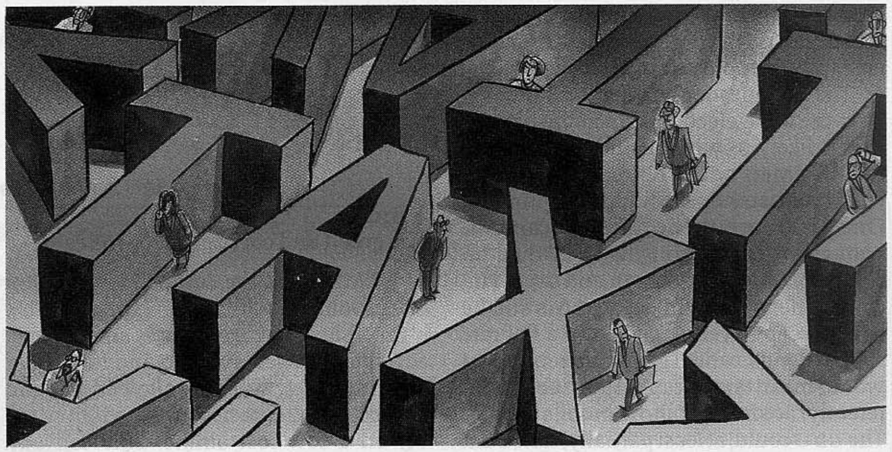
German tax reform

Systematic chaos



BERLIN

The prospects for tax reform recede, unfortunately

EVEN if German academics left their ivory towers, few politicians would notice. Which makes it surprising that Paul Kirchhof, a lawyer at Heidelberg University, has persuaded a group from the two professions that the country's tax system needs radical reform. He did it by drafting 12 pages of legislation that would do away with most tax exemptions and cut the top marginal income-tax rate to 25%.

Alas, this coalition of scholars and statesmen may not get anywhere. On January 18th Angela Merkel, the leader of the opposition Christian Democrats (CDU), said that she did not expect tax reform this year. This was taken as a signal that she was taking the topic off the priority list. A big change is anyway unlikely before the 2006 federal election, if only because there are so many preoccupying local and regional polls before then.

That Germany badly needs tax reform has been recognised for years. What is new is the attention being paid to simplicity, which is popular with voters. Hardly a day passes without a politician demanding that tax returns be made no larger than a "beer mat", or quoting the claim that Germany produces over two-thirds of the world's academic tax literature.

Germany is hardly the only country to suffer from fiscal complexity. But marginal and average tax rates are high, especially for companies. That matters, as it makes the country a less attractive place in which to invest. Other countries have responded to a similar lack of competitiveness by lowering marginal-tax rates and scrapping tax breaks, broadening the tax base and simplifying the system. But Germany has managed only incremental reforms. These have left a patchwork that, says the German council of economic experts (a group of wise men), "is fast losing any semblance of being a structured, rational system".

One oft-cited explanation for this is Germany's federal system, which gives the opposition a de facto veto over tax changes. Less well known is the role of the country's Constitutional Court, says Steffen Ganghof, a researcher at the Max Planck Institute for the Study of Societies in Cologne, in a forthcoming book. The court often has the last say in tax policy. It is widely assumed that it would strike down any law openly breaking with one tradition of German taxation: that corporate- and income-tax rates must be about the same. Combined with the *Gewerbesteuer*, a court-protected local trade tax, this has meant that politicians are limited in their ability to respond to tax competition without losing revenue.

The CDU, adds Mr Ganghof, has often proposed bolder tax reforms than other right-wing parties. One recent plan drawn up by Friedrich Merz, a CDU parliamentary leader, would have put Germany ahead of other countries in simplicity. It suggests three tax rates: 12%, 24% and 36%, for incomes above €8,000, €16,000 and €40,000 respectively. Such radicalism does not make for easy compromises. Despite scrapping many tax breaks, Mr Merz's plan would cut revenues by €24 billion in the first year—which the government cannot afford. Anyway, the governing Social Democrats (SPD) dislike low tax rates, because they want progressive taxes to balance high social-security contributions, which tax lower incomes proportionately more than higher ones.

More surprisingly, the Christian Social Union, or CSU, the CDU's sister party in Bavaria, has qualms of its own. It recognises that the CDU's tax ideas do not square with its health-care plans, which would make social-security contributions more regressive. The CSU has come up

with a rather less ambitious proposal, which gets rid of some tax breaks and lowers the top rate only from 45% to 39%.

The big question is what will happen after the 2006 election, which the opposition is likely to win. Might it then implement Mr Merz's plans? By early March, the CDU and CSU hope to find a compromise. One option would be to copy Scandinavian countries by bringing in a "dual income tax" that treats labour and capital income differently. While wages can still be taxed progressively, this allows a flat rate for dividends, capital gains and rents. That would mean taxing capital and labour differently, according to how mobile each is. The CDU could, at least partially, test its flat tax; the SPD and CSU would keep their progressive income tax. But would this be legal? No, says Mr Kirchhof, who once sat on the Constitutional Court. Perhaps he should have stayed in his ivory tower. ■