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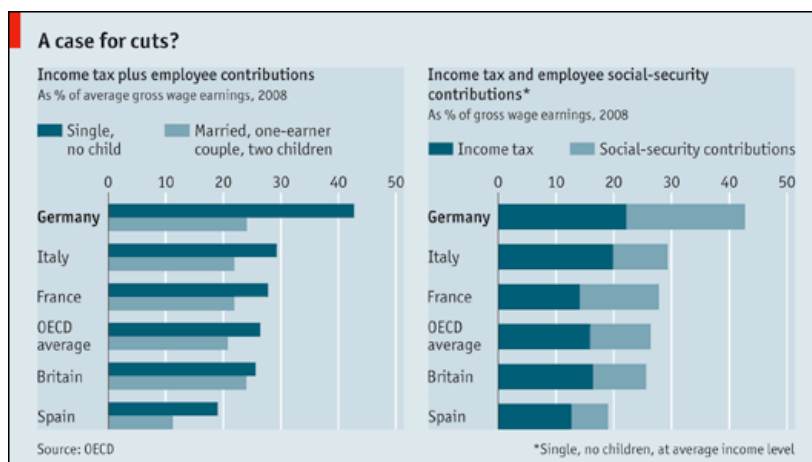
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Germany's election

The parties' tax tangle

Aug 20th 2009
From *The Economist* print edition

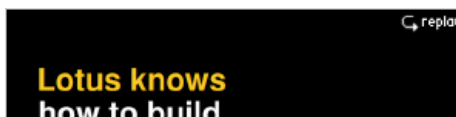
Tax cuts emerge as a central issue in the election campaign



WITH little more than a month to go before Germany's parliamentary election, the Social Democratic Party (SPD) has so far failed to draw Chancellor Angela Merkel into a fight. Its chairman, Franz Müntefering, accused her of not caring about jobs, which sounded silly (the SPD says it will create 4m by 2020). Ms Merkel did not rise to the bait. Her plan is to shun the grubbiness of campaigning as long as she can and hope that on September 27th her personal popularity propels the Christian Democratic Union (CDU) back into power at the head of the next coalition government.

On one subject, though, the CDU seems willing to offer battle: taxes. Its election manifesto promises taxes that are "simple, low and fair". Ms Merkel flatly rules out tax increases to narrow the gaping deficits caused by the economic crisis. Her preferred coalition partner, the liberal Free Democratic Party (FDP), would go further, demanding a drastic overhaul of the income-tax system. Its leader, Guido Westerwelle, insists he will sign no coalition agreement that does not bind the next government to tax reform. The SPD, meanwhile, derides such plans. They have "no chance", says the Social Democratic finance minister, Peer Steinbrück. Currently the junior partner in Germany's "grand coalition" government, the SPD suggests a bit of relief for lower-income taxpayers but wants to raise the tax on the rich and to impose one on stockmarket trades.

Whichever coalition takes power after the election will face painful choices. The public sector balanced its books in 2008 but there is likely to be a deficit of 4.7%



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of GDP this year and 6% in 2010. Public debt will rise from 66% of GDP to 84%. Some countries are in even worse shape but by German standards these numbers are horrific. As a member of the euro zone, Germany's public-sector deficit should normally be no more than 3% of GDP. Gradually it will have to squeeze into an even tighter corset of its own making:

under a new constitutional amendment, the federal government must cap its structural deficit (ie, adjusted for the economic cycle) at 0.35% of GDP by 2016; the 16 *Länder* (states) must eliminate theirs by 2020. At the same time, the main parties want to invest more in things like education and research. If the CDU and FDP are in charge, all this must somehow be reconciled with tax relief.

Taxpayers certainly deserve a break. A single person earning an average income pays more of his wages in income tax plus social-security contributions in Germany than almost anywhere else in the rich world. When they talk about taxes, Germans sound like they are discussing diseases. "Middle-class paunch" is the steep rise in tax rates at relatively low levels of income; "cold progression" means being pushed into higher tax brackets by inflation. Taxpayers earning just 1.3 times the average income pay the "top rate" of 42% (in fact there is an even higher rate for very high incomes). The bureaucracy required to pay corporate tax costs companies €20 billion (\$28 billion) a year, they complain.

The CDU and FDP vow to relieve these ailments but there is a big difference between them. The CDU, for all its talk, is offering little relief. It wants to cut the lowest tax rate from 14% to 12% and to introduce the top rate at a slightly higher level of income. The FDP would sweep away a thicket of tax rates, leaving just three: 10%, 25% and 35%. That would be expensive. The FDP puts the cost of its income- and corporate-tax proposals at €35 billion. "The FDP is offering a substantial change, while all the others are marginal," says Nils aus dem Moore of RWI-Essen, an economic-research institute.

The party insists the money can be found. It has proposed 400 spending cuts worth €10.5 billion and predicts that lower rates will lure part of the €350 billion black economy out of the shadows, allowing it to be taxed. Above all, the party says, lower taxes will provide incentives to work, which will boost economic growth, fill the state's coffers and narrow the deficit.

Social Democrats accuse the would-be tax cutters of pandering to the rich. Close to half of Germans pay virtually no income tax; for low earners the main misery is social-security contributions. Reducing these would give them relief while lowering the cost of employment. But the state may not be able to afford relief of any sort. Even if the economy bounces back from recession more quickly than expected, the government will struggle to meet its deficit-reduction targets. The federal government's finance plan calls for an annual reduction in the structural deficit of 0.2% of GDP starting in 2011. "There's no room to cut taxes during the next parliament," says Michael Bräuninger of the Hamburg Institute of International Economics.

Ms Merkel seems to realise this. The CDU's Bavarian sister party, the Christian Social Union, pushed her into promising tax cuts. Sometimes she hints that fiscal discipline is a higher priority. The CDU's tax-cut proposal is not a pledge of immediate relief but a signal that the party is on the side of the economy's producers, says Viola Neu, a political scientist at the CDU-linked Konrad Adenauer Foundation. Ordinary Germans are not expecting much relief. A majority favours a tax rise as long as it weighs on upper-income earners, according to a recent poll. Oddly, voters may end up electing a government keener on tax cuts than they themselves are.

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