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Excess Profits Taxes

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Excess Profits Taxes

Summary

The economic shockwaves caused by the Covid-19 crisis and Russia's attack on Ukraine have fuelled the discussion about an excess profits tax. The Advisory Board strongly advises against introducing an excess profits tax. Attempting to approximate excess profits through heuristics leads to arbitrary charges and distortions in the production structure. The current debate often overlooks the fact that almost all economic activity is subject to substantial fluctuations. Profits in some years are offset by losses in other years. Taxing above-average profits in good years would reduce market entries and thus the overall level of economic output. Temporarily high profits have a fundamental steering effect in a market economy. They lead to more resources being directed to these areas, thereby alleviating shortages. Taxing above-average profits would prevent this redirection effect and consolidate the shortages in the long run. In particular, an excess profits tax can be

fatal to an economy's innovative strength. Innovation races typically generate many losers and a few winners. With a good design, this type of competition benefits society. If the profits were taxed away ex post, there would no longer be an incentive to participate in these productive innovation races ex ante. Moreover, ad hoc taxation of individual activities would destroy much of the long-established trust in the rules-based nature of the German tax system. In particular, promises never to use such special taxation arrangements again would hardly be credible. Although current plans for the further development of corporate taxation in the direction of net profit taxation are actually aimed at subjecting large international corporations to appropriate taxation, they contain elements of excess profits taxation. However, the planned further development of corporate taxation goes hand-in-hand with a smaller tax base and would result in a loss of tax revenues.

1. Historical examples and current proposals

Recently, there have been numerous calls for an excess profits tax on surprisingly high profits of companies. Currently, the focus is on energy companies, under the assumption that they have profited from the rise in oil and gas prices. The same applies to defence companies, whose business environment and demand prospects have improved as a result of a reassessment of the international security situation. During the Covid-19 crisis, demands were made to make companies that profited from developing a vaccine pay up, or to subject online retailers such as Amazon to an excess profits tax as “crisis profiteers”. The same argument – in slight variations – crops up again and again, especially in times of crisis.

Excess profits taxes have historically been levied mostly during wartime or in the immediate aftermath of war. France, the United Kingdom and the US introduced such a tax during World War I and World War II.¹ In order to determine the excess profit, a hypothetical normal profit was defined by the legislator. This was done either by setting a normal rate of return, which in the US for example was defined as 7–9% on capital employed, or by calculating the average profits of a number of “pre-war” years at the level of the individual company. In the US, the tax rate was as high as 95% from 1943 onwards.²

Even in peacetime, there were occasionally selective taxes on profits, especially after large price shocks. In April 1979, President Jimmy Carter announced an end to price controls on US-sourced crude oil, but linked this deregulation to a proposal

for a tax on the “windfall profits” that resulted (Tolchin 1979). The tax on domestic oil was imposed from 1980 to 1988. It taxed the difference between the market price and a base price set using 1979 oil prices adjusted for inflation. The effective tax rate ranged from 15% to 70% depending on daily production volume, age of the production facility, and type of oil produced (Thorndike 2005).³

There are also currently concrete proposals for an excess profits tax; in some cases, such a tax has even already been implemented. The UK introduced an Energy Profits Levy in May 2022. This is intended to impose a 25% surtax on excess profits in the oil and gas sector (HM Revenue & Customs 2022). The European Commission (European Commission 2022a) recommends that member states impose a temporary tax on supernormal profits to finance measures taken to cushion the price shock to households and industries that are particularly affected. However, the European Commission also cautions that the measures, including the special tax, must not result in energy companies being unable to recoup their costs or destroy price signals to reduce CO₂ emissions. Romania already passed a law in October 2021 that imposes a tax on excess profits on electricity producers using non-fossil energy sources, with 80% of revenues from electricity prices above a statutory limit being taxed (CMS Law-Now 2021). Italy has introduced a special tax for companies in the energy sector; increased revenues in the period October 2021 to April 2022 – determined in comparison with the same period of the previous year

1 Moreover, during World War I, Australia, Austria-Hungary, Canada, Denmark, Germany, Italy, the Netherlands, New Zealand, Russia, Spain, Sweden, and Switzerland, among others, introduced such a tax (Keen and Slemrod 2021, 225).

2 For a more detailed description of historical examples, see Wissenschaftliche Dienste des Deutschen Bundestages (2021).

3 In the historical examples of excess profits taxes, the introduction was driven by sudden price changes. Large segments of the population perceive such price changes as unfair even compared with other rationing mechanisms such as first-come, first-served or government allocation procedures that address the same scarcity problem (Frey and Pommerehne 1993).

– will be taxed at 25%.⁴ Spain attempted to impose an additional tax on energy companies as early as 2021, which ultimately failed due to political opposition from utilities (Chee and Abnett 2022). In the US, Democratic Senators Sheldon Whitehouse and Ro Khanna introduced a bill in March 2022 that would tax 50% of oil company profits beyond \$66 per barrel, the average price from 2015 to 2019. The proposed legislation is modelled on the aforementioned Crude Oil Windfall Profit Tax Act, which was passed in 1980 under President Carter (Blackmon 2022).

Even more than in other tax policy debates, the current discussion about a profit tax mixes value judgments and considerations of fairness, distributive justice and tax justice with conceptual questions of the tax system as part of an efficiency-oriented state revenue policy. To many, it seems “unfair” or “unreasonable” when individuals accumulate substantial wealth without any discernible efforts or special achievements preceding these increases. This is all the more true when such inflows occur in the context of business areas and actions that are perceived to be related to the suffering of others. This may explain the popular calls for a special tax on such increases in wealth. Politicians must adopt a position on such questions of justice and make sociopolitical decisions on issues of allocation and redistribution.

However, it can be questioned whether taxing companies is the right approach for such a distribution policy. Companies are not human individuals. Redistributive policies are usually justified on the basis of income differences between individuals. This reasoning does not make sense for corporate firms. Moreover, corporate taxes often have pass-through effects that are not easy to determine in terms of direction, e.g. to employees, customers, or suppliers, so it is unclear whether this

tax burden reaches the owners.⁵ After all, even if the tax succeeds in taking revenue away from companies, it ultimately takes it away from their owners. Whether the distributional implications of such measures are to be judged socially desirable depends primarily on the ownership structure, i.e. on the question of who owns companies and to whom profits and losses accrue. In partnerships, the relationship between corporate profits and the personal income of the shareholder is still apparent. Where corporations are concerned, it usually remains unclear whether a special tax on their profits will affect small savers and pensioners with their life insurance policies and retirement funds, or individuals in Germany or abroad with net assets worth billions. A redistributive tax policy geared to questions of fairness must therefore focus much more precisely on the incomes of natural persons.

In the area of corporate tax policy, there is much to be said for a rational tax policy that aims to have as little negative impact as possible on economic activity and the emergence and development of economic power. This paper undertakes such a classification and assessment of a taxation of extraordinary corporate profits, oriented towards allocative aspects of corporate taxation.

4 <https://www.zdf.de/nachrichten/politik/energiekrise-italien-uebergewinnsteuer-draghi-100.html> and Wissenschaftliche Dienste des Deutschen Bundestages (2022).

5 The corporate tax can also place a burden on the employees of the taxed firms. Fuest et al. (2018) show that about half of the profit tax burden in Germany is passed on to employees in the form of lower wages.

2. Basic idea: efficiency of taxation of a pure rent

Fiscal theory recommends levying taxes primarily where taxpayers' evasion reactions are as small as possible. From an efficiency point of view, the ideal tax is one where taxpayers do not show any evasive reactions. In this case, every euro lost due to tax payments is matched by a euro in tax revenues for the state; welfare losses do not occur.

The textbook example of this is the taxation of genuine economic rents such as land rent: for example, if a property has a particularly favourable location on a beautiful lake, the owner accrues use benefits. If the state can tax such rents on the use of land, the current owners of the lake property cannot avoid this taxation. Nor will the number of such preferred lakefront properties usually be changed by the tax. The owner will not give up the use of the property because of a property tax on the land on which the property is located. They will not even change the intensity or type of use. The sale of the real estate is also not a purposeful evasive reaction because the new owner will then have to pay the same tax and will therefore only

offer the old owner a purchase price reduced by the amount of tax. In this example, the state demands a contribution from the land owner, regardless of how the land is used.

The same could apply to genuine corporate profits ("net profits," i.e. taking into account all costs, including return on equity). If the state succeeds in imposing a tax on such genuine corporate profits, entrepreneurial activities will not change. With or without tax, the entrepreneur will produce the same range of products with the same input from production factors. What maximises net profit in a world without a profit tax will also maximise profit for the entrepreneur if the government diverts some of that profit to itself with a tax. As will be shown below, the attempt to identify pure profits and tax them while avoiding evasive reactions runs up against very narrow limits.

3. What are excess profits?

But what is meant by such net profits, or “excess” profits as they are called in the current discussion? In production theory, profit is defined as the amount by which a company’s revenues exceed its costs. To determine true economic profits, one must apply an appropriate concept of costs and also measure costs and revenues correctly. The costs of the enterprise also include, for example, depreciation, the opportunity costs of using input factors, such as the equity capital of the enterprise, and the entrepreneurial labour input.

It is important to distinguish such net profits from other definitions of profit under tax law. In the determination of profits for tax purposes, parts of the revenues are attributed to the entrepreneur as profit that are actually only compensation for the costs incurred by the company. Examples of this include the opportunity costs of the capital used in the company and the efforts and endeavours of the entrepreneur that are not directly compensated financially. The actual costs of the enterprise often differ from the factor charges considered in the determination of taxable profit. If the revenues exceed the actual costs, one could speak of excess profits; in economics terminology, these are called economic profits, net profits, or rents.

In functioning competitive markets, competition among firms ensures that excess profits do not occur systematically in the longer term but largely disappear on average. In the shorter term, shocks such as the Covid-19 pandemic or frictions caused by the war in Ukraine, such as supply bottlenecks, the disruption of supply chains, sanction-related interruptions in trade relations, or abrupt changes in demand, can rapidly change the ratio of revenues to costs. Some companies may quickly find themselves in a predicament that threatens their very existence. Other companies temporarily

generate extraordinary revenues; these surpluses are referred to as excess profits in the current debate.

In practice, the excess profit is almost impossible to define. Therefore, revenue and price comparisons with the previous period are often used. An excess profit determined in this way depends heavily on the choice of the reference period. For example, in the above-mentioned American bill for an excess profits tax on oil companies, the 2015–2019 oil price is taken as the reference value. If the years 2011–2015 were chosen instead, when the oil price was significantly higher, no excess profits would be reported (see Figure 1).⁶ Second, companies are often allowed a certain return on capital. Only a company’s excess profits above that level are partially skimmed off with the tax. The second approach comes closer to the economic definition of profits. However, its practical implementation has undesirable side effects.

⁶ Brümmerhoff (1975) already pointed out the arbitrary delimitation of “excess” profits.

Fig. 1: Price trend for crude oil (Brent) in the 2006–2022 period (in US dollars per barrel)

First, the return on investment differs greatly between different industries. According to the Bundesbank (2021), in 2018 the trade sector reported a net profit (plus interest expenditure) of 5.8% of total assets, while in the construction sector this figure was 3.8%. These differences in return on capital have several possible causes. For example, they include industry-dependent risk premiums. Such a definition of excess profits would thus treat companies from different industries differently. Other approaches focus on returns on sales. The question that arises with these methods is whether such ratios permit accurate and legally secure discrimination, and how this should be assessed with regard to subsidy controls under European law.

Second, this definition allows companies to take evasive action (at least if such tax rules apply to future profits rather than retroactively). Suppose

companies know that a return on capital in excess of a certain percentage will be partially or fully skimmed off. In that case, they can modify their financing structure, production structure, shareholding ratios, and the sectoral composition of the various subsidiaries in such a way that their return on capital hardly shows an excess return. For example, the higher the company's capital stock, the more profit the company is allowed to make without being penalised by regulators or tax authorities with a tax on the excess profit or excess return. This creates incentives for excessively capital-intensive production, as is also known from the theory of return regulation of public firms (Averch and Johnson 1962). An excess profits tax structured in this way is no longer a neutral tax on rents. It evokes evasive reactions, which then lead to welfare losses because regulated firms, in order to save taxes, deviate from cost-minimising behaviour.

Even if the practical accounting problems can be overcome, the question arises as to whether the profits determined in this way actually represent excess profits and what the effects of taxation would be. This is discussed in the following section.

4. Excess profits in an ex post and ex ante analysis

4.1. Excess profits as an incentive to enter the market and profit fluctuations

Entrepreneurial activity typically takes place in an uncertain environment. The factor prices of production are subject to random fluctuations, and the demand for a company's products is also subject to such fluctuations. Possible interruptions in the production process due to technical reasons, labour disputes, uncertain adjustments in the regulatory framework, payment defaults, or pending lawsuits are other reasons why a company's profit cannot be precisely predicted. Given these uncertainties, a company will base its market entry and exit decisions and the scope of entrepreneurial activity primarily on its expected profit. For entrepreneurial activity to be attractive, the expected revenue must at least cover the imputed costs (including a return on capital measured by opportunity costs and a management salary etc.). A company which, based on this definition, does not generate a positive expected profit will (have to) cease operations in the long run. In the random ups and downs of the business cycle, however, there will inevitably be periods with "excess" profit and periods with "insufficient" profit.

From an economic perspective, it is desirable that the company expands its activities, or that additional companies enter the market in the case of a high expected profit, while in the case of unsatisfactory profit expectations, companies should relocate their activities or exit the market in question.

If the state were to argue in the periods of "excess" profit that this excess profit was unjustified and should be skimmed off for tax purposes, the entrepreneurial calculation would no longer add up. The expected after-tax profit would become negative, even if the expected pre-tax profit were zero or positive and this entrepreneurial activity was desirable. Entrepreneurial activity would be dampened.⁷ Empirical evidence confirms the negative effect of an excess profits tax. Rao (2018) examines the 1980 windfall profit tax on US oil producers. The tax was levied on the difference between the market price at the time and the price of a reference period, similar to the proposals currently under discussion. Rao shows that a tax that reduced profit per unit sold by 10% reduced US oil production by about 3–4%.

⁷ The existing taxes on profits have similar effects to the extent that the option to offset losses is not fully available.

In addition, prices set market signals and guide entrepreneurial behaviour. Rapidly rising prices, as currently observed in many markets, signal changes in scarcity conditions – for example, because supply has collapsed as a result of military conflicts or destruction caused by natural disasters, or because demand has increased. The increased prices and the resulting profit expectations provide incentives to expand production capacities precisely where shortages are particularly severe. Such adjustments are highly desirable from an economic perspective because they direct the economy's scarce resources to uses where they add the most value. An excess profits tax, which taxes away all profits resulting from the higher price, would destroy precisely these incentives to expand capacity or enter the market.⁸

These considerations can also be applied to events and shocks that are unlikely and non-recurring, as was the case with some of the shortages and “excess” profits observed in 2020 and 2021. Examples related to the pandemic include markets for respirators, for surgical masks, and for drugs. In the context of the war in Ukraine, the oil and gas sector and defence companies are likely to benefit.⁹ Figure 1 shows the very long cycles in the oil market. A boom phase between 2011 and 2015 was followed by a difficult phase for the oil industry. The Ukraine crisis interrupted this long difficult

economic phase, at least temporarily. The defence industry is also subject to very long-term fluctuations, which have their roots in changes in the global security architecture and national political attitudes toward defence equipment and defence markets, among other things. A similar case can be made for merchant shipping, which for many years had to contend with considerable overcapacity and correspondingly low freight rates and corporate losses. Generally speaking, during difficult phases companies have to decide whether to give up or to remain active in the market and wait for better times. If it were foreseeable that “excess” profits would be skimmed off by the state in subsequent boom years, far-sighted companies would have no choice to leave these markets. It would not pay to hang on during difficult phases. Conversely, economic policy would also indicate that the state should hold back on aid as far as possible when such industries are in a downward phase.

4.2. The competition for innovation rents

A similar economic assessment applies to “excess” profits that arise because many entrepreneurs fail at market entry, but some become “unicorns” or even corporate giants. This can be illustrated by the race between pharmaceutical companies during the pandemic. Several companies engaged in an international race to develop a vaccine against SARS-CoV-2. Within a short period of time, several vaccines were developed, licensed, produced, and used. From an ex ante perspective, the question for each pharmaceutical company was whether to enter the race. From an economic point of view, the ex ante evaluation of profitability was influenced by the expected number of competitors, a company's assessment of its innovative capacity and speed compared with its competitors, the company's assessment of the technological possibilities for a vaccine, the general conditions under patent law, the behaviour of governments as buyers, and other competitive parameters that play a role in such a race. The race for a vaccine was a patent race from which a few emerge as winners and

8 The same applies to long-term changes in the environment that lead to sharply declining profit expectations in an industry. In this case, it is desirable to redirect the economic production resources from this industry to other industries with better profit expectations. To achieve this, changes in profit expectations must reach the companies as signals, and permanent government subsidies must not absorb these lowered profit expectations. One of the difficulties and challenges of entrepreneurship is to anticipate fluctuations in profit. Even rare events and random shocks must be included as contingencies in the entrepreneurial calculus and the company must be optimally equipped for them. Suppose the excess profits and the shortfalls from a changing business environment are not absorbed by the state. In that case, the market economy's welfare-enhancing effect can come into play and direct society's means of production into the areas where they eliminate scarcities and generate the most significant added value for the national economy.

9 Contrary to popular belief, however, 85% to 100% of the fuel discount introduced for a limited period on 1 June 2022 was passed on to customers (ifo 2022).

many other companies suffer only losses. The losers remain mostly unmentioned in the current discussion about excess profits. Only the winners and their substantial profits are in the public eye.

The theory that analyses such races predicts that the sum of the expenses of all the companies competing with each other accounts for a significant share of the winning premiums. The exact share depends on the competition parameters already mentioned. If one reduces the attractiveness of winning for the winning companies by imposing additional taxes on the winning premium, and if this intervention is anticipated by the potential participants in the race, fewer competitors will enter the patent race, and the efforts of the participating companies will tend to decrease. This may be desirable if the number of competitors entering the race is too large in the initial phase, their efforts lead to mere duplication of research or lead to a rate of innovation that is too high or too costly compared with the resulting public health or economic benefits. However, the government intervention can also be harmful to the national economy if, in the initial phase without fiscal intervention, too few companies participate in the race or make too little effort.

What determines whether innovation races run efficiently, whether the potential winning prizes induce too much or too little or the right type and diversity of innovation effort, is the subject of a broad literature that has its starting point in pioneering work by Loury (1979), Lee and Wilde (1980) and Dasgupta and Stiglitz (1980), among others. These and many subsequent works show that the course of such races is determined by many factors.¹⁰ Government intervention can influence innovation events through the design of patents or patent law in general, through

instruments of competition law, and through other economic policy instruments. Such interventions are presumably much more suitable than the taxation of “excess” profits of companies that have won an innovation race.

Taxation theory has paid considerable attention to the issue of the effect of government participation on positive and negative deviations in risky corporate profits through a tax on volatile corporate profits. Domar and Musgrave (1944) formulated the influential initial hypothesis that a government that participates in corporate losses and profits provides an economically desirable insurance service. It is argued that government participation in profits and losses reduces net entrepreneurial risk and may thus motivate entrepreneurs to expand their risky business activities. Meanwhile, the reasoning that corporate taxes have a welfare-enhancing effect because of government risk sharing has been questioned in a world with functioning capital markets. Under these conditions, unsystematic risks are already optimally diversified so that no further risk consolidation is to be achieved by profit taxes (Bulow and Summers 1984, Konrad 1991). Under imperfect capital markets, especially in a world of asymmetric information with entrepreneurial moral hazard, government taxation of risky entrepreneurial activity can lead to a reallocation of resources. For example, taxation can stimulate risky investment (see chapter 7). The effects of taxation can also be economically detrimental, even if the state shares losses and profits in a completely symmetrical way.¹¹

The winners of risky innovation races already have to pay part of their premium for winning the race as corporate tax under “normal” taxation. However, under the existing taxation system, the state does not share equally in the losses of unsuccessful competitors because of considerable restrictions on the use of tax losses. The often considerable

10 Konrad (2009) points to the wide variety of relevant aspects of such races and their implications for competitive equilibrium. Specific works on, for example, the incentives to duplicate or the incentives to pursue different promising research approaches include Erat and Krishnan (2012), Konrad (2014), and Matros and Smirnovic (2016).

11 See Buchholz and Konrad (2000), who also provide a literature review.

expenditures for innovations lead to tax losses for these companies. Companies that participate unsuccessfully in the race cannot adequately offset these losses for tax purposes. This is the case, for example, when the entire company goes bankrupt as a result of a failed innovation effort. In a reversal of the often-quoted slogan of “privatising profits and socialising losses”, the opposite often occurs in innovation markets: profits are partially socialised via the state’s tax participation in profits, while losses often remain largely with the private innovators. Even without a one-sided excess profits tax, standard taxation of profits already has a distorting effect on the willingness to engage in risky innovation activity (Buchholz and Konrad, 2000, pp. 82–86). A one-sided excess profits tax would further exacerbate this problem.

The high profits of firms that emerge victorious from an innovation race and now hold patents or other forms of intellectual property may be seen as unfair, unjust, or excessive. This is especially the case when the events and shocks that cause these profits adversely affect many individuals in the economy. From an allocative perspective, however, these gains are necessary incentives from an ex ante perspective that make innovation activity attractive in the first place. To impose an additional tax burden on these rents at a later stage would be a kind of “breach of contract”. The state would behave opportunistically ex post. If this time-consistent taxation behaviour is anticipated by future potential innovators¹², innovation activity would be less worthwhile and this would have adverse economic consequences.

4.3. Natural resources

“Excess” profits in the sense of expected revenues that systematically exceed the costs of production typically arise in the natural resources sector. There, resources are mined and these natural resources are sold on the market or processed

further. The extraction and sale of natural gas and oil deposits is a typical example. Here, the costs of capital and labour incurred in exploration, extraction and sale are lower than the proceeds of the sale.

Basically, the companies simply convert one asset (the resource in situ) into another asset and then sell it. There is a broad literature on the state’s treatment of such natural resource companies and their fiscal treatment, as well as extensive experience on how different states tackle this issue. Mineral resources are often owned by the state initially. The state may then engage in entrepreneurial activity itself. This happens, for example, in connection with state-owned oil companies. Alternatively, the state licenses the extraction of these mineral resources to private-sector companies, auctions off the exploitation rights, or otherwise charges a fee for the opportunity to extract and sell these natural resources.

With optimal pricing of such exploitation rights, the state should largely skim off the natural resource rents. Ultimately, these are rents that actually belong to the state, i.e. to its population. At the same time, to create efficient incentives in the corporate sector, the state should make the natural resources companies “residual claimants”. It should design exploitation rights in such a way that they bear the full advantages and disadvantages of their own behaviour.

Complications arise from the fact that the existence and quality of deposits are often uncertain at the time of licensing/auctioning and that exploitation rights are occasionally awarded through auctions. In this process, bidders are imperfectly and asymmetrically informed about resource deposits and must consider what exploration activities to engage in before the auction. Payment models also exist in which the government participates in ongoing extraction or sales. In all these approaches, the company’s payments should approximate the value of the resource rents so that there is no “excess” profit for the resource companies in the expected value.

12 Langenmayr and Simmler (2022) show empirically that investors do indeed try to anticipate future tax rate changes.

Payments by the company for the exploitation rights and proceeds from the extraction and sale of the resources may occur at different times. Thus, over time, the impression of excess returns may arise, where these returns are not excessive relative to the total life of the resource extraction. Of course, uncertainty about the quality of the deposits, about extraction costs, about changes in environmental regulations, about price fluctuations on the markets, and about other entrepreneurial risks give rise to fluctuations in corporate profits ex post. Similarly to what has already been discussed for companies outside the resources sector, these fluctuations do not constitute a direct reason to appropriate accidental ex post excess returns through an ad hoc special tax, provided that the exploitation rights were priced correctly.

In Germany, commodity rents from oil and gas deposits play a very minor role; accordingly, the question of a specific excess profits tax related to the oil and gas sector is of secondary importance for the present report. Germany is essentially an importer of oil and gas. As a medium-sized consumer, Germany is also unlikely to be large enough to be able to skim off part of the rents from resource extraction on its own via an import tax. This would only be possible if Germany, as an importing country, could use such taxes to change the import and export prices at which it can buy and sell on the world market in its favour.¹³

¹³ The considerations are analogous to those in the area of optimal tariff theory (see e.g. Feenstra 2004).

5. Political-economy aspects

5.1. Discretionary taxation and loss of confidence

Arguments from the field of political economy also need to be considered. Even if one accepts the long-term incentive problems described in chapter 4 and could solve the definitional problems, it remains to be feared that the definition of what “excess” profits are and whether a crisis could have been anticipated is subject to a certain arbitrariness in the political process. For example, a pandemic may be seen as an unanticipated event. However, a look at the Global Risks Report 2019 (World Economic Forum 2019) shows that the risk of “spread of infectious diseases”, while ranking low in probability, is mentioned there and was ranked among the 10 most significant global risks in terms of its impact.

Suppose a new tax is introduced, which taxes windfalls from unanticipated crises. In that case, it is to be feared that, over time, the concept of an “unanticipated crisis” will be softened and new excess profits taxes will be introduced with lower bars. Such taxes would no longer tax pure rents but would have the usual negative effects of existing taxes on corporate profits, which also cover the remuneration of equity and entrepreneurial labour. Germany would jeopardise the positive reputation it has built up over decades as a location with secure property rights and reliable legal structures. Companies would have reason to fear that, if successful, their industry would become a candidate for a new excess profits tax. Accordingly, they would be more reluctant to make new investments, with all the disadvantages this would have for Germany as a business location. The state would introduce additional uncertainty into the planning of investments by making recurring, ad

hoc decisions as to when excess profits exist and should be skimmed off. Due to the poor predictability of such additional taxes, these negative effects would be expected to be more pronounced than, for example, in the case of corporate income tax.

Also relevant in terms of political economy is the observation that high profits in individual sectors are often linked to government procurement processes during crises. Procurement processes related to refugees from Syria, the pandemic, and war events in Ukraine unquestionably presented unexpected and significant challenges to public decision-makers. In some cases, there would have been room for improvement in these procurement efforts. Areas leading to particular media attention included mask procurement, pandemic vaccine purchasing, and stockpile planning. Exploiting efficiency reserves in these procurement processes might have resulted in lower “excess” profits in some areas. Ad hoc taxation of such excess profits should not become a substitute for efficient planning and procurement within the public sector.

5.2. Time consistency of taxation

The proponents of an excess profits tax refer to the current special situation in their arguments, since the Covid-19 crisis has not yet completely subsided and now the war in Ukraine is also sending additional shock waves through the global economy. This is – so the argument goes – a unique situation that will not recur. Thus, an excess profits tax would only be applied once, in order to finance the many necessary expenditures. However, severe economic crises unfortunately occur more frequently. During the financial crisis, most people hoped that public finances would have decades to recover. However, the migration crisis followed within just a few years, at least in Europe. Similarly, the Covid-19 crisis also appeared only a decade after the global financial crisis. Once each of these crises gained momentum, it was perceived as a singular crisis of unprecedented magnitude in which policymakers had to act. (And policymakers did act, and mostly for good reason.)

Once excess profits taxes are introduced to finance crisis responses, there will always be political pressure to resort to this instrument during the next crisis. The government will assert that this tax is unique and that the instrument will not be reused in the future. However, the state cannot credibly commit to this promise. The state is not subject to any supranational institution that could monitor and enforce compliance with such a promise, analogous to compliance with private contracts. Policy promises are thus not time-consistent. The best thing the state can do to counter the lack of any possibility of making a binding commitment is to build up its reputation. So far, Germany has done very well by taking on debt in times of crisis within the legal framework and using the available tax policy instruments. Softening this policy toward ad hoc taxes would damage the credibility of German fiscal policy.

6. The international context

In current reforms of the international tax system, the concept of “residual profits” also plays a role. Residual profits are defined as profits in excess of 10% of revenue; in this sense, they can be regarded as “excess” profits. However, these international tax reforms do not pursue the goal of subjecting particularly high profits to a special tax that goes beyond normal profit taxation. Rather, the aim is to curb tax avoidance through international profit shifting and to reallocate taxing rights among states. The objective is thus to tax at a minimum level profits that are currently taxed at a very low level or not taxed at all and thus to reduce inequalities in taxation. In contrast, the aim of an excess profits tax would be precisely to tax different types of profits differently.

Specifically, the reform of international taxation involves the transfer of taxing rights to market states (referred to by the OECD as “Pillar 1” of the reform) and the introduction of a global minimum tax (“Pillar 2”).

Pillar 1 defines “residual profit” as the portion of a profit that exceeds 10% of revenue. This residual profit is thus similar to an “excess” profit. However, the objective is different: in conceptual terms, this residual profit acts as a proxy for profits shifted for tax reasons. A certain part of the residual profit is to be taxed in the states in which the company provides services on the market. The market states are to be given the right to tax 25% of the residual profits of the companies concerned (amount A). To the extent that the relevant profits were previously reported in low-tax states, Pillar 1 is expected to result in higher taxation of residual profits. The effect is similar to that of an excess profits tax, even if the objective of the measure is different.

Pillar 2 introduces a global minimum tax. The latest proposals provide for so-called “substance-based carve-outs”: companies are to be allowed to

initially deduct 8% of non-intangible assets and 10% of payroll from profits. These amounts will be gradually reduced in the coming years. Only the profit in excess of these amounts is to be subject to the minimum tax. As a result, companies located in low-tax countries with significant real economic activity will only be affected by the minimum tax if their profits exceed the carve-outs, i.e. if they are particularly profitable. This effect is also similar to that of excess profits taxation, although the actual objective is different here as well: the carve-outs are intended to prevent the minimum tax from hitting companies that report profits in low-tax countries but can also demonstrate real economic activities there that justify these profits.

In addition, there are academic calls for explicit excess profits taxes as part of international tax reforms. Christians and Diniz Magalhães (2020) call for such a third pillar (“Pillar 3”) of a “Global Excess Profits Tax”. The authors justify such an excess profits tax by referring to the absence of a global antitrust authority. Without globally coordinated competition intervention, global platform companies with a dominant market position are only inadequately regulated. Economic rent arises from market power, which the excess profits tax aims to partially skim off (Christians and Diniz Magalhães, 2020).¹⁴ They propose defining excess profits based on the distinction anchored in Pillar 1 between routine profits (average return for normal entrepreneurial activities, e.g. amounting to a return on sales of 10%) and residual profits (actual return generated beyond routine profits).

¹⁴ In another paper, Christians and Diniz Magalhães (2022) emphasise that companies do not fully bear the social and environmental costs of their activities themselves. The profits that arise from the fact that these costs are borne by the general public could also be skimmed off through an excess profits tax. However, even in these cases, there is the problem that excess profits cannot be clearly delineated. Moreover, these externalities can be regulated more directly through direct pricing (e.g. in the context of CO₂ pricing).

Christians and Diniz Magalhães (2020) suggest that such a tax should be introduced worldwide and the revenue distributed globally. While such a tax may satisfy many people's sense of justice, it cannot solve the fundamental problem of distortions due to market power. For a further assessment of such a tax, see section 4.

7. Reference to corporate income tax

The discussion on the excess profits tax often ignores the fact that “excess” profits are already subject to regular profit taxation. Depending on the local business tax rate, “excess” profits – like all other taxable profits – are taxed in Germany at an average rate of around 30%. The state therefore already receives a share of these excess profits.

If excess profits were taxed at a higher rate or subjected to an additional tax, this would further reinforce the existing asymmetric taxation of profits and losses. In the case of losses, a full tax refund is often not possible – due to the limited loss offset or minimum taxation when carrying losses forward – while profits are fully taxed. The resulting asymmetry in corporate taxation reduces investment and innovation incentives, especially for risky investments (Langenmayr and Lester, 2018). If profits are subject to an additional excess profits tax, or if the company has reasons to fear that such an excess profits tax will be introduced, this will reduce investment incentives.¹⁵

As an alternative to an additional excess profits tax, it would be conceivable to orient the existing system for taxing profits, in particular corporate income tax, more closely to a taxation of economic rents. To this end, an imputed interest on equity could be deducted from the tax base. Such a deduction would have two advantages: first, equity

and debt would be treated equally and, accordingly, the tax-induced excessive use of debt would cease. Second, provided that the full cost of equity is deducted, such a tax would tax genuine economic profit, i.e. an economic rent. In this case, in theory, the tax would no longer affect investment decisions (Devereux and Freeman, 1991). In reality, however, the imputed rate of return on equity will differ from the true cost of capital. Accordingly, empirical studies of existing Allowances for Corporate Equity (ACE) do not find a positive investment effect (Hebous and Ruf, 2017). Even if deducting the cost of equity would de facto align the corporate income tax with economic profits, the objective here is different from that of the currently discussed excess profits tax: the goal would be financing and investment neutrality, not a targeted taxation of crisis profits.

The European Commission's current proposal for the restructuring of corporate taxation in Europe provides a step toward financing and investment neutrality (see European Commission 2022b). The proposed “debt-equity bias reduction allowance” (DEBRA) combines a deduction of imputed equity costs (calculated as a lump sum from the 10-year risk-free interest rate and a surcharge of 1%, or 1.5% for SMEs) with a restriction on the tax deductibility of interest on the debt. However, due to the restriction on the tax deductibility of interest on borrowed capital, it is unclear whether the profit defined in this way would be closer to an economic

¹⁵ See also Buchholz and Konrad (2000, pp. 82-86) on the effect of taxes in the case of incomplete loss offset.

rent than is currently the case. The objective of the regulation is again not to tax crisis profits but to strengthen the equity financing of companies.

While the Advisory Board is sceptical about the introduction of an excess profits tax for individual industries or in specific situations for the reasons mentioned above, these concerns do not apply to the further fundamental development of corporate taxation in the direction of a stronger focus

on net profits, which would ideally lead to financing neutrality and better investment incentives. From an efficiency perspective, an alignment of the tax definition of profit with the definition of economic rents is to be welcomed. However, if tax rates are kept constant, tax revenues would be expected to be significantly lower. Proponents of an excess profits tax, however, are mostly concerned with raising more, not less, tax revenue.

8. Conclusion

In times of crisis, scarcities often shift abruptly. Prices soar or plummet. The rapid changes create winners and losers in these times. In particular, extraordinarily high corporate profits resulting from such changes in scarcity ratios are perceived as unfair by large sections of the population. In times of crisis, therefore, the discussion repeatedly flares up as to whether particularly high profits associated with the crisis should be taxed away. This report urges great caution in the use of excess profits taxes; such taxes may be popular, but they are economically dangerous in the long run.

- True economic profits are difficult to determine in practice, which is why there is a risk of allocatively harmful distortive effects when attempting to tax them.
- Attempting to approximate excess profits through heuristics leads to arbitrary burdens and distortions in the production structure.
- Longer-term excess profits are often generated by the state itself – through regulations or government procurement processes.
- Economic activities are subject to major fluctuations. Profits in some years are offset by losses in other years. Taxing above-average profits in good years would reduce market entry and thus the overall level of economic output.
- Temporarily above-average profits have a steering effect that is fundamental in a market economy. They lead to more resources being directed to these areas, thus alleviating the shortages. Taxing above-average profits would prevent this redirection effect and cement the shortages in the long term.
- In particular, an excess profits tax can be fatal for the innovative strength of an economy. Innovation races typically generate many losers and a few winners. If well designed, these innovation races are to the benefit of society. If profits were taxed away ex post, there would no longer be an incentive to participate in these productive innovation races.
- From a political perspective, too, an excess profits tax harbours dangers. Confidence in the German tax system is based on its rule-based nature. Taxes are levied on those who earn high incomes or profits, as measured in euros. It is irrelevant for the level of taxation in which sectors, with which products, or in which phases of world events these profits are generated. Ad hoc taxation of individual activities would destroy much of this long-established trust.

- In particular, promises to never use such special taxation again are hardly credible. Once introduced, there would be a risk of constantly claiming new special circumstances to justify selective taxation of individual industries or groups. This could have massive repercussions on the long-term willingness to invest.
- Current plans for the further development of corporate taxation already contain elements of excess profits taxation. A stronger orientation of corporate taxation to net profits would ideally lead to financing neutrality and better investment incentives. However, the associated reduction in the tax base would result in tax revenue shortfalls.

Overall, the Advisory Board strongly advises against introducing an excess profits tax, which may appear politically opportune in the short term but which is harmful in the long term.

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