Economy of Germany

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is expected to produce $4.2 trillion[1] in 2019 as measured by nominal gross domestic product. The nation is the world's fourth-largest economy following the United States, China, and Japan. To compare GDP between countries, you must use purchasing power parity. Some say that Germany has been flourishing over the past 12 years, as Chancellor Angela Merkel has led the country to robust economic growth and record low unemployment rates.

Germany's Economic Growth StatisticS

In 2017, Germany's GDP growth rate was 2.4% better than it had been in the previous year. Germany's GDP per capita was $46,749 in 2017, better than the 2016 average of $45,923. It is lower than the $53,129 enjoyed in the United States and less than the European Union overall at $36,593.

Before the 2008 financial crisis, Germany's growth was less than 1% per year, for three reasons:

Modernization of Eastern Germany cost $70 billion per year[2] at first. By 2008, spending had dropped to $12 billion.

High unemployment (9.5%) and an aging population (20% aged 65+). That means Germany depletes its Social Security fund faster than it can add to it via payroll taxes.

Germany managed to get its budget deficit below 3% of GDP, as mandated by the EU. It lowered fiscal spending, and the country advocates this method to solve the Greek debt crisis.

Type of Economy

Germany has a mixed economy. It allows a free market economy in consumer goods and business services. However, the government imposes regulations even in those areas to protect its citizens. Germany has a command economy in defense since everyone receives the benefit, while those with higher incomes pay more in taxes. The government provides health care insurance and education. That means you pay into the system according to your income and receive benefits according to your need.

Benefits from Eurozone Membership

Germany benefits from its membership in the EU and its adoption of the euro. Like many other Eurozone members, the power of the euro means interest rates stay low, which has spurred investment.

In fact, many say Germany profits the most from its membership. Its strong manufacturing base means it has plenty to export to other members of the Eurozone and does so more cheaply. That gives German companies a competitive advantage that only improves over time. That creates prosperity, giving German consumers more money to spend locally. As a result, the domestic market recently became a more significant driver of economic growth.

German Chancellor Angela Merkel

Current Chancellor Angela Merkel was a low-key physicist and economic reformer from East Germany. She won the 2005 election by promising reform to lower the 11.5% unemployment rate.

The recession allowed Merkel to successfully push through stimulus efforts and tax cuts. This increased Germany's budget deficit to 3.3%, violating the EU's 3% debt-to-GDP ratio. Merkel had to impose austerity measures such as a sales tax increase and higher taxes on the wealthy. That is why she pushed for similar measures to resolve the Greek debt crisis. Opposition to her leadership delayed resolution, which resulted in its expansion to a Eurozone debt crisis.

The Refugee Crisis

In 2015, 1.2 million refugees[3] from the war-torn Middle East applied for asylum in Europe. Almost 75% were men, and 40% of them were between the ages of 18 and 34. That is likely because of the dangers of making the trip itself. However, that created a problem for Germany.

On New Year's Eve 2016, a gang of young refugees robbed and sexually assaulted more than 600 women. There was a large political backlash. Many countries sealed off their borders to new refugees. As a result, 8,000 migrants were marooned in Greece. The EU signed an agreement with Turkey for them to take back refugees who had reached Greece. In return, the EU would pay Turkey[4] 6 billion euros.

In the September 2017 election, opposition to the refugees cost Merkel's party its majority[5] in the government.

How Germany Overcame Historic Struggles with Unemployment

In 2017, unemployment was 3.8%. That is better than the 7.7% rate during the recession. Germany struggled with high unemployment for historical and cultural reasons.

First, Germany's laws made it difficult to lay off workers and lower wages. Second, the reunification of East and West Germany after the fall of the Berlin Wall heightened unemployment. The economy had to absorb workers from the former Communist bloc. Third, the culture supports saving for a rainy day rather than spending that would boost the economy.

Unemployment would have been worse in Germany were it not for reforms launched between 1998 through 2005. The government subsidized businesses to reduce working hours. That kept people employed during the recession, although only part-time.

Introduction to the German Tax System

The German tax system often has a reputation for being complex as it consists of more than 40 different types of taxes; however, it follows very strict and systematic rules. In addition, the effective tax burden in Germany is lower in various cases than expected at first sight. Individuals and entities can often benefit from numerous exemptions, deductions and depreciation provisions.

The German tax system usually ties in with the residence of the taxpayer. If the latter has his domicile or residence in Germany, residence tax liability concerning his worldwide income is the consequence. For non-resident investors, non-resident tax liability concerning income from German sources results. The same rules apply for corporate entities; concerning corporate tax and municipal trade tax, the registered office and place of management in combination with a permanent establishment are decisive for resident or non-resident taxation in Germany.

Resident taxpayers are generally divided into two groups; the income is either business profit or non-business profit. However, it must be emphasized that non-business profits have to be re- qualified as business profits if certain criteria are met.

Business Taxation

Corporate Entities

a) Taxation of Corporate Income

German corporations such as the GmbH, AG and SE are subject to corporate income tax with respect to their entire income, whereas all income always qualifies as business income. Foreign corporations are subject to corporate income tax only with income generated in Germany (unless their registered office or place of management is in Germany; then the foreign corporation is subject to resident taxation). The corporate income tax rate is 15.8 % (including solidarity surcharge).

A distribution of dividends by a German corporation generally triggers withholding tax of 26.4 % which is creditable at shareholder level or equals the flat tax that is due at shareholder level. For dividend income and capital gains from the disposal of shares held by another corporation, Germany offers 95 % tax-exemption at the level of the shareholding corporation for corporate income tax.

The 95 % participation exemption is to be abolished for dividends received by portfolio investments after February 28, 2013, i.e., such dividends are subject to tax at regular rates. A portfolio investment means an investment where the shareholder holds directly less than 10 % of the share capital of the distributing corporation at the beginning of the calendar year in which the dividend is distributed. The 95% exemption with respect to capital gains on such shareholdings remains unchanged.

In case a foreign corporation is subject to non-resident taxation in Germany, the withholding tax can be reduced to 15.8 % if certain substance criteria are met. Exemption from withholding tax applies to distributions to foreign EU corporations (minimum shareholding of 10 % required). Moreover, withholding tax can be reduced to a lower percentage or be eliminated/refunded according to a respective double tax treaty or an EU Directive. However, in these cases, the foreign shareholding corporation must fulfill certain conditions in order to benefit from such favorable rules (see V. 2. below).

b) Trade Tax

A corporate entity is also subject to German municipal trade tax, as it is deemed to generate business income. Businesses which do not have their registered office or place of management in Germany but earn income which is allocated to a German permanent establishment are also subject to a municipal trade tax at a rate of 7 % to 17.2 % (average rate approx. 14 %), depending on the location of the permanent establishment.

For dividend income and capital gains from the disposal of shares held in another corporation, Germany offers tax-exemption for trade tax purposes by excluding this income from the trade income, resulting in an effective tax burden of only approx. 1.5 % for this income (so-called Schachtelprivileg). However, the exemption of dividends for trade tax purposes requires a minimum shareholding of 15 % at the beginning of the fiscal year.

The overall combined tax rate for corporations is approx. 29.8 % for corporate income tax and trade tax.

Taxation of Partnerships

a) Taxation of Income

German partnerships are the civil law association (GbR), the general partnership (OHG) and the limited partnership (KG). All assets, liabilities and income of a partnership with regard to taxes are allocated to the partners in proportion to their partnership interest (transparency of the partnership). However, the possibility of offsetting losses generated by a KG at the level of a limited partner is generally restricted to the amount of the respective committed equity.

Partnerships can either obtain business income or conduct private asset management. For business income, the general rules apply; all income related to the business is qualified as business income. Partnerships that solely conduct private asset management (generating interest, dividend income, lease income and capital gains) do not earn business income, except for partnerships that generate deemed business income due to their structure (general partner is a corporation and no managing limited partner).

Exemptions are made for the taxation of dividend income and capital gains. Dividend income and capital gains resulting from a disposal of shares in a corporation are 40 % tax-exempt and 40 % of related costs are non-deductible (so-called Teileinkünfteverfahren). Interest income is not tax-exempt and related costs are fully deductible.

The tax rate for partners is equivalent to the tax rates for individuals (see III.1. below).

b) Trade Tax

If a partnership conducts business activities, the entire income of the partnership is qualified as business income (i.e. also the income from non-commercial activities) and is thus subject to trade tax. To a large extent, the trade tax burden can basically be offset with the personal income tax liability of an individual partner in proportion to its equity interest in the partnership.

Anti-Avoidance Rules/CFCs Legislation

In order to prevent the misuse of legal forms, the use of proxies, tax havens and treaty/directive shopping, Germany has passed the Foreign Transaction Tax Act (AStG). The act gives tax authorities the right to ignore abusive and artificial circumstances which would lead to an untaxed constellation.

Taxation of Individuals

Resident Taxation

An individual with residence or domicile in Germany is subject to resident taxation, meaning the worldwide income is taxed in Germany, supplemented by a solidarity surcharge. Taxable events are exclusively enumerated in the German Income Tax Act (EStG), e.g., income of business, rental income, income from personal services (self-employed or employed), certain other taxable events listed in the act and capital income.

Income of individuals generated personally is currently (2013) taxed at a rate starting at 14.0 % (taxable income from EUR 8,131 to EUR 13,469), increasing proportionally up to 23.97 % (taxable income from EUR 13,470 to EUR 52,881). The marginal rate for taxable income from EUR 52,882 to EUR 250,730 is 42.0 %; for taxable income of EUR 250,731 and more, it is 45.0 %. A solidarity surcharge of 5.5 % is added on to the respective tax rate.

For certain categories of interest income, dividend income and capital gains, a flat tax rate of 26.4 % (including solidarity surcharge) applies (so-called Abgeltungsteuer). Expenses and costs effectively connected with such capital gain are not deductible from the flat rate tax base. Flat rate taxation is not applicable but regular taxation applies in the following circumstances:

The financial assets generate business income and are thus qualified as business assets.

With respect to interest income: the borrower is a corporation and the lender holds at least a 10 % shareholding or is a related party of the borrowing corporation.

With respect to capital gains: the shareholder has a shareholding in a corporation of at least 1 % at one point in time within the last five years.

The taxpayer can opt for standard taxation instead of flat rate taxation concerning dividend income in cases of:

shareholding of at least 25 %; or

shareholding of at least 1 % and employment by the corporation (typical MBO structure).

Trade Tax

Business income of an individual (sole proprietorship) is subject to trade tax; however, the trade tax burden can largely be offset with the personal income tax liability.

Non-Resident Taxation

If an individual is not subject to resident taxation, i.e. has no residence or domicile in Germany, but has income from a German source, he is usually taxed in Germany. The following list specifies the types of taxable events regarding non-resident taxation:

business income to the extent of the business activities that can be allocated to a domestic permanent establishment or a permanent agent;

rental income from domestic real estate;

(if not already included in business income) capital gains resulting from the disposal of domestic real estate, except if the real estate does not qualify as a business asset and was held by an individual or non-business partnership for more than ten years;

income from personal services which are utilized in Germany and provided by individuals (self-employed or employed) or entities;

capital gains resulting from the disposal of shares in a German corporation (minimum shareholding of 1 % at one point in time within the last five years required);

dividends and liquidation proceeds received from German corporations;

performance-related interest income paid by German debtors and capital gains derived from the disposal of such instruments;

Certain other (non-performance-related) interest income (including capital gains) if the debt instrument is registered in Germany or secured by domestic real estate.

Sometimes double taxation results from such cases. The solution for this issue will be described in the section dealing with double taxation (see V.2. below).

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