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The Red-Green Government Lowers Income Taxes (July 15, 2000)

A journalist discusses the complicated parliamentary maneuvering that Chancellor Schröder employed to pass an income tax cut. He also discusses some of the problems involved in lowering the corporate tax rate more than the individual income tax rate. In the end, he praises the measures as a sign that the reform deadlock has been lifted.

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### **The Inevitable Reform**

The way the chancellor got a Bundesrat majority for his finance minister's tax reform might be called spectacular. But in the end, his haggling, pleading, and threatening probably got him nothing more than a calm summer break. After the break, the reform would have gotten an "aye" in the states' chamber [*Länderkammer*] anyway, based on what we now know. It is extremely unlikely that the reform would have failed after renewed proceedings in the fall. [Hans] Eichel's law, if you will, has long since become an inevitable reform. Inevitable, because most experts think it is moving in the right direction, even those who are close to the Union [CDU/CSU]; inevitable, because with a consistent "nay" the CDU and CSU would have been going against virtually the entire German economy; inevitable, because the consequences of an obstruction strategy would have been incalculable for the federal states; and inevitable, finally, because failure was threatening to damage the image of the entire country.

### **Good and Bad Income**

The reform even benefited a little from last-minute negotiations between the federal and state governments. The maximum tax rate for income tax is supposed to drop another percent; owners of older small- and medium-sized businesses only have to pay half the tax rate if they want to sell their businesses. Previously, there was a regulation to this effect. It was abolished just last year as part of the austerity policy, but now it is back in the law. Together, both of these cuts are ultimately supposed to relieve taxpayers of another eight billion marks.

Mind you, all the proceedings and direct efforts to find a compromise between the federal and state governments have not turned the tax reform into a good law. From the standpoint of the tax system, in fact, it is even downright bad. A central flaw has run through the entire project since its genesis, a flaw that only a totally new law could have eliminated. The problem is that

an individual entrepreneur's income is treated differently than a company's income. The latter is advantaged, the former disadvantaged. There are a lot of explanations for this situation; in the beginning, it seems there was a theory – utterly false in its sweepingness – that money that stays in companies will be invested, whereas dividends will be used to fund consumption by the wealthy. This false theory led to disturbing results: the rate for corporate taxes, which are paid only by joint-stock corporations, was lowered much more (to 25 percent) than the maximum individual income tax rate (to 42 percent). But because tradesmen and family businesses pay income tax, but not corporate tax, a complex set of regulations was necessary to prevent small- and medium-sized businesses from suffering major disadvantages – a goal that was not really reached in the end. This is apparent, for example, in the fact that the German Confederation of Skilled Crafts was the only industrial association to openly oppose the reform. The tax reform also favors large businesses in another way: starting next year, company shares can be sold tax free. This regulation makes it extremely economical for German banks and insurance companies, for example, to restructure themselves for intensified international competition. That is far more than the economy would have even dared to ask for a year ago, much less hoped to attain. The Allianz insurance company rose a proud six percent on the stock exchange on Friday. In the finance minister's view, there is an advantage in putting individuals and partnerships at a disadvantage as compared with large corporations: it makes it possible to pay for the spectacular lowering of the corporate tax in the first place. But this is what tips the balance when it comes to foreign investors. Nominally low tax rates provide the strongest argument in the competition for business locations – to the extent that tax arguments are even used in the discussion. Thus, the reform is a clear-cut plus for Germany in terms of attracting jobs at home within the scope of a globalized economy. In addition to very big businesses, very small ones are also among the winners of the tax reform. The income tax rates will result in clear (and in this case, justified) relief, especially for low-wage earners. People in the middle, however, will be worse off: skilled professionals with high incomes will be hard hit by the tax rate progression. The highest rate already applies for an annual income of 98,000 marks. This disproportionate attack on the income of the "New Center" is the price that Eichel will have to pay for the distinction he wanted between good and bad income. No doubt, as regards systematics, the CSU's counterproposal for a tax reform would have been more elegant, and it would have offered more convincing relief. But it was a proposal from the opposition and, as such, was unrealistically expensive. The state finance ministers, including those from the Union, would have never allowed it to go through. Incidentally, during the last legislative period the Union exceeded its allowable tax deficit: Theo Waigel, then finance minister and CSU head, tackled the subject of tax reform far too late and dismissed smart proposals because he feared they would lead to unpopular reductions in tax relief benefits. The chancellor let the subject slide and then ran into the blockade that the SPD had understandably set up shortly before the Bundestag elections.

### **End of Reform Deadlock**

Memories of the tax policy standstill during the final Kohl years won the Eichel strategy a lot of support from business. His strategy was viewed as a political turning point, not only in

comparison with the direction provided by Oskar Lafontaine, his immediate predecessor, but also in comparison with the political practices of the former coalition. That's why businesses were filled with the mood that, in the words of one top manager, "The worst thing that can happen to us is for nothing to happen." Tax reform, people are convinced, will either happen this year or not at all. German politics has to prove that it can act, if the country is supposed to continue attracting international notice. So now there is a complicated reform with lots of problems. It will keep the financial courts busy for a while. Specific regulations regarding commercial taxation might have to be improved. But at least it is a reform. Taxpayers will save a total of more than 50 billion marks, businesses have a basis for making calculations for the future, and, with low tax rates, the Federal Republic can attract foreign investment capital. At least the old cliché of a reform deadlock in Germany has become obsolete.

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Source: Nikolaus Piper, "Die unvermeidbare Reform" ["The Inevitable Reform"], *Süddeutsche Zeitung*, July 15, 2000.

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