

UNCLASSIFIED
SAVING TELEGRAM

FROM BONN

FRAME ECONOMIC

TO FCO TELNO 8 SAVING OF 15 JULY 1988. Info. Brussels, Luxembourg, The Hague, Paris, Rome, UKRep Brussels, UKDEL OECD, UKMis Geneva, all Consulates-General in the Federal Republic and West Berlin, Washington, Tokyo, Vienna.

THE FRG ECONOMY

SUMMARY

1. Fiscal and budgetary policy in the limelight. After much argument and brinkmanship, the tax reform package for 1990 received approval of the upper house, the Bundesrat, on 8 July. Although the package will benefit the taxpayer with a net DM 20.76 billion tax reduction, planned consumer tax increases and poor Government presentation have confused the issue and the macro-economic effects remain unclear. (Paras. 9 and 10)
2. Consumer tax increases agreed for 1989 and 1991. Higher taxes on petrol, heating oil, tobacco, insurance and for diesel vehicles. New tax on gas to remain in force until at least 1992. Total additional revenue of DM 8.08 billion in 1989. (Paras. 11 and 12)
3. Details released of draft budget for 1989. Government spending to increase by 4.6% to DM 288.15 billion, including new structural help for northern Länder and additional funds for the Federal Labour Office. Revenue to increase by 8.5% to DM 256.18 billion. Federal deficit to fall to DM 31.97 billion following a forecast DM 39 billion this year. New five year financial plan also released covering the period until 1992. Government spending to increase by only 2% in 1990 and by 2.5% thereafter. (Paras. 13 and 14)
4. Unemployment fell in June to 2.13 million (8.4%) unadjusted compared to 2.15 million in May but that was 35,000 higher than June last year. The growth in employment continues to slow. May employment stood at just over 26 million. (Para. 15)
5. The Bundesbank raised the Discount Rate from 2.5% to 3% with effect from 1 July, but the Lombard Rate remained at 4.5%. The fixed rate on securities repurchase transactions was also increased in two stages from 3.25% to 3.75%. Other interest rates were volatile with yields on bonds outstanding climbing to 6.27% before falling back and 3 month Fibor reaching 4.55%. (Paras. 16 and 17)
6. Inflation, cost of living index, in June was unchanged at 1.1% which leaves the moving annual average at 1%. Private consumption remained buoyant. Retail trade sector expects turnover to increase by 2.5% in real terms this year. Business climate has also improved greatly. The Ifo business survey recording its fifth consecutive monthly rise in May. New orders increased by 1% with foreign demand rising by 2.5% and domestic orders expanding by 1%. Production remained unchanged in May although construction activity rose by 2%. On a two-monthly comparison, construction activity in April/May fell 4% compared to February/March. (Paras. 18 to 24)

7. The current account surplus rose to DM 8.6 billion in April following DM 4.7 billion in March. The visible trade surplus grew to DM 9.5 billion, an increase of 3.6% on a year earlier. Exports in April were 2.4% lower than in April last year while imports were 4% lower. FRG/UK trade details. (Para. 25 to 29)

DETAIL

8. Fiscal and budgetary policy continued to occupy centre stage as the summer break approached. At issue were the tax reform package for 1990, proposed increases in consumer taxes in 1989, the draft budget for 1989 and the new five year financial plan for the period to 1992.

1990 TAX REFORM

9. The package due for implementation on 1 January 1990 passed its final parliamentary hurdle on 8 July when it received the formal approval of the upper house, the Bundesrat. The package allows for gross cuts in income and some corporate taxation amounting to DM 39.66 billion. The measures include further moves towards a linear-progressive income tax tariff, increasing family allowances and reducing Corporation Tax by 6 percentage points to 50%. Some DM 18.9 billion of the gross amount will be offset through 59 separate measures to reduce personal allowances, to cut regional incentives and by the introduction of a 10% withholding tax on certain savings and investments.

CONSEQUENCES OF THE TAX REFORM IN 1990
 (in DM billion)

MEASURES	TOTAL (+ or -)	OF WHICH : FEDERAL	LÄNDER	GEMEINDEN
Loss of revenue through :				
Income tax reforms	34.0	14.45	14.82	4.72
increased family allowances	2.36	1.05	1.03	0.33
improved depreciation allowances	0.6	0.25	0.26	0.08
lower Corporation Tax	2.7	1.35	1.35	.
Total revenue loss	<u>39.66</u>	<u>17.06</u>	<u>17.47</u>	<u>5.14</u>
Revenue gain/losses through :				
reduced income tax relief	5.52	2.28	2.34	0.9
10% withholding tax	4.2	2.1	2.1	-0.1
Corporation & Trade Tax changes	0.65	0.05	0.13	0.46
special provisions	2.65	1.25	1.22	0.18
residual measures	5.74	2.16	2.15	1.41
Total revenue gain	<u>18.90</u>	<u>7.95</u>	<u>8.03</u>	<u>2.92</u>
BALANCE (net gain to taxpayer & net loss to Government)	<u>20.76</u>	<u>9.11</u>	<u>9.44</u>	<u>2.21</u>

NB: Discrepancies in totals due to rounding.

10. Despite the benefit to middle and high income earners which the package will bring, it had been the subject of much controversy and elements of it have contrasted unfavourably with the proposals for consumer tax increases next year. The Government's presentation of the package has been at best poor. Its approval by the three coalition parties earlier this year was characterised by public bickering over relatively minor elements; its passage through the lower house, the Bundestag, was marked by open revolt among