Editorial

Dr Bernhard Seidel,
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'Corporate tax reform in Germany – will the government keep its promise?'

Following its initial difficulties, Germany's new coalition government of social-democrats and greens is still not out of the woods. Demoscopic surveys point to a marked loss of image, and the reforms that the government initially sought to implement with great verve exhibited many weaknesses of detail, repeatedly forcing the government, under heavy attack from all sides, to amend or even withdraw proposed legislation. The reform of corporate taxation that had initially been envisaged for the year 2000 has now been postponed for one year, in order to elaborate a more solid basis from the outset. The contours of the proposal have already emerged, though. It involves not merely changes in taxation rates and the definition of the tax base, but represents a break with the existing system in a number of respects.

The centre-piece of the reform is a sharp reduction in the rate of tax on corporate profits to 25%, irrespective of whether profits are distributed or retained. Distributed profits will remain subject to income tax. However, shareholders will no longer be able to offset the corporate tax paid against their income tax. Instead, only half of the distributed profits on which corporate tax has already been paid will be subject to income tax. The taxation of corporate profits is to be removed entirely from the context of income taxation. To this end, entrepreneurs who do not run their company as a legally separate entity are to be given the choice of opting for paying corporate tax rather than income tax on their business income. This offers the government a degree of freedom: it can refrain from matching the radical cut in tax on business income with an equally major cut in income tax, thus avoiding massive losses of tax revenue in direct income taxation. The marginal rate of tax for the income of natural persons is still to be 48.5%, as planned for the year 2002.

This degree of freedom comes at a high price, however. For the gap in the rate of tax on firms' business income and that on the incomes of private households will create a major incentive to retain profits, or more generally to transfer income components to the corporate sphere. It will become more attractive to finance investment out of own resources than using external funding, and may lead to a double tax burden on owners of capital. Small-scale savers will be the worst affected. Hence the reform infringes the principles that the tax system should be neutral regarding the use of profits and the mode of financing, and may damage the allocative functions of the market by restricting the dispositional freedom of private shareholders.

There can be no doubting the need for changes in Germany's corporate taxation system. Tax reforms in other countries, which in many cases have taken the form of a "race to the bottom" in tax rates, have meant that in international comparative terms Germany now has among the highest tax rates in the world. The government would be ill-advised to fail to keep its promise to significantly reduce the tax burden. The concept by which this goal is to be achieved, however, requires considerable revision.