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Why a Reform of the German Corporate Tax System Is Urgently Needed

The current crises have led to a debate about the future of Germany's business model and German industry. Rising energy prices, disrupted foreign trade, and the US IRA subsidy program raise the question of what needs to be done to maintain Germany's competitiveness as a location for companies and highly productive jobs.

Taxes on corporate profits are an important location factor. Tax cuts generally cause short-term revenue losses for the government; however, they can improve the conditions for investment in such a way that stronger and more productive economic activity will increase tax revenue later on.

Opportunity to Reform Corporate Taxes Was Missed

Unfortunately, German tax policy has neglected this for years – the last major reform was in 2008, when the German government lowered the tax rate on retained corporate profits from 38 to 30 percent. This significantly improved the country's position in international tax competition. Among the G7 countries, only the UK had a lower tax rate immediately after this decrease. Since then, however, the other countries have also reduced their corporate taxes, while Germany has remained passive. The result: in 2022, our tax rate was the highest among the G7 countries.

Germany's passivity extends beyond its failure to respond to global tax competition: politicians also persistently ignore the need for reform to the structure of the tax system. This is particularly striking in the case of corporate taxes. Germany currently has three taxes on corporate profits: corporate income tax for corporations, personal income tax for partnerships, and a business tax levied by local authorities. The latter accounts for around half the burden on corporate profits.

Business Tax under Construction

The local business tax has serious weaknesses. It is unsuitable as a municipal tax because its revenue depends on economic cycles and fluctuates strongly. In economic crises, the revenue of cities and municipalities regularly slumps, which usually leads to municipalities reducing their investments. This is also harmful to the economy as a whole.

In addition, revenue is distributed highly unevenly. In 2019, Wolfsburg had per capita business tax revenue of 1,231 euros, while in Gelsenkirchen it was only 273 euros, and in many rural communities even less. In addition, the business tax unnecessarily complicates the tax system. In the case of partnerships, the business tax is first collected at great expense and then refunded at a flat rate. In initiatives to coordinate business taxes in Europe, for example through common tax bases, the corporate tax is an obstacle.

Replacing the tax is politically difficult, because this must go hand in hand with a reform of municipal finances. But there are convincing concepts for doing so. For example, the business tax could be replaced by a surcharge on corporate income tax and a share in local wage tax revenue.

Transformation of the Economy Needs Modern Tax Legislation

There is a need for action on corporate taxes, not least against the backdrop of the current economic transformation. Digitalization, decarbonization, and demographic change pose major challenges for the economy. Many companies need to change their business model, make significant investments, and take risks.

Current tax law does not provide the right framework for this. Risky investments require reliable tax relief in the form of loss offset. In Germany, however, this is severely restricted, which discriminates against risky investments and start-ups. The government often promotes research and development through complicated programs with high application costs. For many SMEs in particular, the time and effort this requires is too high. It would make sense to redirect these funds and expand tax-based research funding that involves less red tape.

Current Plans Fall Short

One positive is that the traffic light coalition wants to improve depreciation rules. However, according to the coalition agreement, this is to be limited to investments in climate protection and digital goods. Policymakers should reconsider this restriction and promote investments more broadly – if fiscally necessary, then less intensively.

Accelerated depreciation means that tax revenue is not lost, but rather is transferred into the future. The government participates in the companies as a silent partner, so to speak. The increasingly restrictive lending policies of banks make the financing effects of accelerated depreciation all the more important.

Against this backdrop, the fact that the Federal Ministry of Finance is now considering a "Competition Strengthening Act" with additional measures is good news. Because whichever way you look at it, there is no longer any excuse for putting off fundamental reforms to corporate taxation.

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