Editorial

Dr Bernhard Seidel,
Head of the Department of Economic Structures and Public Sector, asks:

'The parliamentary hurdles facing tax reform in Germany: Is stalemate or compromise the likely outcome?'

Recently, after lengthy debate, the German lower house (Bundestag) passed the bill on tax reform, the central elements of which are a marked cut in tax rates starting in 2001 and a major reform of business taxation in terms of the interaction between corporation, income and trading (Gewerbesteuer) tax. In future the profits retained by corporations are to be taxed at a substantially lower rate – namely 25% – than distributed profits, on which shareholders also have to pay income tax. The full crediting of corporation tax paid against income tax dues is to be abolished, not least in order to make German tax laws compatible with European law; this will hit small savers hardest. Unincorporated companies may opt to be taxed as corporations, or alternatively may set off part of their trading tax payments against income tax dues. By 2005 the top rate of income tax will have been cut to 45%, the initial rate to 15% and the basic tax-free allowance raised to DM 15 000. The reductions in the tax burden apply broadly to taxpayers in all income categories, and can therefore certainly be considered balanced in terms of income distribution.

The basic elements of the tax reform have received broad support. For many years it has been generally accepted that the German tax system – especially its characteristic high marginal tax rates, on the one hand, and generous exceptions and concessions, on the other – is in need of reform, not least in the light of international tax competition. The reform as passed by the Bundestag will reduce tax rates to a level that is rather low compared with other countries. Yet there has been criticism of a number of detailed proposals, not merely from the opposition, but also from the ranks of the governing coalition itself. The opposition claims that the cuts in income tax rates do not go far enough: the differentiation between the rates of corporation and of income tax has been widely criticised, and the retention of the full tax-credit system demanded; last but not least, circles close to the governing social democrats have expressed criticism of the fact that corporations are not to be taxed on the receipts from sales of shares in the company. Consequently, it is unlikely that the bill will be passed by the upper house, the Bundesrat, at the first attempt. Not only does the opposition have a majority of the state governments that are represented in the Bundesrat; a number of representatives of states governed by the SPD will take the opportunity of removing what they see as imperfections.

However, it is unlikely that the tax reform will suffer the same fate as under the last Kohl government, when opposition from the Bundesrat ensured that no tax law was finally passed by parliament. For the opposition would suffer a serious loss of credibility if it were to block a reform that has already been welcomed by business and which it itself has propagated for many years. On the other hand, the conservatives' call for even more drastic *cuts in the top rates of tax exceed what would appear to be financially feasible in the medium term. Budgetary constraints leave only a limited scope for compromise. A slightly more substantial cut in the top rate of income tax seems likely. The government could also do more to meet demands to reduce the disadvantaging of unincorporated companies vis-à-vis corporations regarding the taxation of the receipts from sales of shares; for instance it could refrain from entirely exempting corporations from tax. This would not call the overall concept underpinning the reform into question.*