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Rawls on Inheritance Taxation: A Study of German Business Transfers

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Abstract

To support the countless privately-held German firms, bequests of companies to relatives are subject to generous tax exemptions. I argue that since the redistributive effect of such exemptions lacks empirical support, they are not just in light of a Rawlsian framework of Justice as Fairness. I also propose a moderate flat-tax on business inheritances payable regardless of family relation between donor and recipient, which would generate higher revenues for redistribution. Since this tax comes closer to justifying Rawlsian Principles of Justice while preserving the financial stability of Germany's privately-held companies, it outperforms the status quo of business inheritance taxation.

Keywords: Rawls; Business Inheritance; Inheritance Taxation; Justice

The backbone of the German economy consists of countless privately-held businesses. To ensure their continued operation across generations, the existing inheritance legislation enables the quasi-untaxed transfer of wealth bound in firms to relatives. In this essay, I argue that this status quo is unjust in light of John Rawls' Theory of Justice, and propose to moderately tax the inheritance of wealth bound up in firms regardless of family relation between donor and recipient.

1. Status Quo

Through inheritance and gifting, the German population annually transfers around €400bn between generations (Tiefensee and Grabka 2017). In 2018, around 80% of these transfers were completely untaxed (Federal Statistical Office 2019), while taxes on the remaining 20% only raised a marginal €6.81bn of the total federal tax revenue of €776bn (Statista 2020a; Statista 2020b). The low revenues arise through generous tax exemptions for intergenerational transfers of wealth.

When wealth is inherited following a death, the recipient pays a receipts tax. Wealth gifted during a donor's lifetime is subject to gift taxes. Both receipts and gift tax apply to wealth

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transfers of *any* kind and have untaxed exemption thresholds. The gift tax exemptions are granted repeatedly every ten years. Tax rates and exemption thresholds for both receipts and gift tax vary with family relation between recipient and donor. For those *unrelated* to the donor, gifts or inheritances above €20k are immediately taxed at 30%, rising to 50% for anything in excess of €6m. Bequests and gifts to children of up to €400k are untaxed, before tax rates slowly rise to a maximum of 30% once a threshold of €26m is reached. The status quo thus systematically favours intergenerational wealth transfers within the direct family.

The book value of inheriting a privately-owned business is taxed under the same regulation as other forms of wealth, thus favouring relatives as recipients. However, further privileges are granted specifically for transfers of firms. If a recipient continues operation for five years without reducing the average payments to employees, the tax owed for the value of the firm is cut by 85%. The tax is entirely exempted after seven years of continued operation. By combining preferential treatment for transfers to relatives with further exemptions for firm inheritance, wealth inside privately-owned corporations passed to relatives is hardly taxed. As such, Germans inheriting businesses worth more than €100m from a direct relative in 2018 merely paid 0.2% in taxes (Sueddeutsche 2019). While proponents of the status quo highlight its benefits to everyone in the economy through lower unemployment and financial stability, critical voices in politics and academia began questioning the justice of a system so unequally benefitting recipients of family businesses (Bundestag 2019; Best 2019). Due to the on-going debate in Germany, I will focus on evaluating the status quo of business inheritance taxation for the remainder of this paper.

2. Justice

I evaluate the justice of the German business inheritance system against John Rawls' Theory of Justice as Fairness (Rawls 1999). The Rawlsian framework is one of the most widely employed standards of evaluation in modern political theory. Rawls' account captures egalitarian intuitions concerning the injustice of policies granting preferential treatment purely based on privileges inherited by birth. On the other hand, Rawls' theory allows for systemic inequalities to classify as just if they are to the benefit of the worst-off in society. A Rawlsian framework thus takes the core of arguments employed both in favour and against the status quo into account and may serve as an impartial standard of evaluation. However, my conclusion crucially depends on the assumption that the Rawlsian Principles are suited to evaluate a given system, an assumption not everyone must share (Sen 1959).

To evaluate a given system, Rawls introduces two Principles of Justice. The First Principle of Justice requires "each person to have an equal right to the most extensive scheme of equal basic liberties compatible with a similar scheme of liberties for others" (Rawls 1999: 53). Since the German constitution protects freedom of speech and association, the rights to vote and hold office and treatment in accordance with the rule of law, the status quo is located within a system where the basic liberties Rawls refers to are granted equally to every citizen. Therefore, the status quo satisfies the First Principle of Justice.

Rawls acknowledges that with the existence of morally arbitrary differences in skills, it is impossible to design a system that secures equality of wealth while sustaining economic incentives (Rawls 1999: 68). From this, he derives the Second Principle of Justice, according to which any arising social and economic inequalities are considered just only if they satisfy two conditions:

Firstly, any arising inequalities are to be attached to positions open to all under fair "equality of opportunity" (Rawls 1999: 72). Two people with the same talent and motivation should have equal chances to attain any position which entails inequality of wealth or responsibility (Rawls 1999: 63). Yet, the status quo is designed to favour succession within the family. Bequeathing the firm to a relative may reassure the donor that their life's achievement is not diminished by taxation and burdens a related recipient with less tax debt upon receipt. The status quo does not grant two equally talented members of society equal chances to attain certain positions of wealth and responsibility, if one of them is related to the owner of a privately-held firm. While owners may still prefer relatives for succession even in the absence of tax benefits, the status quo institutionalises inequality of opportunity based on arbitrary factors of birth. Therefore, I argue that Rawls' First Condition of the Second Principle of Justice is not satisfied.

The Second Condition of the Second Principle of Justice (Difference Principle) demands that any economic and social inequalities are to be to the greatest benefit of the least-advantaged members of society (Rawls 1999: 72). For our case, the unequal business inheritance regulations are *perfectly just* only if they *maximise* the wellbeing of the least-advantaged members of society. The regulations are *just throughout*, if they *increase* the well-being of the least-advantaged. If decreasing the inequalities could improve the situation of the worst-off, a system is deemed *unjust* (Rawls 1999: 68).

If firms with family succession were more successful than firms without family succession, higher profits and employment would yield more taxable revenues to finance the German social security and benefits systems for the worst-off. Therefore, if firms with family succession outperformed their counterparts with succession to non-relatives, the status quo could satisfy the Difference Principle by generating increased revenues for redistribution, which would justify institutionally incentivising business bequests to relatives. However, empirical evidence is largely unsupportive of this argument and remains inconclusive at best (Bertrand and Schoar 2006). In the US and Denmark, bequeathing control to relatives was associated with subsequent underperformance compared to firms with competitive succession (Perez-Gonzalez 2006; Bennedsen et al. 2007). In Germany specifically, firms held within the family were marginally more profitable than non-family firms from 2009 to 2018 (Achleitner et al. 2019). Yet, the same study shows no outperformance by family businesses for the previous ten years (Achleitner et al. 2009). Research suggests family succession leads to an overemphasis on trust in decision-making (Fukuyama 1995), bad management practices due to lacking managerial scrutiny (Bloom and Van Reenen 2007), and less capable management due to non-competitive selection (Perez-Gonzalez 2006). Since little empirical evidence supports that the Difference Principle is satisfied, we cannot conclude that the status quo qualifies as perfectly just or just throughout. However, it would be premature to conclude that the status quo is unjust. Only when removing the regulatory inequalities could actually benefit the worst-off in society, we can conclude the status quo to qualify as unjust from a Rawlsian perspective.

3. Proposal

Any alternative system should increase the satisfaction of Rawls' Principles of Justice to represent an upgrade to the status quo. In doing so, it cannot threaten the continued operation of the firm, for this could decrease revenues for redistribution and thus lower the satisfaction of the Difference Principle. Thus, any alternative system of business inheritance taxation should preserve the financial stability of privately-held firms.

In line with suggestions by Germany's *Institute for Economic Research*, I propose a one-time flat tax of 10% on the book value of a company at the time of gifting or inheritance, applicable regardless of the recipient's family relation to the donor (Fratzscher 2017). Until

2008, Germany had a business inheritance tax rate higher than the 10% proposed here. The *Institute for Business Taxation* found that eliminating inheritance taxation did not have any measurable effect on the performance of privately-held firms and concluded that removing the taxes was not necessary to preserve their financial stability (Grossmann and Strulik 2010). This indicates that reintroducing a moderate tax at 10% should not harm privately-owned German companies. However, to ensure that privately-owned firms are not threatened by illiquidity following a transfer, the amount due will not have to be repaid at once. Instead, it is due within ten years of receipt to give recipients sufficient time to generate returns for the tax owed, while providing financial flexibility in times of financial downturns. If a firm is sold with unpaid inheritance taxes, the outstanding amount will be deducted from the sales price to disincentive the sale of an inherited firm to save taxes. Overall, this proposal would likely preserve economic incentives without financially destabilising privately-owned firms following transfers of ownership.

My proposed taxation applies to firm transfers regardless of the family relation between recipient and donor. Without inequality of opportunity institutionalised into the system, donors are more likely to pick those they deem most capable and motivated for the position even beyond their relatives. Bequests may still favour relatives; however, arbitrary privileges of birth no longer entitle them to preferential tax regulations. In the proposed system people with equal talent and motivation should have more equal opportunities to a given position of wealth and responsibility. As a side effect, companies could be operated by more capable individuals. This proposal could thus have beneficial effects for economic development and increases the degree of satisfaction of the First Condition of Rawls' Second Principle of Justice.

The status quo generates close to no tax revenue through business inheritances (Federal Statistical Office 2019). With expected annual family business transfers of €40bn (Tiefensee and Grabka 2017), a 10% tax could generate €4bn annually and increase the current inheritance tax revenue fluctuating around €6-8bn by 50-65% (Statista, 2020b). In context, the generated excess revenue would be roughly equivalent to the 2020 federal budget allocated to sustaining the German education system (Budget 2020). While the proposal will not eradicate all inequalities arising through intergenerational business transfers, it would likely increase tax revenues for redistribution to the worst-off without threatening the stability of privately-owned firms.

Since the proposal comes closer to giving equally talented members of society access to positions of higher wealth and responsibility, and generates more tax revenues to potentially benefit the least-advantaged, it comes closer to satisfying the Second Condition of Rawls' Second Principle of Justice. If implemented, the proposed system would eradicate the unequal privileges for business inheritance to relatives. Since Germany currently has a system in which reducing a systemic inequality could increase the welfare of the least-advantaged, the status quo qualifies as unjust if we accept Rawls' Theory as a standard of evaluation. I do not claim that the proposal is perfectly just. However, I believe that since it comes closer to satisfying Rawls' Principles of Justice without introducing any obvious downsides, it outperforms the status quo of family business inheritance. Of course, this conclusion crucially rests on the as yet unconfirmed assumption that this proposal works as indicated.

The existing German inheritance taxation incentivises intergenerational business transfers to relatives. I argued that the status quo violates the First Condition of Rawls' Second Principle of Justice, while empirical evidence fails to support the claim that the status quo satisfies the Difference Principle. Since an alternative moderate flat-tax system comes closer to satisfying Rawls' Second Principles of Justice, the status quo classifies as unjust from a Rawlsian perspective, while the proposed system presents a suitable alternative to tax businesses inheritances.

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