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By PwC Deutschland | 04 November 2022

Adaptation of the Inflation Compensation Bill

On 2 November 2022, the Federal Cabinet adopted the 5th Tax Progression Report and the 14th Subsistence Minimum Report. The Inflation Compensation Bill, which was introduced on 14 September 2022, is now to be adapted during further parliamentary procedures. It is to take effect on 1 January 2023

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The aim of the Inflation Compensation Bill is to prevent additional burdens for citizens by compensating for the effects of the so-called cold progression. In this way, wage increases to compensate for inflation should actually benefit taxpayers, and additional burdens should be avoided.

What is cold progression?

People with high incomes pay a higher average tax rate in the progressive tax system than people with low incomes. In times of rising prices and wages, this causes problems: if wages increase only to compensate for inflation, then people have more money in their pockets but cannot afford more. Although increased wages are not associated with higher purchasing power, taxpayers pay higher taxes due to the "progression" – i.e. change in tariff bands. This would be tantamount to a creeping tax increase through which the state takes more money in times of rising prices and wages. The Inflation Adjustment Act was drafted to prevent this.

How will it work?

In concrete terms, this means that the basic tax-free allowance, the tariff bands, the maximum amount for maintenance payments as well as the child benefit and the child tax-free allowance will be increased.

In the draft of the Inflation Compensation Bill of 14 September 2022, the planned adjustment of the tariff progression was still based on the data of the spring projection of the Federal Government available at that time. It was already foreseeable at that time that the inflation forecast contained therein would lag behind the actual price development. For this reason, it was evident to the Federal Government at that time, that any necessary adjustments for inflation would have to be made during parliamentary procedures. The adjustment can now be quantified.

Reports as a basis for inflation adjustment

The tax progression report quantifies the amount of cold progression.

The Subsistence Minimum Report determines the amount of the tax-free subsistence minimum for adults and children.

The projections of the two reports confirm expectations that the adjustments to the tax-free allowances and the income tax rate previously provided for in the Inflation Compensation Bill would not be sufficient to compensate for the price increases. The target for the price development of private household consumption expenditure for 2022 is now 7.2% and for 2023 6.3%.

Based on the reports, the following changes to the Inflation Compensation Bill have become necessary:

- The income tax rates for 2023 and 2024 will be adjusted and the effects of cold progression will be compensated for through adjustment of the income tax tariff bands.
- The basic tax-free allowance is to be increased by 561 EUR to 10,908 EUR from 2023 and by a

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further 696 EUR to 11,604 EUR from 2024.

- The child allowance (including the allowance for care, education and training needs) is to be increased by 404 EUR to 8,952 EUR from 2023 and by a further 360 EUR to 9,312 EUR from 2024.
- The top tax rate band is to be raised from the current 58,597 EUR to 62,827 EUR in 2023, and for 2024 it is to be levied from an annual income of 66,779 EUR.

Source:
Federal Ministry of Finance press release on 2 November 2022

Keywords

Income Tax Act, child benefit, income tax exemption