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Why We Need to React to Trump*

US President Donald Trump began 2018 with a tax policy bang: he announced massive tax cuts in the US, with tax rates on corporate profits falling from 35 percent to 21 percent. With this reform Trump wants to encourage companies to invest more in the USA and to post a greater share of their global profits there.

In Germany the US reform has given cause for concern; and rightly so given that the last major changes to corporate taxation in Germany were made 10 years ago. Since then the approach to tax policy has been to let sleeping dogs lie. In view of the positive developments in the German economy, German politicians saw no reason to give any thought to taxation conditions and Germany as a business location.

Corporate profits in Germany are taxed at 15.8 percent, including the solidarity surcharge. On top of this, companies also have to pay a municipal trade tax. In 2008 the average collection rate was 388 percent. This figure has now increased to 400 percent. Combined with a trade tax base of 3.5 percent this translates into a tax rate of 14 percent. When combined with the corporate tax, this leads to a total corporate tax burden of roughly 30 percent. In major cities like Munich, this figure is as high as 33 percent.

In view of the massive tax cuts in the USA, this raises the question of whether Germany is still well positioned in global tax competition. In addition to the USA, France and Belgium both posted higher tax rates than Germany of 34 percent respectively in 2017. France intends to gradually reduce its tax rate on companies to 25 percent by 2022, while Belgium also plans to cut the rate to the same figure by 2020. Other countries in Europe have been even more aggressive about tax competition. Britain, for example, will cut its present tax rate of 20 percent to 17 percent by 2021.

What does this mean? If Germany does nothing it will soon impose the highest tax burden among the world's leading industrialised countries. This, in turn, will mean that companies will relocate profitable investments, and the jobs related to them, abroad. They will also use scope for tax planning to post profits abroad, make their costs in Germany as high as possible and reduce their profits. Studies show that a tax rate differential of 10 percentage points to other countries on average leads to an international outflow of around 8 percent of corporate profits posted domestically.

But what changes should be made to German taxation policy? The German government's coalition agreement proposes to introduce an EU wide lower threshold for the corporate taxation rate. This could ultimately even involve tax increases, which would be counterproductive as a response to tax

cuts in the USA. In fact, it would make sense to do the opposite. We need to cut tax rates, as well as take measures to combat profit shifting and tax avoidance.

Formulating a response to US tax reforms at a European level, however, would be a bad idea. Tax policy decisions are taken unanimously in the EU and if reforms are implemented at all, the groundwork for them often takes years.

That is why Germany needs its own strategy. This could, of course, be jointly developed with France. In this case the French government has taken a sensible line by proposing a gradual and moderate tax cut to 25 percent. Germany's new government should follow suit and reduce corporate tax from 15 percent to 10 percent. In combination with the trade tax, this would also lead to an overall tax burden of 25 percent. Tax policy in Germany also needs to encompass major private companies, who pay personal income tax. Such firms can currently declare retained earnings as so-called accumulated retained earnings and tax them at 28.25 percent. When distribution to shareholders occurs, the latter are taxed just like dividends of incorporated companies. This means that the tax burden is similar to that of incorporated companies. Taxation of accumulated retained earnings can be reduced to 25 percent as well.

A widespread objection to corporate tax cuts in Germany is that they would fuel tax competition. This objection is based on the illusion that other countries will not reduce their taxes if Germany remains silent. But this is not the case. Germany's passivity in recent years has not prevented the USA, France or Britain from implementing tax cuts.

The fact is that Germany is simply too small to exert any major influence over global taxation policy. To do nothing about competition and watch profits and investments flow out of the country would do damage to the German economy.

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