TAXATION IN EUROPE

IREF 2008

What did 2007 bring in terms of fiscal reforms in Europe?

IREF, the Institute for Research on Economic and Fiscal Issues, asked eleven experts from the four corners of Europe to report on the main trends in their countries and neighboring countries. All the reports are available on IREF's website. Below you will find one of the reports that Jan Schnellenbach contributed and that presents recent trends in German fiscal policy.

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GERMANY

Balancing the budget has obviously been the primary concern of German tax policy in 2007 to achieve budget balance through increasing the tax burden, rather than further cutting government spending.

The last year saw a sharp increase of the normal tax rate of the value added tax from 16% to 19% (the reduced tax rate has remained stable). This measure, combined with a favorable development of the business cycle, has led to an increase of revenue from the value added tax in the first three quarters of 2007 of 16% compared to the first three quarters of 2006. However, the federal government reports that the latest November estimates of the VAT revenue for the entire year of 2007 are significantly lower than expected at an earlier estimation at the beginning of the year. Apparently, the increase of the VAT rate did indeed have adverse effects on private consumption in Germany, if we use earlier expectations on the evolution of private consumption as the benchmark. These kind of effects have turned out to be particularly visible for expensive consumer goods, such as new cars. In the first eleven months of 2007, 8,2% fewer new cars have been bought by German customers than in the same months of 2006, and expensive German car manufacturers have in particular suffered from this effect.

In addition to this, one can also expect that, at the margin, the increase of the VAT will drive more economic activity into the shadow economy. In particular, self-employed individuals and their customers do now have an even stronger incentive to collude in evading taxes. In essence, the VAT increase has thus served its short-term budgetary purpose well – the federal government is reporting a balanced budget for 2007 – but this comes at substantial costs, both economic and legal.

The personal income tax in Germany has been supplemented with an additional surcharge for high-income earners. Beginning with the year 2005, the top marginal income tax rate, which is to be paid on taxable incomes above € 52,152, had been lowered to 42%. Apparently this ran counter to the sense of distributive justice held by large fractions of the electorate. From 2007, individuals with a taxable income above € 250,000 (or € 500,000 for married couples) will face a top marginal income tax rate of 45%. While this tax increase may not be too dramatic in itself – an earner of € 1,000,000 in taxable income pays € 22,500 more income tax than he did in 2006 – it is the accompanying rhetoric that is somewhat dubious. In the political debate preceding its institution, the surcharge has been marketed as a „Reichensteuer", i.e. as a tax on the rich, and its proponents have appealed in a rather unsubtle manner to a crude, but widespread aversion to income inequality. The underlying problem of

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the „Reichensteuer" is that it represents a large stream of politics driven by an urge to redistribute incomes on a much larger scale. Measures such as the introduction of a minimum wage or the proposal to regulate the incomes of managers in private-sector companies are other, more recent symptoms of a distributive populism that is currently gaining momentum in Germany.

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The taste for additional revenue also manifests itself in more detailed changes of the German income tax of 2007. An allowance for tax-free interest income has been cut in half, it now stands at € 750 per taxpayer and year. Of greater importance from a systematic point of view are two changes that restrict the taxpayers' ability to deduct work-related costs from their gross incomes in calculating their taxable incomes. Costs for driving to work can be deducted only by individuals who live at least 20km from their workplace, and the costs for having a workplace at home can only be deducted if this is the primary workplace.

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One of the larger problems in current German tax policy is the planned reform of the inheritance tax. It is planned to enact this reform with retrospective effect, in force from January 1, 2007. In order not to collide with basic principles of the rule of law, taxpayers will be given the option to choose between the currently effective and the post-reform inheritance tax code. The inheritance tax is a relatively small tax, generating only € 4,000,000,000 per year in revenue, which is then split among the sixteen sub-federal German states. Nevertheless, there are huge problems associated with it. If real estate is inherited, then it enters the tax base with an appraised value that often differs substantially from the actual market value. In most cases, the appraised value lies below the market value. Recently, the constitutional court has ordered that this practice is unconstitutional, because heirs of real estate carry a lower tax burden than heirs of, for example, company shares, even if the market value of both bequests is identical.

...the planned reform of the inheritance tax

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The second important problem is that the inheritance tax is perceived as an obstacle to smooth transitions of company ownership from one generation to the other, particularly for small and medium-sized family businesses: Heirs of a business that is large enough to be subjected to the inheritance tax often are forced to either sell the company or to go into debt in order to be able to pay their due taxes. The currently debated inheritance tax reform attempts to solve both problems, subject to the condition that the reformed tax can be expected to generate at least the same revenue. The cornerstones of the planned reform of the inheritance tax are the following:

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- Close relatives of the bequeather will be relieved by being subjected to relatively low effective tax rates. They can expect to pay a substantially lower inheritance tax under the new tax code.
- Distant relatives, or heirs who are not related to the bequeather at all, will be subjected to significantly higher effective tax rates than they are at present.
- The main instrument by which close relatives are relieved is a substantial increase of their tax-free allowance. This will result in a smaller number of heirs having to pay inheritance tax at all in the future. First estimates by the government expect that about 140,000 taxpayers per year will have to pay a tax under the new tax regime, while well over 200,000 taxpayers per year pay the tax now.
- All inherited property will be valued at the actual market price (or an estimate thereof).
- If a company is inherited, then 85% of its value are exempt from the inheritance tax, provided that for fifteen years (i) the business remains in the ownership of the heir, (ii) the capital equipment of the company does not substantially decline and (iii) the overall payroll of the company does not decline below a critical value. If the conditions are not met, if e.g. after two years the heir decides to sell the company, or to lay off a large fraction of employees, then the heir will be forced to pay a significant surcharge on his inheritance tax.

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Obviously, the provisions regarding the inheritance of companies are not enlightened by any economic reasoning at all. It is a very peculiar idea that an heir should have special (maybe even inherited?) entrepreneurial abilities that distinguish him from other potential owners of the company, such that it is warranted to introduce tax incentives that make it very disadvantageous for him to sell the company. From an economic perspective, it would be efficient not to distort this decision at all. Ownership of companies should be allocated to those who expect to use this property right most efficiently, and since such an expectation will be positively correlated with willingness to pay for the property right, an undistorted price mechanism will yield efficient results. Apparently, an irrational fear of foreign investors and a romantic view of the family-owned, medium-sized company, rather than economic reasoning, are the driving forces behind these provisions in the proposed new inheritance tax code.

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Furthermore, the newly drafted law also suffers from the serious deficiency of treating different types of companies differently. If an incorporated firm (or shares therein) are inherited, then the tax burden will be drastically higher than it would be if a non-incorporated, privately owned firm was inherited. Economically identical firms are treated differently only due to their legal form, which is again a highly distortionary approach to taxation. Furthermore, it is constitutionally dubious, and it remains to be seen if a discrimination due to legal form can be upheld, when, sooner or later, a discriminated heir will take her grievance to the constitutional court. Making the burden of the inheritance tax depend on the stability of a company's payroll over a period as long as fifteen years is also rather obscure from an economic point of view.

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The leitmotif of this tax code appears to be the exact opposite of a dynamic, Schumpeterian economy open to processes of restructuring and creative destruction – German legislators apparently favor the preservation of the status quo, by any means necessary. Even if we accepted the good intention of preserving jobs, the present tax policy will often backfire: A company in crisis, typically suffering from shortages in liquidity, may be driven out of business completely if it is forced to pay high inheritance tax surcharges as a response to economically warranted layoffs.

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Another important tax policy issue that was hotly debated in Germany during the recent year is the reform of the corporate income tax, which will come into effect in 2008. It is expected that this reform will have a relieving effect on incorporated firms; the federal government estimates a long-term decline of € 5,000,000,000 in annual revenue compared to the situation under the pre-reform tax code. The overall tax rate on profits of incorporated firms will decline from 39,6% to 29,8% including local taxes and calculated for an average local tax burden (depending on the municipality a business is located in, the actual tax burden may differ somewhat). To avoid discrimination of non-incorporated firms, their retained profits will also be taxed at a reduced rate of 28,25%.

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In order to avoid even larger losses of tax revenue, the lowering of statutory tax rates is partly compensated by a broadening of the tax base. An earnings stripping rule is introduced which limits the ability of German corporations to deduct interest payments from their tax base. The first limit is that own interest payments can only be deducted to the same amount as the received interest payments of the same year. Interest payments exceeding this first limit can only be deducted up to 30% of EBITDA. Interest payments exceeding also the second limit become a part of the tax base for the corporate income tax, but can be carried over to later years. Again, there is also a tax exemption: Only if own interest payments exceed received interest payments by more than € 1,000,000 does the earning stripping rule come into effect.

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This leads the German government to expect that only around 300 large firms will have to deal with the rather complicated provisions of the rule. The aim of introducing the earnings stripping rule is twofold: On the one hand, it is aimed at encouraging firms to rely on equity financing to a greater extent than they do now. On the other hand, it is believed that a transfer of profits to related, foreign-based firms in order to take advantage of low tax rates abroad should be discouraged.

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One very controversial plan, which is not decided in detail at this point, is the taxation of profits from foreign investments by German companies. A final decision on this issue is expected for early 2008. At the moment, a likely outcome is that additional foreign investments will not be subjected to such a tax, while profits from foreign investments that count as a relocation of productive facilities from Germany to other countries will be taxed. Obviously, it is very questionable that both types of foreign investment can be precisely distinguished in practice. Thus, it remains