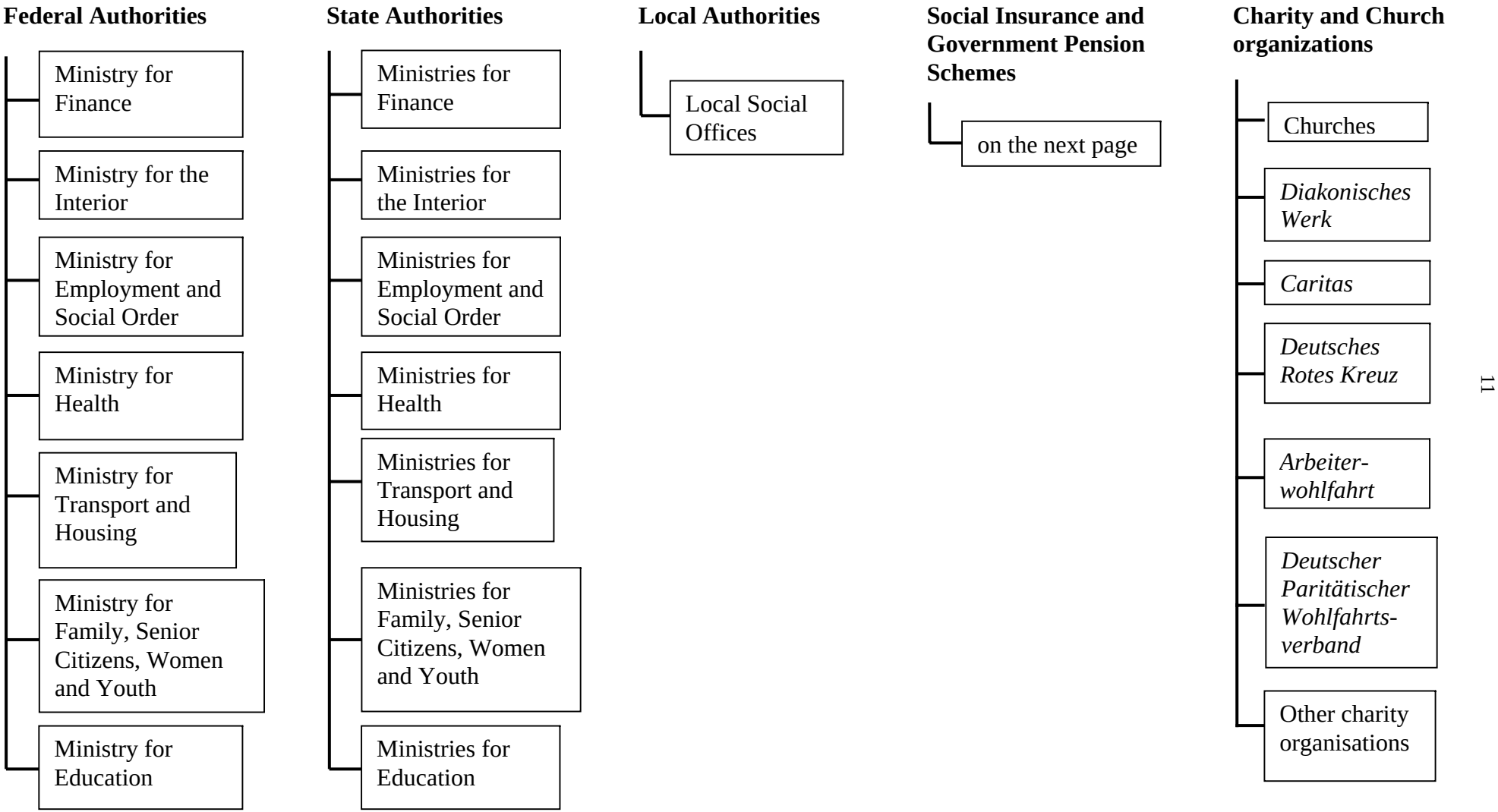

Figure 5 continued

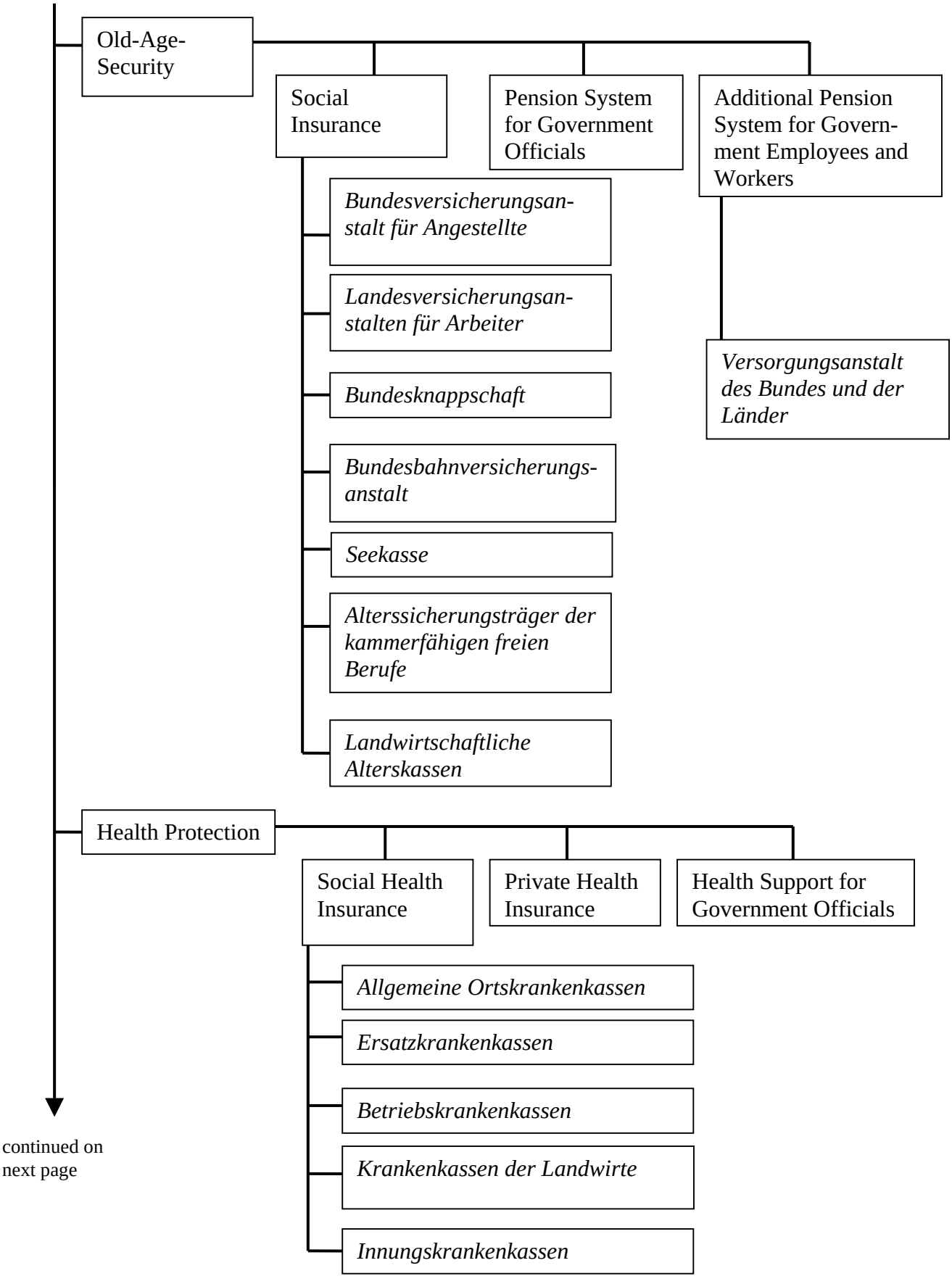

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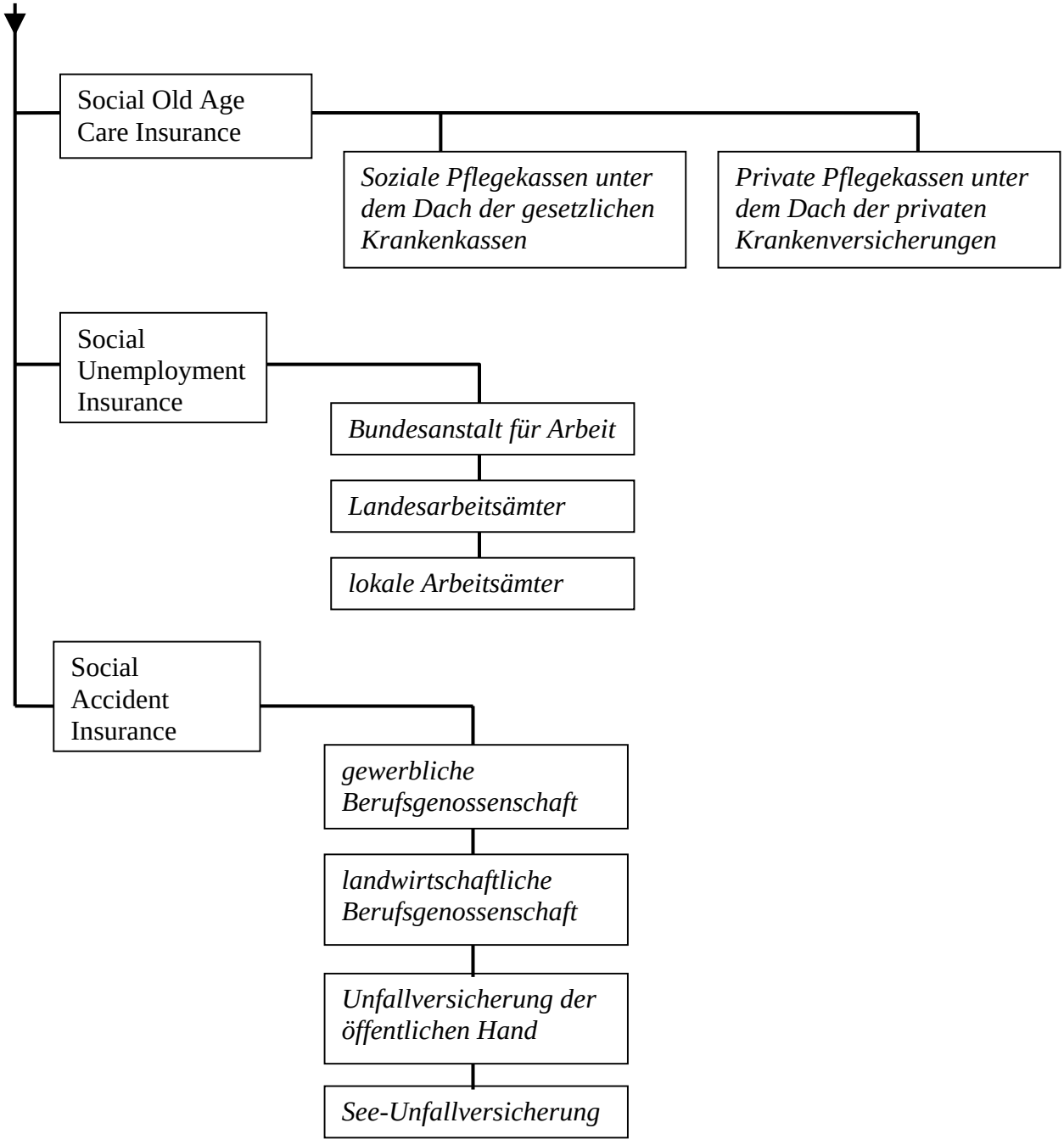
Figure 5 continued



The primary responsibility of the family is typical of the constitution of the German social security system. Parents are obliged to maintain their adult children whilst they are in the education system or in times of need; this obligation extends to all first-degree relatives and is regulated by the German Civil Code (BGB, §§ 1601 ff.). In accordance with the subsidiary principle, social aid is only available in cases of insufficient income or property. The Social Aid System now secures a ‘socio-cultural’ minimum, whereas in the first post war decades a concept similar to the ‘relative poverty’ definition was followed. Due to historical reasons the

system is predominantly financed by the local jurisdictions; this often creates serious financial problems in regions suffering from great structural change and associated unemployment.

Under the original Bismarckian model, the social insurance institutions were founded as self-administering institutions. In social elections the representatives of the employers and employees are still today elected in parity. Meanwhile, influence and power has in fact shifted to the political sphere, so that all important decisions have to be decided by the Federal Parliament. This is true for contributions to, as well as for benefits from, the social insurance system. In general the social insurance system is wage-oriented, in the sense that almost all contributions are linked to gross wages; benefits are also wage-oriented according to a socially modified insurance principle.

Compared with private insurance scheme, personal redistribution is built in the system to a certain extent, as the wage distribution differs from individual risk distribution. With steadily increasing political interventions into the social insurance system, redistribution measures have been intensified. At the same time, demographic development has impaired the rate of return of the system and will continue to do so in the future. Therefore the nature of the insurance has been lost and the system has become more one of aid or care. Consequently, the contributions are taken as quasi-taxes, thus generating the same behavioural changes as taxes. Today we not only complain of tax avoidance and evasion but also of contribution avoidance and evasion, a problem which is closely linked to the treatment of low incomes for part-time work.[8]

In comparison with the social aid system, the benefits of the transfer scheme are predominantly defined in accordance with income tax, but several modifications have led to the fact that the upper income ceilings are quiet different. If family income exceeds certain income limits the sudden abolishment of transfers like housing benefits, education benefits, and support of property formation leads to erratic increases in marginal tax and transfer rates (see Figure 9 below). The benefit levels for payments out of the social insurance system are partly gross- and net-wage oriented and treated quite differently within the income tax system. Because the social insurance and income tax systems have not been rationally planned from the very beginning, and their integration has never been a political target, they are not well co-ordinated.

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[8] In Germany, low part-time wages have until now been taxed at a fixed proportional rate and the tax burden is anonymously paid by the employer (so-called 630/530 DM jobs in the old/new States of Germany). The new

Because the German social insurance system is oriented towards causality factors of social need (the causality principle), and not to clearly defined income targets (as in case of the final principle), in many cases benefits from different insurance branches and aid systems might be accumulated. In such cases very high replacement income ratios are often realized. Otherwise the social network is not focussed on avoiding poverty, so that social aid has to be paid in addition. On the whole the redistribution process seems to be very inefficient because an enormous part of the GDP is spent for social policy purposes while the net re-distributive effect is small. Most of the redistribution is not directed from the rich to the poor but redistribution within the middle income classes – a brilliant example of a welfare state in which income is shifted from the one pocket to another, in conjunction with an effect on employment for the welfare bureaucracy.

These trends are clearly reflected in the empirical development of the Social Budget in Germany. Table 2 demonstrates the development of outlays on social welfare after German unification. Over the whole post-war period the West German Social Budget had been increased but has obviously never solved the poverty problem. Even before unification (in the late eighties) a new social phenomenon was envisioned, connected with the popular image of two-thirds of society being well-to-do, while the remaining third lived in need and poverty. If such a popular description were correct, it would provide yet more proof for the inefficiency of the welfare state, in which the redistribution process is not directed at those actually in need.

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coalition plans to substitute the wage tax with a social security contribution, which will no longer be paid anonymously.

Table 2: *Social Budget in Germany*

	1991	1992	1993	1994	1995p	1996p	1997s
	in billion DM						
Social Budget	**883.08**	**999.88**	**1059.04**	**1108.31**	**1177.88**	**1236.15**	**1256.1**
General System	**570.9**	**653.95**	**697.69**	**736.31**	**788.04**	**810.87**	**829**
Social Old-Age-Insurance[1)]	260.69	287.64	309.33	334.92	361.11	375.64	384.7
- Old-Age-Insurance for Worker	134.15	146.64	157.43	170.33	182.33	189.23	193.4
- Old-Age-Insurance for White-Collar Worker	106.69	119.5	128.91	140.07	153.07	160	164.6
- Old-Age-Insurance for Miners	19.85	21.50	22.99	24.51	25.71	26.42	26.7
Social Old-Care-Insurance	0	0	0	0	10.32	21.35	29.3
Social Health Insurance	181.66	208.85	209.89	227.64	239.12	247.3	244.5
Social Accident Insurance	14.89	17.08	18.49	19.38	19.98	20.22	20.5
Employment Promotion and Unemployment Benefits	87.34	111.22	131.5	126.67	128.99	138.58	142.6
Children's Allowance	20.41	21.92	21.64	21.03	21.27	0.82	0.4
Child-Care-Benefits	5.92	7.23	6.84	6.68	7.24	6.96	7
Supplementary Systems	**6.98**	**7.62**	**8.09**	**8.45**	**9.02**	**9.56**	**9.8**
Old-Age-Protection for Farmers	4.81	5.3	5.6	5.81	6.21	6.6	6.7
Add. Pension System for Government Employees	2.17	2.32	2.48	2.64	2.8	2.96	3.1
Benefits for Government Officials	**69.12**	**74.23**	**77.95**	**80.02**	**84.73**	**87.64**	**89.6**
Pensions	46.84	50.02	52.46	53.8	54.42	59.8	61.5
Income Supplement for Families	11.52	12.22	12.66	12.89	13.18	13.2	13.3
Health Allowance	10.77	11.99	12.83	13.33	14.13	14.64	14.8
Employer Benefits	**85.36**	**91.54**	**91.84**	**91.88**	**99.34**	**96.92**	**93.4**
Sick Leave Compensation	47.53	51.16	50.23	49.43	55.27	52.33	47.1
Company Pensions	21.13	22.49	23.73	24.96	26.57	26.8	28.1
Supplementary Insurance	11.59	12.76	12.82	12.6	12.93	13.33	13.8
Other Employer Benefits	5.11	5.13	5.06	4.9	4.58	4.46	4.4

Table 2 continued

	1991	1992	1993	1994	1995p	1996p	1997s
				in billion DM			
Compensation	**17.29**	**18**	**18.18**	**18.44**	**18.27**	**17.06**	**15.4**
Social Compensation	13.43	14.15	14.42	14.51	13.94	13.11	12.3
Equalization of War-Burdens	1.02	0.93	0.84	0.74	0.64	0.54	0.5
Compensation of War-Victims	1.9	1.93	2.21	2.39	3.09	2.89	2.3
Other Compensation	0.94	0.99	0.72	0.79	0.61	0.53	0.4
Social Aid and Support	**76.68**	**89.93**	**97.97**	**103.05**	**105.28**	**104.2**	**102.4**
Social Aid	35.72	40.14	46.03	52.35	54.39	53.12	50.8
Youth Aid	21.32	25.04	27.68	28.53	29.19	29.33	29.5
Education Benefits	2.59	2.49	2.24	1.96	1.86	1.79	1.8
Housing Benefits	4.94	7.32	6.99	6.19	6.22	6.64	7
Public Health Servicies	2.89	3.29	3.27	3.14	3.15	3.18	3.2
Support of Property Formation	11.22	11.65	11.77	10.87	10.47	10.14	10
Total Direct Benefits	**828.34**	**836.28**	**991.73**	**1038.15**	**1104.69**	**1126.25**	**1139.5**
Indirect Benefits	**54.75**	**63.6**	**67.32**	**70.16**	**73.19**	**109.9**	**116.6**
Tax Measures [2)]	54.75	63.6	67.32	70.16	73.19	66.6	66.9
Family Benefits	0	0	0	0	0	43.3	49.7
[1)] Consolidated	27	29.5	30.2	31.1	32.4	41.1	41.5

[2)] Splitting advantages for the spouse

p – provisional
s – estimate or projection

Source: Bundesministerium für Arbeit und Sozialordnung. *Sozialbericht* 1997 (1998, pp. 214-215)

The Social Budget (DM 1256.1 billion or 34.5 per cent of GDP) has reached such a volume that further increases would be met with resistance by tax payers and the majority of voters; thereby impairing the further growth potential and competitiveness of German society. The current direct tax burden resulting from the highly progressive income tax schedule especially for employees in the middle income brackets who do not have the potential and opportunity for tax avoidance and evasion is only one problem. Much more serious is the high burden of social insurance contributions, which up to some upper income ceilings, are proportionally determined. Unlike wage tax, they start being levied from the time the first Deutschmark is officially earned. By the end of 1998, the total percentage of social insurance contributions had reached 42.3 per cent (employers' and employees' contribution) of the payroll,[9] while employers also have to pay almost 5 per cent for sick leave compensation.[10] For some social security insurance institutions (especially for the Social Old-Age Insurance) additional federal government grants are paid, and these are financed out of the general tax revenue. Adding all these burdens together, households, and especially enterprises, in Germany have to face one of the highest wage costs in the world. This has clearly led to disincentives for job creation in Germany.

What we are currently left with is a *welfare state with empty pockets* – unable to fulfil the entitlements promised by politicians, resulting in feelings of annoyance and betrayal, thereby strengthening resistance to the tax and welfare state. This fact might have been one of the motivations for the recent political change, in spite of the fact that the new coalition does not have better policies. Therefore fundamental reform perspectives are as badly needed as they are regrettably absent. One such perspective is a return to the original concept of the German social state. This will be elucidated below.

IV Principles, Benefits, and Marginal Rates

As I have already mentioned, the tax and transfer system was not planned rationally. Consequently, the underlying principles are quite diverse within the single branches of the system. The causal orientation, as mentioned above, predominates. Due to the German Civil Code, the family's maintenance obligation is one strong argument for implementing the 'household' principle rather than an individually-based one. But there are other societal and economic arguments for following a household approach. Firstly, the family is the natural

[9] See *Deutscher Bundestag* (1998).

[10] See Prewo (1995, p. 14).

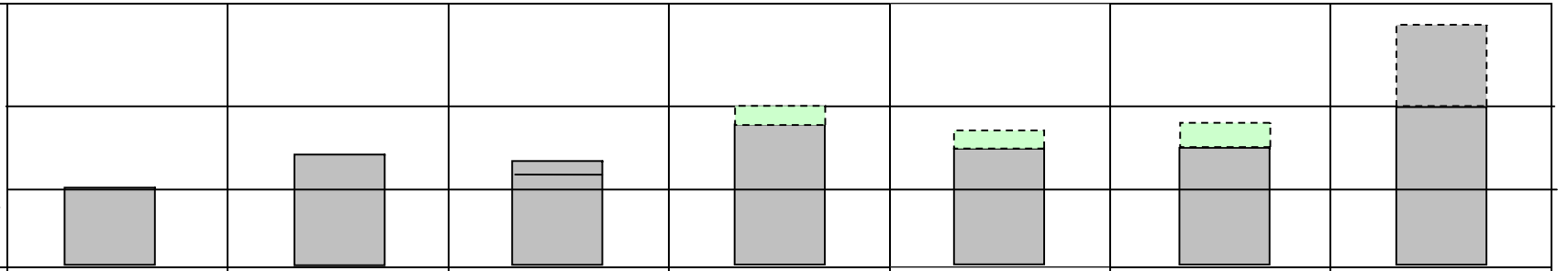
reproduction unit. Also, within households, basic decisions are made regarding labor market participation, intra-family specialization and the division of labor. Synergetic effects within household production is another strong argument in the welfare context.

In the German income tax system, the household or 'family' principle is applied.[11] Spouses are taxed while their dependent children are being educated, applying the 'splitting procedure' and child benefits or exemptions guaranteeing a tax-free minimum income which corresponds to the social aid level. Within the Social Aid System, the pure household principle is applied, even for couples who are not legally married, though problems in regulation mean that transfer fraud is common.

In addition, another choice has to be made regarding transfer or benefit calculation: Should benefits be gross-wage or net-wage oriented? The German system does not have a simple answer. Figure 6, which is only a stylized picture, demonstrates how complex the German system is, even in light of numerous simplifications. In this example a single household has been taken and all the possible cumulative effects have been excluded. The explanations and comments are of general application, and for the purposes of comparison the net-wage has been set at 100 per cent. The Social Aid System guarantees a socio-cultural minimum (45-50 per cent of the average net-wage). If this amount is taken as a basic security level, it can be seen that the other social insurance branches and public pension schemes are well above that level.

[11] 'Family' principle is more apt because the tax concessions are dependent on a legally formalized marriage.

Figure 6: *Stylised Overview of Social Benefits in Germany*

100 % basic security							
							
replacement net-wage ratio	45 - 50 %	70 %	60/53 %	100/90 %	75 - 80 %	75 - 91.75 %	100 %
kind of social benefit	Social Aid System (one person)	Social Pension System	Unemployment Insurance (benefit and aid; for families 67/57 %)	Social Health Insurance (sick leave compensation and sickness benefit)	Pension System of Civil Servants	Pension System of Public Employees and Workers	Wages (gross, net)
employees contributions	no	individual	Individual	individual	no	individual	gross wage oriented
benefits	household	individual, partly household	individual (benefit), partly household (aid)	individual	individual, partly household	individual, partly household	individual
calculation according to	socio cultural minimum	calculation: gross wage; adjustment: net-wage increase	net-wage	net-wage	Calcuation: gross wage; adjustment: gross wage increase	Calculation: gross wage; net-wage ceiling at 91.75 %; adjustment: gross wage increase	
comments	depends on family status and net-wage, family maintenance obligation, needs-based	reference old age pensioner (45 years of contributions), usually income tax free	aid is needs-based, provision concerning progression	sickness benefit individual, non-cash benefits: household-oriented provision concerning progression	reference pensioner with 40 years, due to income tax	supplementary insurance (VBL) without employees‘ contributions, reference pensioner with 40 years, taxed as social pensions	the average wage tax burden is about 20.0 % for singles and 18.6 % for families

With regard to the replacement net-wage ratios, sick leave compensation corresponds to the net-wage, whereas sickness benefit is 10 per cent less. After 45 years of employment, the social pension is almost 70 per cent, while the replacement gross-wage ratio is slightly below 50 per cent. This is due to the fact that social pensioners only pay a reduced contribution to Social Health Insurance, and the social pension itself is in fact income tax-free.[12]

In both State and Federal government, officials receive the higher replacement gross ratio of 75 per cent earlier (after 40 years). But for civil servants (*Beamte*) the pension is taxed like wages (albeit with a maximum annual exemption of DM 6000), and the replacement net-wage ratio is between 75 and 80 per cent. In contrast to civil servants, employees and workers contribute to the Social Pension System while their supplementary system (which secures the standard of the civil servants system) operates without contributions. Because their pensions are predominantly tax-free, their replacement net-wage ratios are correspondingly higher. About ten years ago, however, an upper net-wage ceiling of 91.75 per cent was introduced to avoid replacement net wage ratios of over 100 per cent. This limitation is regulated in the supplementary pension system (*Versorgungsanstalt des Bundes und der Länder* – VBL), financed only by employers' contributions.

The unemployment pension (the 'dole') and aid are again net-wage oriented and differ for singles and families; the replacement net-wage ratios for the dole are 57 per cent for singles and 67 per cent for spouses. The dole is paid for the first twelve months of unemployment, after which unemployment aid is paid. In contrast to the dole, unemployment aid, like social aid, is needs-tested and is also subject to the family maintenance obligation. If the remaining replacement income is below the social aid minimum, the person under consideration falls back into the Social Aid System.[13]

Within the Social Insurance System, benefits are household-oriented, insofar as the single institutions guarantee reduced monetary benefit levels or in-kind transfers for the non-insured

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[12] Because of specific concessions, income tax would only begin to be levied at social pensions above DM 52000 for singles (doubled for couples), but such pensions exist only in theory. For calculation of the reference old age pensioner's entitlement see Bundesministerium für Arbeit und Sozialordnung (1997, p. 178) und Lampert (1996, p. 256).

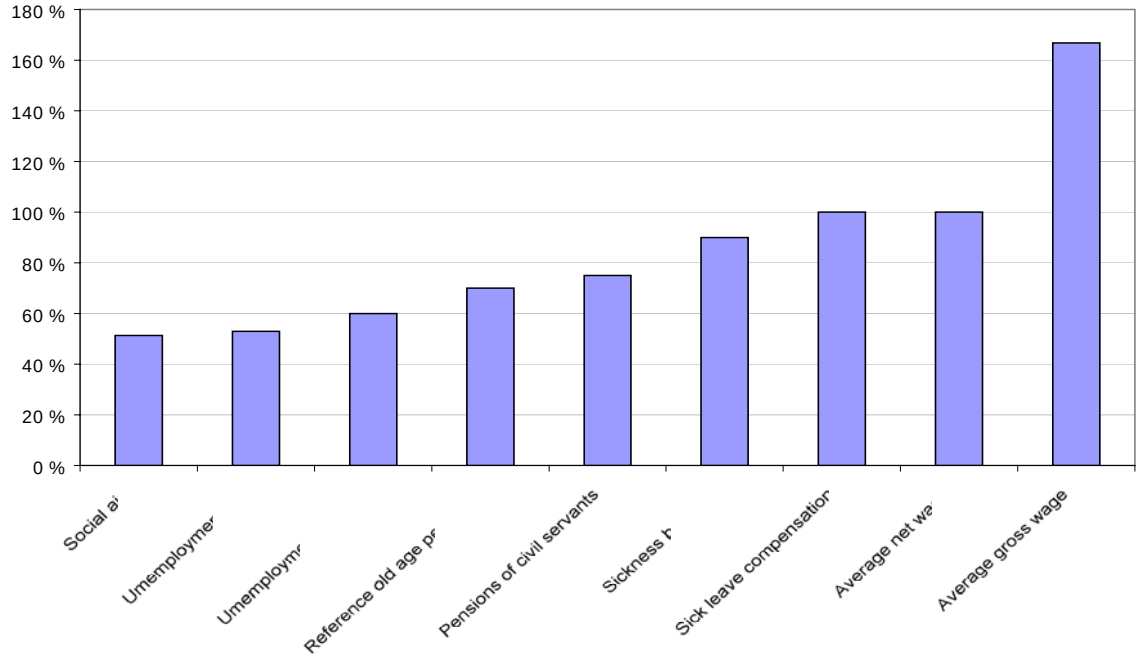
[13] Unemployment aid is paid by the Social Unemployment Insurance; deficits are financed by the Federal budget. As mentioned above, the Social Aid System is overwhelmingly financed at the community level. By reducing the replacement net-wage ratio, the Federal State has produced an increasing number of people whose replacement income has fallen below the social aid minimum. The fiscal burden is then shifted from the Federal level and Unemployment Insurance to Local budgets, thus changing the balance between jurisdictions. Several reform proposals have therefore expressed the demand that the Social Aid System be organized and financed at the Federal level. This would also mean a fundamental change within the fiscal equalization and revenue sharing system.

family members. Within the Social Health Insurance system, dependants in single bread-winner families are insured without having to make any contribution, and they receive the same transfers in kind as do the insured. All pension adjustment schemes are dynamic, but they can be partly gross- or net-wage oriented. If whole life cycles are taken into consideration it is obvious that the replacement ratios and the benefits paid by the public systems greatly favour the publicly employed.

The lack of coordination within the income tax system can be seen in the different treatment of social benefits, as well as in several complex provisions which have been introduced to avoid the result that temporarily paid benefits counteract progression of the income tax schedule. Nevertheless, net-wage orientation and net-wage adjustment for single kinds of benefits impair the progression because benefits (or parts thereof) are burdened with average implicit tax rates which are independent of the actual income situation of the person or family under consideration. If we take, for example, the adjustment of social pensions, then the net adjustment means that an average tax rate of active wage tax payers is used, even though this is often much higher than the correctly estimated average tax rate of the individual pensioner would be. Low income pensioners are especially burdened, as their own total income would fall below the basic exemption of the income tax schedule. Thus we are again confronted with a perverse redistribution measure.

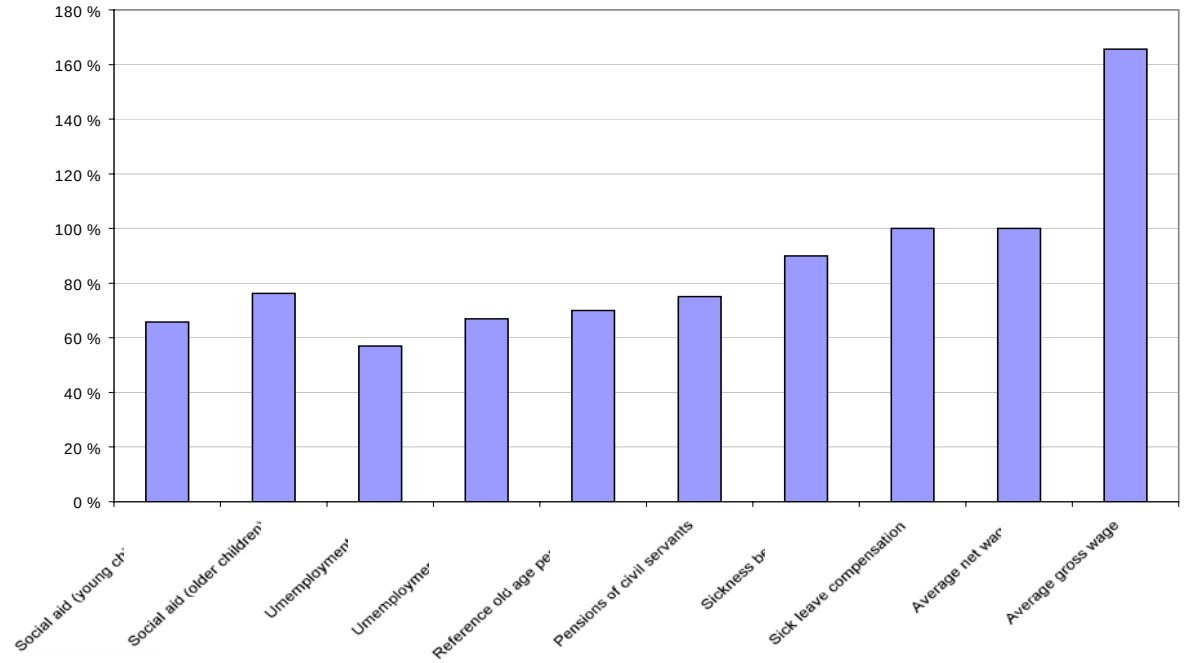
For further elucidation of the problem the replacement ratios for two different types of households are depicted in Figures 7 and 8. Estimates from the German Income and Consumption Survey (EVS 1993) have been used and the net-wage was again set at 100 per cent. In both cases the empirical effect of the regulations can be clearly seen.

Figure 7: ***Comparisons of the Replacement Ratio of Social Benefits – One-Person Household***



While in the first example, the social aid payment is about 50 per cent of the average net-wage, in the four-person household (two income-earners, two children), the social aid depends on the age of the children. The social aid payment for families with two children under 13 years of age (social aid I) is less than for a family where the children are over 13 (social aid II). In the first case the social aid payment reaches about 65 per cent of the average net-wage for that type of household, while in the second it is about 78 per cent.

Figure 8: ***Comparison of the Replacement Ratios of Social Benefits – Four-Person Household with Two Income Earners***



If lower gross-income groups are taken into consideration, it becomes obvious that the gap between active labor income and the social aid is diminishing. This is especially true for families living in large cities with high rent rates, since rent and all extra costs are borne by the Social Aid System. In specific cases, especially for families living in Eastern Germany,[14] social aid payments are higher than the active family income, which naturally creates serious disincentive effects for the work supply. This problem is not only dependent on the amount of social aid apportioned, but also on the fact that even low-income groups are heavily burdened by social security contributions (until 1993 also the case in relation to wage tax). But the so-called difference principle, which requires that there be a considerable gap between wages and social aid payments (about 15 per cent in favour of the employees), is at least partially impaired. Additionally, the combination of social aid payments and income from illicit work is often much more attractive than income from a job in the official labor market. Serious disincentives have been set with respect to transfer fraud.

On the one hand, the net-wage orientation and the lack of coordination are the consequence of different historical developments. On the other hand, in social aid and insurance institutions, political decisions on replacement ratios have to be made. Without any precise explanations, very different replacement ratios have been politically applied. The main purpose was to guarantee average replacement ratios for people of similar social status, a target which was closely linked with the egalitarian principle. In fixing single net-replacement ratios, the cumulative effects of the social insurance system and the supplementary private provision systems have been totally neglected. In addition to supplementary firms' pension systems and the private life insurance system, the latter group includes all the provisional saving and capital formation made for the retirement period.

Most pensioner households have quite substantial sources of income other than the social pension, so it is often less than a minimum provision.[15] Though households constituted by people over the age of 60 represent less than a third of the total number of German households, they account for over two-thirds of the personal and real property. Obviously income is distributed unequally amongst pensioners, and many do in fact fall below social aid standards, but old-age poverty in general is a political myth which has directed all social pipelines in pensioners' favour, thereby exacerbating adverse redistribution effects. The

[14] For more information see Petersen (1997, p. 64).

[15] For details see Petersen (1989, p. 187) and the more recent empirical investigation of the Institut der Deutschen Wirtschaft (1997).

practical social policy still adopts traditional patterns in order to promote the interests of ‘poor’ social pensioners, while the employed workforce is heavily burdened, with reactive disincentive effects.

The political determination of the net replacement ratios has recently come under intense political pressure because of demographic trends in old-age security and cost explosions within the health system. The new coalition abolished the reductions in replacement rates which had been implemented by the old coalition, so Germany once again faces serious public discourse on essentially theoretical fixed replacement ratios which not only impair political popularity but also affect trust in the social security system. These questionable ratios are predominantly theoretical because the effective replacement ratios are determined by the individual procurements of the single pensioner households. Additional private provision schemes might lead to much higher ratios. In particular, pensioner households with higher total income benefit from private insurance and property, as well as from the fact that they are not subject to taxation.

Again, I must mention the perverse re-distributive effects. Because of the structural deficits within the social insurance system, it is often proposed that contributions be linked not only to wages but also to additional income sources (for example, income from rent and leasing), as well as capital income. Obviously such a measure would increase the contribution revenue for the total system, but would also create extra social pension entitlements in the future. Such measures would make no sense, because current burdens are only shifted into the future. It would make no sense that social pensions, which have been accumulated for old-age purposes, be spent on capital income. These measures are also irrational, since they once again would only favour groups who do not need in fact social assistance. Until now, blind political activism has increased the problems surrounding this issue. Politicians have always cured symptoms while causing increased complexity and adverse redistribution – in spite of the fact that they often have had the best political intentions (a common German saying: With best intentions the way to hell is paved). Therefore it is possible – and desirable – that we go back to the roots and develop a more reliable perspective to overcome the current malaise.

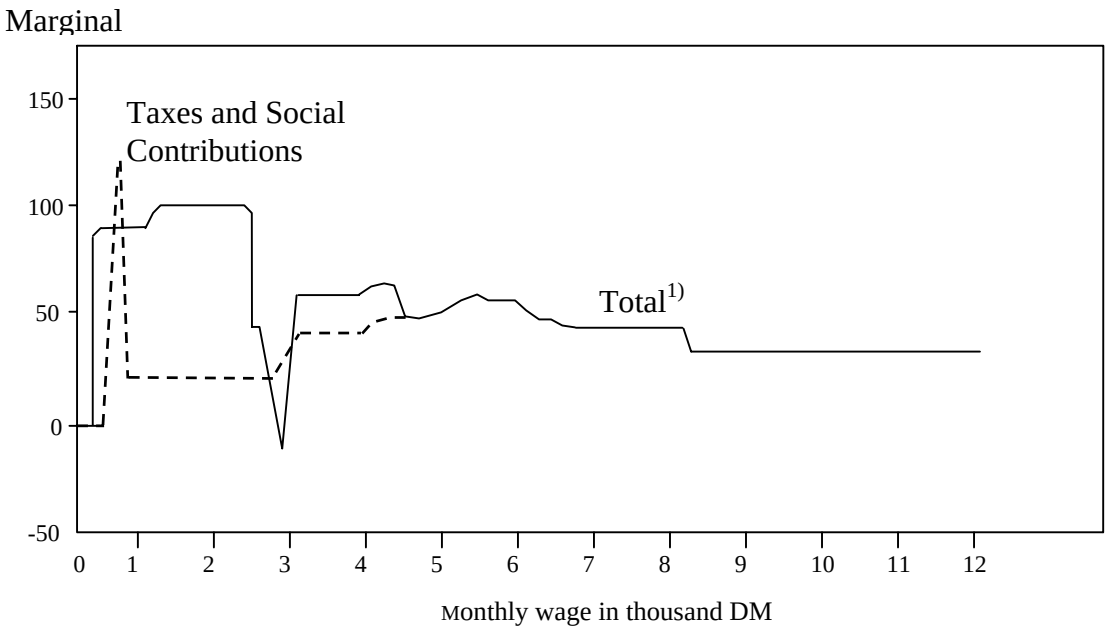
V Integrated System and Basic Security

Only causal therapy would help to overcome the current problems within the German tax and transfer system. One of the main points is that the income bases and brackets within the tax,

transfer and social insurance institutions must be coordinated.[16] The current status quo is expressed in Figure 9. The scope of the marginal tax and transfer rates are determined by the abolition of transfers with increasing market income (from wages and other sources) and the non-coordinated income limits within the tax and transfer system. For families with children receiving educational benefits, even marginal tax transfer rates of above 100 per cent are possible.

Figure 9: *Marginal Tax and Transfer Rates in Germany*

Marginal Tax and Transfer Rates for Spouses - One-Income-Earner, Two Children

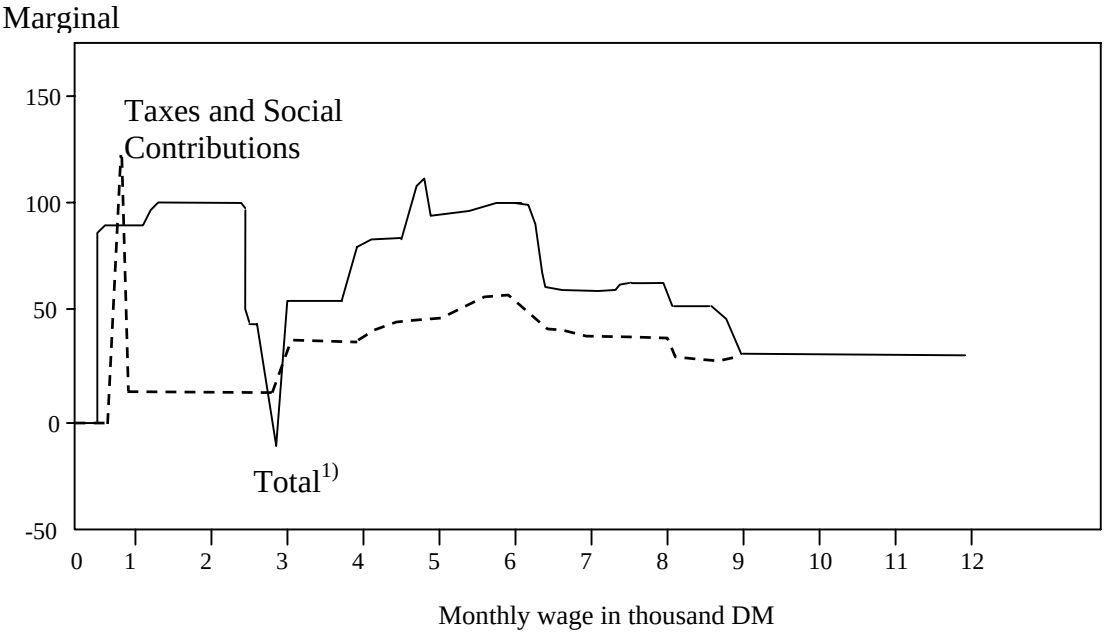


[1)]Income Tax, Solidarity Surcharge, Employee Contributions to Social Insurance and Withdrawal of Income Dependent Social Benefits

[16] The problem of a comprehensive and modern consumption oriented income tax base is addressed by Rose (1999).

Figure 9 continued

Marginal Tax and Transfers Rates for Spouses - One Income Earner, Child-Care Benefit and Education Benefit



[1)]Income Tax, Solidarity Surcharge, Employee Contributions to Social Insurance and Withdrawal of Income Dependent Social Benefits

Source: Institut für Weltwirtschaft (1996, pp. 6 and 9)

If such irrational tax hikes and perverse re-distributive effects are be avoided, fundamental reform steps are necessary. Within both the income tax and Social Aid System, the current *household* principle should be further applied. But within the social insurance institutions, contributions and benefits should be linked to the *individual* principle (including, where relevant, individuals' own contributions for the dependent family members). The current net-wage orientation needs to be substituted by a gross-wage orientation. This would also mean that all benefits would be included into the individual or household income tax base. Then the accumulation of benefits from different sources and entitlements (eg for spouses), together with income from private provision and capital, would be progressively taxed, and thereby reduced. Only then would the total income be adequately treated and the ability-to-pay principle once more realized.

Another important step is the reform of the German Social Aid System. In principle, this system guarantees a basic security standard to every German citizen. It is the social net which people can fall back on in times of need, whatever the cause of that need might be. Coming back to Figure 6, this demonstrates that the social insurance schemes guarantee replacement levels which are clearly above the basic security level. While social aid is paid without any

individual contribution from the general budget and tax revenue, employees have paid a substantial part of their annual or lifetime market income in the form of employees' and employers' contributions towards basic security within the social insurance institutions.

An illustrative example is provided by comparing the social aid payment of an old-age social aid recipient with the net pension payment of an unskilled worker who has worked all of his or her life in a low-wage group. During his/her retirement period the single unskilled worker gets – again depending on the housing costs – nearly the same amount as he/she could have got from the Social Aid System. The only difference is that his/her income was substantially reduced by contributions made to the Social Pension System throughout his active life. The fact remains that the basic security guaranteed by the social insurance institutions is financed by contributions which especially burden the lower income groups. This holds not only true for the replacement income but also for the transfers in kind from Social Health Insurance, which are granted to social aid recipients without any contribution being made.

Hence the notion of a basic security strategy[17] has often been discussed, one which would guarantee that all contributors to social insurance institutions receive the socio-cultural minimum of the Social Aid System. Consequently the component of social insurance expenditures which is needed in order to secure the basic income or care levels should be borne by a grant from the Federal Government, financed by general tax revenue. The task of the social insurance institutions would be reduced to financing the insured amounts above the basic security level via individual contributions.

Obviously such a fundamental reform would mean considerable adaptive measures during the transitional period, and a lot of research still needs to be undertaken to estimate possible aid and benefit levels as well as the costs of the transition and the new system.[18] Since unnecessary redistribution and institutional inefficiency could be avoided, while strengthening the revenue dynamics of the income tax revenue, the overall effect for the Federal budget and the social insurance institutions would very likely be positive. But in the mid-term perspective the reform process could even go further; because basic security would be guaranteed within the Social Aid System, and contributions individually oriented, the social insurance institutions would to a large extent be liberated from the former redistribution task. If the wage-related contributions could then also cover the individual risk

[17] In Germany, like elsewhere in the world, many basic security proposals exist; some of the literature can be found in Petersen, Hüther & Müller (1992) and Petersen (1997).

[18] Some estimates have already been made in Petersen, Hüther & Müller (1992) and in Hüther (1990).

situation,[19] the benefits could be calculated according to the equivalence principle as it is applied in the private insurance system.

Similar to the reform process in the cases of the German Post and Railway, a step-by-step strategy could be developed to put the social insurance institutions into competition with the private insurance system, creating competitive advantages in form of efficiency gains. The existing legal regulations as well as the price control mechanisms within the private insurance sector would, however, need some reconsideration. In addition, the compulsory membership within the social insurance would have to be discussed, as well as the necessity of a compulsory private insurance. In principle, liberal solutions might be better at giving citizens back much of their consumer sovereignty and control over their life-time income. Real competition between the public and private systems is only possible if employees – perhaps under a compulsory insurance membership and sensible income limits – are themselves able to choose their preferred insurance.

Such choice would have to be backed by self-determination of the insurance contract, for example, the choice of the extent of insurance and the replacement income ratio. Such self-determined contracts would give the insured clear information about the costs and the services they receive, thereby further strengthening the equivalence principle and avoiding the disincentives of the current social security contributions. And such individual solutions would even have positive effects politically: While in the current system politicans are pressed to define replacement ratios for benefit and care levels connected with difficult ethical problems, those decisions in such a liberal system would have been made individually by self-responsible behaviour. Political interventions and social policy then would be limited to those in real need, thus even enhancing the conditions for better social assistance.

VI Further Political Patterns

In Germany, the erosion of political influence has been obvious for over a decade; this is especially true of the tax and transfer system. Almost all substantial interventions into the social network can attributed to rulings by the Constitutional Court - further evidence of the lack of concepts or courage on the part of tax and social politicians. Their lack of courage is obviously the result of fears that the bureaucrats and interest groups engaged in the numerous

[19] The adverse selection problem as well as the problem of relative poverty can be solved by an individual subsidization of people with bad risk structures or those in need; for details see Petersen (1989) and Petersen & Müller (1999).

welfare institutions might strike back by disinforming the public, thus diminishing politicians' popularity and causing them to lose votes.

But there is another reason why such political behaviour is rational. Assuming the politicians to be the most important group in society, then the success of a politician today is dependent on society's prevailing image of them. Politicians' popularity depends mainly on whether they maximize their interventions into public or - even worse - private sector activities. Even if politicians were to be fully aware of the shortcomings of their personal resorts - an assumption which is, in view of those currently involved in this arena, slightly too optimistic - no rational incentives exist to abolish the failures of the system by means of a fundamental reform. To the contrary, such behaviour would be a serious mistake. On the one hand, politicians have to intervene into people's personal affairs, which impairs their popularity. On the other hand, fundamental reform would mean that politicians would have to diminish the scope of their very *raison d' être* – that is, the necessity for permanent interventions. From the politicians' point of view, it is rational to remedy the symptoms rather than the causes: this strategy is in accordance with the moral hazard theory.[20] Their alleged preference for market solutions is merely lip-service.

Instead of a fundamentally market-oriented reform, temporarily effective measures to decrease the costs of the social security system are much more promising. These will only work until all involved parties have adapted their behaviour to the new regulations. If these reforms were coordinated with the reelection cycle, the short-term effects would be calculatedly realized to increase personal popularity. The cost explosion that would follow several months later would not terrify experienced politicians, as they could demonstrate their importance and renew their popularity in interviews and TV talk shows, etc. If such political behaviour cannot be traced back to a lack of information, ignorance, indolence or simply stupidity – none of which are very attractive attributes for a politician - it must follow a certain system. And that can be seen in the fact that the politicians are able to exploit systemic failures for their own interests. Every fundamental reform would block their opportunity to cast themselves in a positive political light. Therefore, because of political self-interests,[21] efficient and frictionless tax and transfer systems are politically counterproductive. To sum up: we are surrounded by political moral hazard.

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[20] See Petersen (1996a) and Petersen & Müller (1999).

[21] Note the discussions on formula flexibility instead of discretionary interventionism in connection with business cycle policy some decades ago, ending in the latter's favour.

The basic security and integrated tax and transfer approach is in accordance with a revival of *Ordnungspolitik* - namely a reformulation of institutional settings to obtain a reduction in the discretionary interventions via a strategy of de-politicisation. Improving the institutional framework also includes strengthening responsible authorities' ethical behaviour. Institutional ethics have a higher degree of universal acceptance than individual ethics; therefore politicians and bureaucrats, acting in social institutions, should have greater societal obligations than private individuals. Corruption and scandals point to the fact that these obligations can be stressful. The consequence of these cases of moral turpitude can only be immediate re-privatisation.

Is the time right for such de-politicisation strategies? This is a general question of feasibility. Politicians are gradually facing the fact that during the last decades they took over too many duties formerly performed autonomously by families or market participants. Because of increases in the information that politicians must digest and a growing discontent and annoyance on the part of citizens, politicians are increasingly unable to solve complex societal problems. The arrogance of knowledge (Hayek) of what is good for the people or what is allegedly unnecessary, the merit and demerit argument, is recognized by well-educated citizens who acknowledge the limited abilities of political planning procedures. Any remnants of euphoria should have been destroyed by the fundamental political change of recent years, but interventionists among the politicians continue to dominate. Some politicians have, however, become aware that they would like to be able to rid themselves of the ghosts they have called into existence. International discussion on privatization and improving the efficiency of a reduced public sector is but one piece of evidence. The standard role of a successful politician should be changed from one of interventionism to one of causal treatment of imperfect contemporary institutions and instruments. Permanent and overwhelmingly blind activism is no attribute or political proof of the quality of democratic leaders.

VII Summary

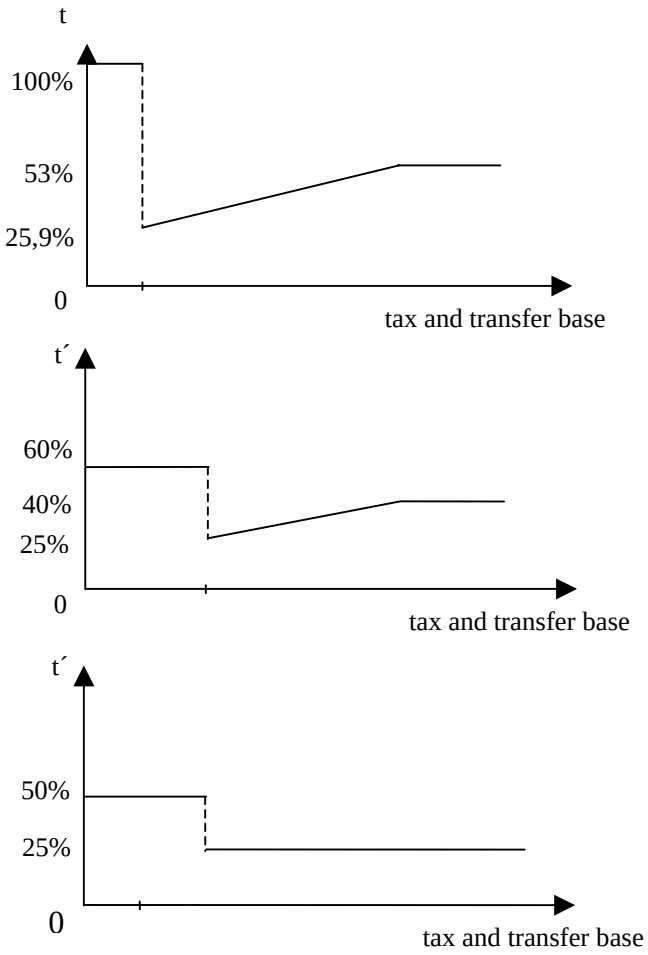
A change in political perspectives and behavioural patterns would allow substantial fundamental reforms to overcome current and future malaise. Under a broader and unique tax and transfer base Figure 10 demonstrates in stylized form the direction that further developments could take; the marginal tax and transfer rates for 1996 were given above. By successively broadening the current tax base and integrating all those transfers which are

necessary to avoid abrupt changes, especially for social aid recipients, and to give all citizens some time for self-responsible behavioural adaptations, a clear decrease in the marginal transfer reduction rate as well as in the maximum marginal tax rate is possible. In the long term, even the introduction of a flat rate seems possible, thus avoiding all the disadvantages and disincentives which are now connected with direct progression (without having any clear impact on the net-income distribution). The progressive marginal income tax schedule mainly serves to feed the sentiment of social envy, which is then misused by politicians for campaign purposes. The re-distributive power of this instrument is negligible, as many empirical studies have shown.[22] Due to the numerous concessions and loopholes, it is not the 'rich', but the lower and middle income classes who are hit by the income tax progression. The erosion of the tax base has impaired what is often referred to as 'the truth of the tax schedule'. Thus reliance upon a progressive marginal rate structure - the falsehood and deceit of the progression - has become a key element in political dishonesty.

Are the lower two illustrations in Figure 10 real world options or simply utopian ones? The question is hard to answer. But one might gain insight from directing one's view away from Germany (and some other European states) towards the East or Far-East; these are new, flexible, and dynamic societies which are not burdened by the elements of an inefficient welfare state - namely egalitarianism and constructivism – which have entered and will enter the world stage. Old Europe not only has to compete with this countries on the world market, but they may also be the home of choice for the capital and the rich themselves. If illusions that a welfare state can be financed by taxing the rich were to continue to work, prospects for the future would be gloomy. The competition from the low-wage countries will force the old welfare states into a reduction cure. By means of the abolition of redistribution from one pocket to another, enough reserves exist for a substantial reduction of the ancillary wage costs. If all citizens were to realize that transfers have to be financed and do not fall from heaven like manna, current entitlement behaviour could be overcome. If one promotes the basic goals of the justice of need and the necessity for a certain personal redistribution, it is a question of honesty not only in order to close the poverty gap but also to keep the burden on the taxpayers in mind - which also determines international competitiveness. From this point of view and in a mid-term perspective, the integrated tax and transfer concept is one of the last resorts.

[22] See, eg Petersen (1988).

Figure 10: *Current and Possible Marginal Rate Development*



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