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Higher Income Tax in Germany May Bring Relief for Europe

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In Germany, the first obstacle to the formation of a new Grand Coalition will likely be the demand by the Social Democrats (SPD) to raise income taxes on top earners. Although such a tax has been rejected by the Christian Democrats (CDU), the SPD has a chance to enforce its agenda, and the consequences of a high-tax Germany would reach beyond the domestic market. Europe might enjoy increased demand from Germany, and possibly lower imbalances in the eurozone, but would also be more likely to hear an even harder "nein" to transfers.

The achievement of a near parliamentary majority by the Christian Democrats (CDU), in the September elections has its price, and any new coalition with the Social Democrats (SPD) or the Greens will be fraught with difficulties. In contrast to the outgoing liberals (FDP), who generally share the views of the CDU on economic issues, Chancellor Angela Merkel now faces parties from a different ideological milieu. Moreover, the SPD and Greens can keep some options open, such as the as-yet unthinkable majority with the post-communists (die Linke). Knowing that, SPD leaders have entered into the negotiations on a Grand Coalition without the usual deference of a junior partner, but rather with a list of demands.

Quite high on the SPD's list is the question of Germany's income tax, and specifically the currently marginal rate on the richest citizens in Germany. The Christian Democrats declared during the election campaign that income tax rates would remain unchanged, or, more accurately, that their proposals would actually entail tax relief—they wanted to adjust the nominal levels to match current rates of inflation, thus to avoid so called cold progression. The SPD (and also the Greens) do not speak about tax relief and instead want to see a rise on income taxes on the rich: if today's top earners pay 42% on incomes over €52,882 and 45% for the bracket over €250,731, in the future they would have to accept up to 49% on incomes over €100,000.

A Likely Scenario: Germany with a Higher Income Tax. It is unclear why this topic has become so central to the SPD's demands in the coalition negotiations, though it must presume Germany has particularly low tax burdens on the rich compared to other countries and an acute need to increase revenues to the government budget. However, OECD data on marginal income tax rates indicate that it is hard to call Germany a low-tax case. The *Bundesrepublik* fits into the eurozone's mainstream, with marginal rates between 40% and 50%, and alongside countries such as Austria, Belgium, France and Italy. Indeed, a more general and appropriate indicator to measure tax burdens—the so called tax wedge—confirms this view (in 2012 Germany was 51.2%, Italy had 52.97%, and France was 54.04% on incomes at 167% of average earnings).

Significantly, though, in recent years Germany has reduced its tax wedge for the rich by around 5%, becoming a leader in "tax relief" policy at a time when other social groups were left with an almost unchanged tax rate. The consequence, theoretically, is that the Gini coefficient, an indicator showing income inequality, should rise. But surprising for many and despite public grumbling, Germany has been able to keep the indicator unchanged since the beginning of the crisis. The issue of the public budget is not unambiguous either. Indeed, Germany has a huge general government debt of 81.9% of GDP. And yet, the fact remains that Germany has a budgetary surplus and has reduced its public debt by €34 billion in the first half of 2013.

So why would it need higher taxes? The SPD-leaders say that additional revenues are necessary to boost neglected investments in infrastructure and education. There is a lot of money to collect—and to spend. Total tax revenues—around €600 billion in 2012—consist to a significant degree of wage and income taxes (€186.3 billion that year). Assuming that Germany's rich usually contribute at least half of the revenues, even a slight increase in the tax rate could bring quite a large amount of revenue into the budget. Still, it is hard to exclude sheer political calculation. The segment of earners most worried by the proposed 49% tax is relatively small (1.3 million taxpayers) and hardly amongst the SPD's core constituents. By contrast, the majority of potential beneficiaries—the lower and lower-middle classes—clearly sit on SPD terrain. But what drives the SPD even more than this basic calculus is an ambitious plan to reorient German economic policy and to differentiate themselves from the CDU. As opposed to the dominant neo-liberal agenda of the CDU and Merkel's approach of austerity and private initiative, not to mention the SPD's own difficult heritage of "Agenda 2010," today's Social Democrats want to put the "state is back" argument at the centre of public debate.

Thanks to this mix of technical argument and political positioning, the tax-rise option still has a chance in Germany. Even such luminaries of the CDU as Finance Minister Wolfgang Schaeuble show some openness to the idea. Meanwhile, some German economists have exempted their usual reservations towards higher taxes in this case. According to them, the safe space for an increase in marginal rates (i.e., which does not provoke a negative reaction from taxpayers) reaches to 50%. Fears that the rich, facing higher taxes, would immediately go on "strike" by earning less or transferring their income abroad could therefore be unfounded.

Implications for Europe and Poland. If the new government pursues this course, the potential effects for Germany's European neighbours would be significant. Higher taxes in Germany would be bundled into a package of more aggressive government spending, and the effects of this combination would quickly jump across the country's borders. At least three of these effects deserve special attention—first and most notably, the increase in German domestic demand. Any increase in this would interest companies from other EU countries in exporting more to Germany, while German companies may be able to sell more on their local markets. For Poland, a boost in German demand could be a blessing. One fourth of Poland's exports goes to its Western neighbour, so an increase in orders could help it return to a faster growth path. On a macroeconomic level, moreover, the huge imbalances in the eurozone would diminish, possibly heralding a true end to the euro crisis.

Second, Germany can exploit such a tax-spending package as a "favour to Europe" and a means to rebuff criticism of its economic policy. Just at the beginning of October 2013, Janusz Lewandowski, the EU Commissioner, demanded repeatedly that Germany express "more reliability" in reducing imbalances in Europe, meaning of course higher spending to boost the European economy. Such arguments, as well as debates about Eurobonds and further transfers to crisis-ridden economies, would carry less weight with a German government that can point to a higher-taxes-and-spending package as proof of its European commitment. For Poland, this debate has no direct implication, as it is not in the eurozone. However, if the notion of Germany as a "demand locomotive" heralds the creation of a joint business-cycle budget within the eurozone, Poland may be at a disadvantage given its lack of direct involvement in the discussions. The creation of this budget would add to the rules and patterns established by the Euro-18 before Poland were to introduce the currency.

Third, higher income taxes on top earners in Germany would allow it to argue even more harshly against countries that attract foreigners with lower income taxes. The fight against tax evasion, evidenced by circulating datasets with names of tax "sinners," the scandal of Uli Hoeness, the Bayern Munich president, and the failed tax agreement with Switzerland, could move to the centre of Germany's European agenda. It is not just Cyprus, Switzerland or Lichtenstein that should take note. German talk about "tax evasion" may shift into "tax harmonisation." This could happen when the current boom ends and a slowdown becomes visible in German growth statistics. Poland cannot ignore this point. Its tax wedge on the rich at 36.16% is staunchly lower than in Germany, which makes Poland a candidate for pressure to raise revenues from a higher income tax. Such an adjustment in a country with an emerging market status and a thin, but very mobile class of top-earners, could be risky.