Economic Analysis: German Unemployment Drives Tax Reform

Author: Sullivan, Martin A., Tax Analysts

After you reluctantly return from summer vacation, your wandering eyes are likely to fall on headlines about the coming German election, scheduled for September 18. It will be worthwhile to give the matter some attention. The leadership of the world's third largest economy is up for grabs, and the overwhelming favorite to be the next chancellor is conservative challenger Angela Merkel, a physicist from the formerly communist East who is the leader of the Christian Democratic Union (CDU). Her election would mark the end of seven years of rule by the left-of-center coalition headed by Chancellor Gerhard Schroeder, leader of the Democratic Socialist Party (SPD). On May 22, after his party suffered crushing defeats in regional votes, a frustrated Schroeder called for a national election a year ahead of schedule.

You are likely to be told that <147>Angie<148> is Germany's <147>Maggie.<148> Like British Prime Minister Margaret Thatcher a quarter century earlier, Merkel would be her country's first female elected leader. And like Thatcher's, Merkel's political philosophy is market-oriented conservatism. You are also likely to come across commentary from conservatives suggesting that Merkel's election would be another nail in the coffin of the European-style social welfare state.

There is no use in liberals trying to deny that. Like it or not, globalization is opening the floodgates of competition, and around the globe it is washing away all sorts of inefficient economic structures. Germany has more than its share of those. With its high taxes, overly protective labor laws, and bloated welfare, retirement, and healthcare systems, Europe's largest country provides the prime example of what happens to an economy that inadequately responds to the challenge of mounting international competition: soaring unemployment and flagging income growth (as shown in figures 1 and 2).

Left Moves Right

It isn't as if Schroeder has not been trying to restore the German economy. He and his cabinet have adopted a wide range of economic reforms. First elected chancellor in October 1998, blocking Helmut Kohl's return for a fifth term, Schroeder quickly showed he had come a long way from his days as chairman of Germany's Young Socialists two decades earlier. In the intraparty battle between leftists and reformers, Schroeder sided with reformers and provoked the resignation of liberal Finance Minister Oskar Lafontaine. To replace Lafontaine, Schroeder appointed the more centrist and pragmatic Hans Eichel. Together Schroeder and Eichel, drawing on all their experience as backroom politicians and assisted by a windfall of $46 billion from the auction of wireless network rights, won parliamentary approval of major tax reform legislation, despite CDU control of the Bundesrat, Germany's upper house.

The Tax Reduction Act of 2000 was widely hailed as a fundamental reform of the German tax system that would make business more competitive. Because Finance Minister Eichel was able to engineer passage of the landmark legislation, <I>Time Europe</I> dubbed him the <147>architect of reform<148> and <147>super Hans.<148>

The new law included a phased-in reduction of the top individual income tax rate from 51 percent to 42 percent and an immediate reduction of the corporate tax rate from 40 percent on retained profits and 30 percent on dividends to a uniform rate of 25 percent. (Because of significant state and local <147>trade<148> taxes, the average total corporate tax rate after the cut is closer to 39 percent.)

Still, despite those and other reforms, unemployment not only did not decline, it increased. Schroeder's coalition should have been voted out of power in September 2002. But the media-savvy Schroeder was able to squeak out a narrow victory over the grandfatherly opposition candidate, Edmund Stoiber, because of two extraordinary events. In 1999 the <147>flood of the century<148> inundated Bavaria. Because of his able handling of the crisis, Schroeder won widespread approval. And in 2002 with Schroeder still trailing in the polls, his opposition to U.S. military intervention in Iraq gave his popularity an added, unexpected boost as the United States stepped up its preparations for war.

In March 2003 Schroeder launched <147>Agenda 2010,<148> a new plan to reduce unemployment and to help the ailing economy. The plan included reductions in healthcare benefits, the restructuring of labor regulations, an overhaul of the pension system, and an acceleration of tax cuts enacted in 2000. In March of this year, Schroeder proposed a further cut in the corporate tax rate -- from 25 percent to 19 percent. That last proposal has been introduced in the legislature, but it has been put on ice since German President Horst Koehler granted on July 22 the necessary approval for an early national election.

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Right-Left Convergence?

On July 11 Merkel released her party’s policy agenda, entitled <147>Seizing Germany’s Opportunities: Growth. Jobs. Certainty.<148> Here’s an excerpt (translated) from the three pages discussing tax policy:

> Businesses badly need an internationally competitive system of taxation so that they can invest and increase employment in Germany. . . . At this point there is no room for a net easing of the burden in view of the fact that a crisis exists in the public budget. . . . The reform of corporate tax law will be done in a measured and budget neutral fashion. . . . The measures are completely financed by the dismantling of tax subsidies. . . . Regarding the budgetary counter-measures, closing the tax loopholes is a priority. As a further step to a comprehensive corporate tax reform, we lower the corporate tax rate to 22%.

Compare that with the position taken by Finance Minister Eichel in an April 2005 speech in Berlin:

> We can and we will send a signal to promote investment and growth by cutting the corporation tax rate from the current figure of 25% to 19%. This will make us more competitive, especially as compared with other major EU countries. . . . As there is no room for tax giveaways in public budgets, we will have to offset the rate cut by broadening the tax base. This is the only way that we can finance all the necessary measures without taking on new debt. Specifically, I am thinking in terms of restricting tax shelters and modifying the minimum taxation of profits.

To a newcomer to German politics, it is striking how similar the CDU tax proposals are to those of the SPD. Both of Germany’s leading parties want to lower corporate tax rates and widen the base.

More generally, the fiscal policies of the two parties are similarly constrained by two often contradictory guiding principles: the need to keep the tax system competitive under increasingly tough international standards and the need to reduce government budget deficits. Their common solution is not to reduce the total tax burden but to restructure it.

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The cuts in corporate and individual tax rates that began in 2000 have been accompanied by many offsetting revenue increases, including tighter restrictions on the deductibility of interest payments for highly leveraged corporations, longer asset lives for calculating depreciation deductions, greater restrictions on loss carryforwards, and new statutorily required documentation of transfer pricing methods.

In the current campaign, Merkel's proposed reduction in the top individual income tax rate to 39 percent is more generous than Schroeder's 42 percent regular income tax rate and a new proposed surtax on the very rich. But to finance a reduction in social security contributions, Germany's conservative leader is also proposing an increase in the rate of value added tax by 2 percentage points, from 16 percent to 18 percent. And regarding other specific tax increases, Merkel has announced her plan for the restoration of capital gains taxes on sales of shares by corporations, a switch from accelerated to straight-line depreciation, and a reduction in tax breaks for commuters and for workers working night shifts and holidays.

Differences From the U.S.

Although German business leaders have been appreciative of Schroeder's efforts to reform the economy, they are welcoming early elections and supporting Merkel. It has not escaped their attention, however, that Merkel's pro-competition tax reductions are being financed with loophole-closing tax increases and not spending reductions. Their endorsements of Merkel are tempered by expressions of disappointment that her reforms do not go far enough. German business leaders share the <I>vision</I> of U.S. conservatives that tax cuts should be financed by cuts in government spending.

Would they be so sanguine about the <I>reality</I> of tax cuts financed with increases in government deficits? Probably not. Germans are known for their thrift. While in the United States there are four credit cards for every person, there is one credit card for every four persons in Germany. In general, Germans seem much more worried about their government's mounting debt than Americans are about theirs, even though German government bonds are AAA-rated and, as a percentage of GDP, the level of German government debt is practically the same as that of the United States.

Perhaps the CDU should be criticized for lacking the conservative resolve to make necessary cuts in social programs. Or perhaps its leaders should be congratulated for their honesty in acknowledging that those spending cuts are not politically feasible at this time. Whatever your view, the combination of international pressure on tax rates and a national aversion to debt has put base-broadening tax reform on the front burner in Germany. In the United States, where international pressures are not as great and the mounting national debt does not seem to stir voters, politicians can avoid the pain of any serious elimination of tax giveaways merely by promising future spending cuts.