

Das Supply-Side

Much of the modern social welfare state (which liberals in the US seem intent on expanding) dates back to German Chancellor Otto von Bismark in the late 1800s. But now, even as the US moves toward more government, Germany may be on the verge of a giant leap in the opposite direction.

Angela Merkel, the current premier of Germany won reelection this weekend. Back in 2005, Merkel's party, the Christian Democratic Union (CDU - a "center-slightly right" group), had gained power by forming a coalition with the "liberal" Social Democrats (SDP). This time, the SDP saw their worst election returns in 60 years. This means that Merkel will form a coalition with the Free Democrat Party (FDP - a "somewhat free-market" group). The FDP was nearly extinct just ten years ago, but won 14.6% of the vote this time around, a record for their party.

The Free Democrats ran on a platform that included a significant across-the-board cut in marginal income tax rates – the German equivalent of the Kennedy or Reagan tax cuts. At present, income tax rates range from 14% to 45%. The Free Democrats want three brackets – 10%, 25% and 35%.

Initial news stories suggest the euro will rally and German bond yields rise, as tax cuts would increase economic growth and widen the German budget deficit. We agree that these tax cuts would push up the euro, but don't think German bond yields will rise much, if at all, and would not worry about the impact on the budget deficit. Lower tax rates would not only accelerate the

recovery from the recent economic turmoil but also encourage the work, saving, and investment that Germany needs to raise its long-term growth potential and address its massive Baby Boom-related fiscal imbalance.

Cutting the top income tax rate translates into a healthy 18% increase in the after-tax return to work for those with the highest incomes. (Top-income workers now keep 55% of their income gains; a tax cut would raise this to 65%, an increase of 18%).

Even if the budget deficit did rise – and we doubt it would if the tax cuts are like the Free Democrats want – a larger economy with better incentives would handle a larger deficit better than a weaker economy could handle a smaller one. A 325-pound barbell is always heavier than a 250-pound barbell. But an NFL tackle can lift the first barbell easier than a jockey can lift the second.

These tax cuts would also put pressure on other countries, particularly Germany's main competitors, to reduce tax rates themselves. After Reagan's tax cuts in the 1980s, many advanced countries around the world also cut taxes, and not just those with "conservative" governments. Sometimes it was just a defense mechanism to hold onto capital and productive workers.

Given the inclination of many policymakers in the US to look to Europe as a model for where we should head next, the election results in Germany are going to cause a great deal of confusion in Washington, DC.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-29 / 9:00 am	Consumer Confidence - Sep	57.0	62.0		54.1
9-30 / 7:30 am	Q2 GDP Third Report	-1.2%	-1.1%		-1.0%
7:30 am	Q2 GDP Chain Price Index	0.0%	0.0%		0.0%
9:00 am	Chicago PMI - Sep	52.0	52.9		50.0
10-1 / 7:30 am	Personal Income - Aug	+0.1%	0.0%		0.0%
7:30 am	Personal Consumption - Aug	+1.1%	+1.6%		+0.2%
7:30 am	Initial Claims - Sep 26	535K	537K		531K
9:00 am	ISM Index - Sep	54.0	54.0		52.9
9:00 am	Construction Spending - Aug	-0.1%	-0.2%		-0.2%
<i>sometime</i>	Domestic Auto Sales - Sep	3.6 Mil	3.5 Mil		5.3 Mil
<i>during the day</i>	Domestic Truck Sales - Sep	3.8 Mil	3.7 Mil		4.8 Mil
10-2 / 7:30 am	Non-Farm Payrolls - Sep	-180K	-135K		-216K
7:30 am	Manufacturing Payrolls - Sep	-50K	-55K		-63K
7:30 am	Unemployment Rate - Sep	9.8%	9.6%		9.7%
7:30 am	Average Hourly Earnings - Sep	+0.2%	+0.3%		+0.3%
7:30 am	Average Weekly Hours - Sep	33.1	33.1		33.1
9:00 am	Factory Orders - Aug	+0.0%	-0.8%		+1.3%