To the point!

Cross-Asset- and Strategy-Research

German evergreen inheritance tax

A reform is inevitable, but the details are up for debate

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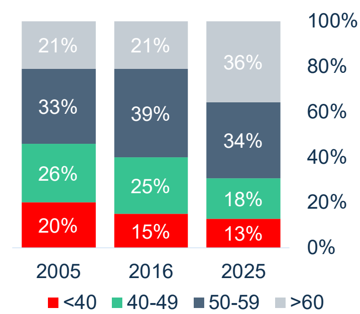
In January the German major center-left Social Democratic Party (SPD) – currently a partner in the governing coalition – rushed ahead with a proposal to reform the inheritance tax. Predictably, this triggered an intense and contentious debate. Alongside a high tax-free allowance, the plan also aims to dismantle the existing special provisions for business assets. Given the fragile state of the German economy – particularly among family-owned firms – this prospect has provoked significant resistance from those in the Mittelstand, the country's broad base of small and medium-sized, often family-owned businesses. Their anxiety is understandable in light of a looming wave of business transfers to the next generation: more than one third of medium-sized business owners are older than 60 (see Fig. 1). The issue is anything but abstract.

Fig. 1: Aging business owners



Source: KfW, LBBW Research. Equity stakes by age group of SME owners

A reform will have to come

No one should be surprised that an overhaul of the German inheritance tax is pending. Since 1995 Germany's Federal Constitutional Court has repeatedly criticized the current rules for violating the constitutional principle of equality before the law (Article 3 of the Basic Law, Germany's constitution). Another case is currently before the court, examining whether business assets are being granted impermissible tax privileges and whether the current relief provisions for such assets breach the principle of equal treatment. Large inheritances are typically taxed at a lower effective rate than smaller ones, which runs counter to the ability-to-pay principle – the idea that tax burdens should rise, or at least not fall, with economic capacity. After several postponements, a decision by the country's top judges is expected towards the end of the year. In my view, it would be wise for politicians to resist

An ill-timed push: waiting for the court's ruling

getting tangled up in public skirmishes and instead wait for this ruling first.

In the crossfire between politics and business

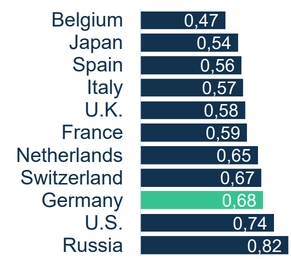
Tax revenue, though, is only a secondary concern. Receipts from inheritance and gift tax are almost negligible. For this year, the official German tax estimate forecasts a little over €12bn – just over 1% of total tax revenues. Moreover, inheritance tax accrues not to the federal government but to the 16 federal states (Länder). Any increase would primarily benefit the already well-funded western Länder, whereas inherited wealth in eastern Germany remains, for historical reasons linked to post-war expropriations and socialist rule, largely negligible.

No quick fix, please

Reforming inheritance tax inevitably means navigating a trade-off between widespread notions of fairness and the desire to preserve family-owned businesses. The German Council of Economic Experts – an official advisory body to the federal government – pointed to the need for reform ten years ago. In its 2015 report it advocated broadening the tax base while keeping rates low and granting generous deferrals.

In broad terms this mirrors the SPD proposal, which envisages a payment period of twenty years. The details are certainly debatable, but if the Constitutional Court shows politicians the red card once again, they will no longer be able to kick the issue into the long grass. In their deliberations policymakers must acknowledge that corporate taxation in Germany is high by international standards. Perhaps inheritance taxation and corporate taxation could be considered together. That might help safeguard the continuity of family-owned firms.

Fig. 2: Wealth inequality (Gini coefficient)

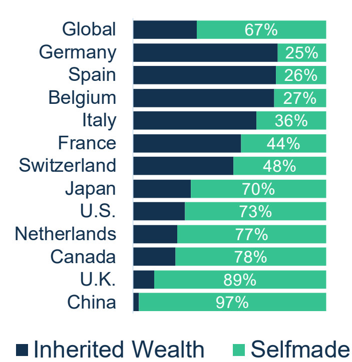


Source: UBS, LBBW Research. The higher the Gini coefficient, the more unequal the distribution

What is fair?

The answer is in the eye of the beholder. Still, it is hard to deny that a growing share of the population feels uneasy when it comes to social justice. In international comparison, the distribution of wealth in Germany is highly skewed (see Fig. 2). Among the so-called super-rich – the billionaires – one striking development is that their number in Germany has roughly quadrupled since 2007. And that is not all: an analysis of the Forbes list shows that in Germany only one in four billionaires has created their fortune themselves. Three quarters owe their wealth to large inheritances. Among the 34 countries examined, this is the highest proportion worldwide (see Fig. 3).

Fig. 3: Origin of billionaires‘ wealth



Source: Datapulse, LBBW Research

Even if the classification methodology is open to challenge, the orders of magnitude make it clear that politicians can no longer duck the issue without risking further polarization of society. Yet even then it remains crucial that Germans look for pragmatic solutions rather than class-struggle-inspired, ideological ones – particularly in a country so heavily shaped by family-owned businesses. The survival of these firms, a central pillar of Germany’s prosperity, must not be put at risk.

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