



## Japan Local Government Centre, London

### Monthly Report August 2010 (Germany) – German cities defend trade tax

The trade tax ('Gewerbesteuer') is the most important direct tax for local authorities in Germany. Although the largest share of funding comes through the shared taxes (mainly income tax, both personal and corporate) which are distributed according to a set formula between the federal level, the states and local authorities, trade tax is levied by local authorities directly on the earnings of businesses. They set the collection rate, which means that there are differences between localities. Usually the tax rate is higher in urban than in rural areas, and since 2004, every municipality is obliged to levy it at least at a minimum level.

However trade tax has repeatedly been the focus of attempts to reform the local finance system, and now under the Commission on Local Finance (Gemeindefinanzkommission) which is due to report in autumn, models outlining its replacement with a local income tax are being discussed.

The German Association of Cities has now published a defence of the trade tax, which it regards as a principally sound model that is worth keeping, with possibly a few modifications.

Compared to other taxes, the trade tax is only marginally more volatile in the long run because of its link to the economic cycle, but has a stronger dynamic. Between 1995 and 2008, the combined trade tax takings of all municipalities nearly doubled from 21.6bn to 41bn Euros. In comparison, the income from other taxes linked to income and profits, including the corporate income tax, only increased by roughly 25%. Added to this is the fact that the corporate income tax decreased even more than takings from trade tax.

Against this background, the chief executive of the German Association of Cities said: 'Despite the fact that trade tax takings nosedived in 2009 due to the world economic crisis and that it is a tax dependent on the economic cycle, the trade tax is fundamentally a sound tax which should not be abolished, but rather strengthened. If the trade tax had been replaced by a higher local authority share in VAT some time earlier, since the mid 1990s this would have meant considerably lower rates of increase in tax revenue, with only slightly reduced volatility. Therefore, replacing trade tax through a greater local share in VAT would mean only slight gains but rather large losses on the other hand. Furthermore, municipalities would become even more dependent on transfers from federal and *Land* governments, instead of deciding themselves on the level of trade tax. This goes against the concept of local self-government as it is understood in Germany.'

*Any opinions expressed in this report are solely those of the author and do not necessarily represent those of JLGC or CLAIR.*

The arguments against the model that is currently on the table at the Commission on Local Finance are as follows:

- Because restraints on businesses will be removed, schemes to minimise tax liabilities may increase, and all levels of government may end up with reduced tax revenues.
- The proposed model puts financially weak municipalities at a disadvantage.
- At local level, the financial burden is shifted from business and industry towards the citizen.
- In those municipalities which had levied relatively high rates of trade tax, a shift towards income tax would mean a proportionally higher burden on citizens than before any reform.
- The current direct link between business and industry on one hand and the municipality on the other will be broken. Municipalities would lose the incentive to attract and keep businesses, as concentrating on new housing areas would become much more of a fiscal motivation.

Another argument that is often used by business people against trade tax is that it is an international anomaly, and that no other country uses this kind of tax. This is not true – although the exact same method may not be used elsewhere, there are enough examples where municipalities tax businesses based on their economic power, for example there is a tax on employees' pay in Denmark, France has a trade tax which also includes the skilled free professions such as lawyers and architects which are so far exempt in Germany, and the US and Canada also have similar systems.

It remains to be seen if these arguments will hold sway with the members of the Commission when they set down their recommendations. After all, it is the federal and the *Land* governments which hold the balance of power in the commission.

*Any opinions expressed in this report are solely those of the author and do not necessarily represent those of JLGc or CLAIR.*