Editorial

Dr. Bernhard Seidel,
head of the "Public Finance" department, asks:

"Is Germany's tax reform destined to fail because of party-political bickering?"

The political debate in Germany on a major reform of the taxation system seems to have become completely bogged down. The leading political parties have met, attracting great media attention, with the purported aim of finding common ground with regard to a reform of income tax and corporation tax. Yet one increasingly gains the impression that the debate is not actually about the issues, but rather – with a view to next year's federal election – about party-political profiling, for which any agreement, which inevitably involves compromise, is a very mixed blessing.

The background to all this is that during the past two decades Europe – and other countries – have entered a "race" to cut taxes in which each individual country has sought to gain advantages over its trading partners from lower taxes. Yet tax differentials have largely remained, as other countries followed suit. In Germany, too, the rates of income tax on business income and the rates of corporation tax were cut in recent years. However, not least the heavy cost of German unification has only permitted the tax burden to be reduced in small steps.

The federal government's proposal for a tax reform presented at the start of this year envisages sharp cuts in tax rates. From 1999 onwards the top rate of tax is to be 39% (instead of 53%), and corporation tax on retained profits 35% (currently 45%). The government puts the revenue losses associated with the cuts at DM 80 billion. To a large extent this loss is to be made good by means of measures to broaden the tax base. Pensions and unemployment benefits, bonuses for working bank holidays and night work are to be made subject to tax, tax allowances for depreciation reduced, tax deductions for employees' income-related expenses cut and the tax-free allowances for capital yields halved. If the planned increases in indirect taxation are added to this, a net reduction in the tax burden of DM 30 billion remains. Opposition criticism relates not to the principle of a substantial cut in taxes, but to the composition of the measures which, it is argued, one-sidedly eases the burden on business and higher-income groups. Doubts have also been raised as to whether the announced package can really achieve a breakthrough for higher growth and employment, as it does too little to bolster mass purchasing power.

The proposal is, indeed, problematic in terms of economic growth, income distribution and the internal logic of the taxation system: appropriate corrections need to be made. Yet this does not mean that the entire package should be torpedoed. The expectations of firms and private households are now tied to tax cuts to such an extent that a failure of the reforms would be counter-productive for economic recovery. This cannot be in the interest even of the opposition. A very different question, on the other hand, is to what extent a country such as Germany can bring about a sustained improvement in its position in the "race" to cut taxes. Unfortunately tax reform in Germany might well induce other countries to embark on a new round of tax cuts. For this reason there is a need to give greater consideration to a harmonisation of direct taxes in the run-up to European Monetary Union.