June 23, 2022

°237

Eight Reasons Why an Excess Profits Tax Is Not a Good Idea

There are currently increasing calls to impose a special tax on the rising profits of energy companies, also known as an excess profits tax. These companies are accused of profiting from the war in Ukraine, which has led to a shortage of energy supplies and sharply rising prices. Some politicians are stoking the mood by speaking of "war profiteers" and a "tax on greed."

Historical models for special taxes on corporate profits can be found during the two world wars. At that time, the United States and the United Kingdom levied taxes to skim off war-related profits and to help cover the burdens of war.

Tax for Crisis Winners: Italy as a Model?

Does it also make sense in the case of less serious crises to levy special taxes on the profits of companies that profit from those crises? Italy recently introduced a special tax on energy companies. However, it relates primarily to the months before the Ukraine war, when energy prices were already rising. There, it is not the profit that is taxed, but the increase in value added. Value added is the difference between sales and expenditure on intermediate inputs. Wage payments are therefore included in the tax base, as are profits. The value added in the period October 1, 2021 to March 31, 2022 is compared with the value added in the same period one year earlier. The difference is subject to a 10 percent tax rate, but only if the increase is at least 10 percent and exceeds EUR 5 million.

Eight Reasons against an Excess Profits Tax

Should Germany follow suit? For the following reasons, this is not a good idea:

1. Profits of companies benefiting from the current crisis are already taxed in Germany, initially at a rate of around 30 percent; when distributed to shareholders, the total burden rises to around 48 percent. Those who make high profits also pay high taxes, and vice versa. Why an additional tax should be necessary or fair is unclear.

2. At first glance, it seems at least fiscally attractive to surprise companies with a special tax, because they cannot avoid this tax. In Italy, the tax even has a retroactive effect. In fact, however, such a move serves to increase uncertainty in tax law. Investors price in for the future that they can be surprised at any time with a special tax. German corporate taxes are already very high by international standards. An additional excess profits tax would make investing in Germany even less attractive.

3. The prospect of high profits due to scarcity is an important incentive for companies to recognize emerging supply crises and make provisions for them. Although such preparations are often denigrated as speculation, they are very useful for society as a whole, because otherwise the supply problems would be even greater in the event of a crisis. High profits also lead other companies to enter the market. This improves supply, bringing prices as well as profits back down. Special taxes impair these market signals.

4. Energy companies are accused of making immoral profits from the war in Ukraine. But energy prices had already risen sharply before the Ukraine war – for the profits of energy companies, this factor is probably more important than the Ukraine war. Regardless, opinions diverge on which businesses are morally more or less valuable – another reason why it makes no sense to impose special taxes on this basis.

5. The rise of energy prices relates also to the fact that in recent years companies from Western countries in particular have invested less and less in the extraction of fossil fuels, partly because there was great political pressure to reduce these investments. The companies that foresaw shortages, took on risk, and invested, despite political pressure to the contrary, should not now face reproach. Their gains are deserved in that without these investments, the shortages would be even greater.

6. Tax systems do not usually make the tax burden dependent on why income or profit was generated, or whether profits were generated more through greed or through nobler motives. In fact, profits are made for many reasons – for instance, because a company happens to manufacture a product that is suddenly in high demand, as was the case for face mask manufacturers when the coronavirus pandemic broke out or for online retailers. But profits are also made because companies have worked hard and taken risks to provide their customers with products that are particularly important to them. Profits can also accrue when companies form cartels. In this case, however, they are breaking the law; rather than having to pay special taxes, they must expect penalties and possibly pay damages.

7. Profits are mostly taxed uniformly across all sectors. There are exceptions, for example in the case of oil-producing companies in the UK, but these exceptions are not time-limited and have to do with those companies' special rights and obligations. Current perceptions of fairness or the special interests of individual politicians, parties, or public sentiment are not relevant to taxation. Equal treatment of all taxpayers is important to protect them from unfair burden and arbitrariness.

8. Incidentally, it is contradictory to first drive up oil companies' profits by lowering gasoline taxes and then call for those profits to be skimmed off again with other taxes.

Steer Clear of Tax Policy Populism

It is understandable that in an extreme situation such as the two world wars, armaments companies in particular were subjected to increased taxation. However, the situation in Germany today does not compare. Technically, it is possible to levy special taxes on energy companies, as the case of Italy shows. However, the tax would worsen the prospects for future investments in Germany and lead to a wave of schemes to avoid such special taxes. The widespread claim that such a levy would serve tax justice is misleading. Rather, it would be an expression of arbitrariness. Why not apply a special tax to manufacturers of Covid vaccines or digital companies, which benefited from the coronavirus pandemic? Or at least to DIY and furniture stores or bicycle manufacturers, which have also done well? Imposing special taxes when shortages emerge and it is popular to antagonize the suppliers of the affected products is incompatible with fair and efficient tax policy. Germany should steer clear of this.

Clemens Fuest
Professor of Public Economics and Finance
President of the ifo Institute

Published under the title "Warum eine Übergewinnsteuer keine gute Idee ist", Handelsblatt, June 10, 2022