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Has the Time Come for Excess Profit Taxes?

Shafik Hebous

Key Messages

- There is a case for taxing economic rent, beyond windfall profits from fossil fuel extraction following the surge in commodity prices.
- Permanent excess profit taxes (EPTs) can be designed to fall on economic rent and to serve as a gateway for an efficient tax system.
- While temporary taxes on windfall profits raise revenues, they do not address structural deficiencies in the tax system and are generally less desirable than permanent well-designed EPTs.
- There are parallels between a coordinated excess profit tax on the profits of multinationals (that ultimately becomes a formulary apportionment) and the destination-based taxation envisaged under Pillar I in the 2021 Inclusive Framework agreement.

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Has the Time Come for Excess Profit Taxes?

Shafik Hebous*

International Monetary Fund, Washington DC, February 27, 2023

What Are Excess Profit Taxes?

Behind the rhetoric of excess profit taxes (EPTs) in the early 20th century was the articulation of a tax that falls on economic rent. Around World War I, EPTs quickly spread from Denmark and other European countries to the US and Australia. EPTs were used again during World War II and other adverse episodes. With the massive fiscal costs of the covid-19 pandemic and the need to support vulnerable households in the face of surging energy prices following Russia's war in Ukraine, EPTs returned to the fore of the policy debate in both developed and developing countries. In October 2022, the Council of the European Union agreed on an emergency intervention to address high energy prices, including temporary windfall taxes.

It is a natural departure point for economists to view excess profits as profits above the opportunity cost of investment (that is, economic rent). This view encompasses 'windfall profit' (that typically refers only to fortuitous gains from unforeseen events), and in some sense it was reflected in the commonplace definition of excess profit early last century as profit exceeding a fixed return on assets. The EPT design at the time was reminiscent of a permanent efficient tax (in the form of an allowance for corporate equity/capital) that does not distort investment decisions (Boadway and Bruce, 1984; Mirrlees et al., 2011), and is different from the one adopted by EU countries in October 2022 (European Commission, 2022). The latter attempts to capture windfall profits in the fossil fuel sectors, defined as above a 20-percent increase of the 2018-21 average taxable profit. As discussed in Hebous et al. (2022), there are lessons that can be learned from previous EPTs as well as different circumstances that need to be considered in today's EPTs. Conceptually, there are also parallels between EPTs and ongoing proposals to reform the taxation of multinational enterprises (MNEs).

* Shafik Hebous: IMF, Washington DC, shebous@Imf.org. The views expressed here are those of the author and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.

Temporary EPTs were successful in the past in terms of raising revenues, reaching 32 percent of total revenues in 1918 in the UK, for instance, and in giving a sense of social cohesion resulting from higher taxes paid by companies that have done very well out of difficult episodes. But a temporary EPT does affect investment decisions, confronting policymakers with a trade-off. In contrast, efficiently designed permanent EPTs do not affect investment decisions and, importantly, can create room for lowering the existing corporate income tax that also captures the normal return. The EPT rate thus can in principle be higher than the corporate income tax rate.

Where Are Excess Profits Nowadays?

Excess profits during World Wars I and II were concentrated in relatively immobile sectors and heavy industries characterized by a high intensity of physical capital. Today, excess profits are mainly made by (i) the extractives; (ii) MNEs that are known to be mobile across borders and heavily reliant on intangible assets; and (iii) a handful of 'domestic' firms potentially in the financial and energy sectors.

Technically, there is nothing spectacularly new about EPTs in the extractives. A permanent tax on windfall profits from fossil fuel extraction is desirable and several countries—including Australia, Ghana, and Norway—already adopt some form of EPTs in their fiscal regimes for the extractives. The current developments, however, do send a reminder for those that don't, to permanently adopt well-designed EPTs on upstream extraction activities avoiding arbitrary references to specific price levels or time periods (Baunsgaard and Vernon, 2022) and, more generally, to ensure a proper taxation of location-specific rent in the source country.

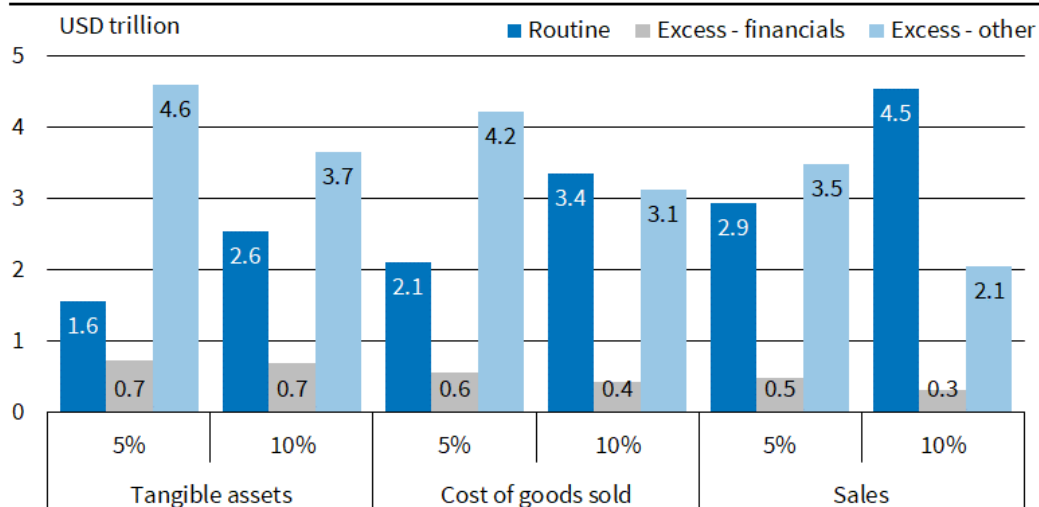
As to the rest of the economy, historical EPTs were eventually not ring-fenced, imposed on any excess profits rather than a pick-and-choose approach. There is no clear reason to discriminate across firms with excess profits and there is a practical difficulty in drawing the line of demarcation. The first EPT, in 1915 in Denmark, was motivated by taxing traders of food (and hence the name 'goulash tax') who were granted exceptions to export to Germany that enabled them to make huge profits. Eventually, however, all other excess profits were subjected to the EPT, not only those of specific taxpayers. Now, some countries are implementing or wrestling with the idea of taxing selected companies, such as banks or renewable-energy electricity companies that are benefiting from increased electricity prices (while their costs are not directly

increasing), but why should excess profits of other companies, say in the IT or pharmaceutical sectors, not be equally taxed?[1]

How to Tax Excess Profits of MNEs?

Multinationals generated US$7.9 trillion in profits in 2019 (9.2 percent of global GDP).[2] To get a feel of the magnitudes, simplifying assumptions suggest that a sizable share (possibly of up to 2/3) of multinationals' profit is excess profit (Figure 1). MNEs evidently can shift profits to lower tax jurisdictions, thereby eroding the EPT base if unilaterally adopted. The results in Hebous et al. (2022) confirm that MNEs' excess profits are currently reported in low tax jurisdictions.[3]

Simplified Measures of Normal and Excess Multinational Profits (2019)



Source: Hebous et al. (2022).

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One alternative is a unilateral EPT imposed on the *globally consolidated* profits of MNEs, which would address profit-shifting concerns because it is based on the global profit of the company rather than what is reported in a specific jurisdiction. This option would not, however, address concerns about tax competition between countries that can prompt MNEs to relocate activities across borders. A unilateral EPT on consolidated accounts would also likely infringe on the country's commitments under tax treaties, inter alia. Thus, coordination between countries becomes important to allocate the EPT

[1] Encouraging activities that have positive externalities (like R&D) using cost-based instruments (such as super-deductions for inputs or investment tax credits) is more effective and efficient than profit-based instruments. Cost-based instruments can in principle coexist with EPTs.

[2] About US$7 trillion excluding the extractives in 2019.

[3] Several studies estimate the magnitude of shifted profits to low-tax jurisdictions. For example, Tørsløv et al. (forthcoming) estimate that 36 percent of multinational profits are shifted to low-tax jurisdictions.

base. Yet, a coordinated EPT on the globally consolidated profits would become a formulary apportionment, similar to existing schemes in some federations and existing proposals by various scholars to reform the taxation of MNEs. Allocating the tax base using sales by destination would be robust to tax competition since consumers are less mobile. For illustration, based on 2019 figures, the estimates in Hebous et al. (2022) suggest that a coordinated 10 percent top-up EPT, with the EPT base being allocated using sales, can raise global revenue by 16 percent of corporate income tax revenues. This coordinated EPT on the consolidated MNEs' accounts would be a different route from Saez and Zucman (2022) and Planterose et al. (2022), who propose an entirely new tax on the stock market capitalization. Such a tax would encourage corporate debt (favoring loans to issuing new equity), exacerbating the existing debt bias in corporate taxation.

Are There Parallels between a Coordinated EPT and Ongoing International Tax Coordination Efforts?

A coordinated EPT is in the spirit of the 2021 two-pillar OECD-led Inclusive Framework Agreement. Pillar 1 of the agreement envisages allocating a portion of the globally consolidated profits to market countries, but this portion is estimated to be less than 2 percent of MNEs' global profit (IMF, 2022).[4] Pillar 2 excludes a portion (although a different one from that in Pillar 1, known as 'substance-based income exclusion') from the foreseen global minimum corporate tax. Conceptually, by starting with aligning those ad hoc notions of 'residual profits' with a better approximation of economic rent, one can build on the progress of the Inclusive Framework agreement to consider a well-designed top-up EPT.

The main merit of the global minimum tax is to mitigate tax competition. An important welfare-improving channel is through giving room for the above-minimum countries to react by reversing the downward trend in their corporate taxes (Hebous and Keen, 2022). In this context, theoretically, an economy-wide EPT offers countries a more efficient option to react than raising the statutory corporate income tax rate.

[4] See IMF (2023) for a broad assessment of the Inclusive Framework agreement. Excess profit under Pillar 1 is defined as 25 percent of the amount of profit exceeding 10 percent of global revenue, and it applies only to MNEs with global turnovers above €20 billion (with some exceptions).

Policy Implications

Overall, EPTs emerge as an option to contribute to the extra needed revenues, avoiding a general increase in corporate tax rates, while having the prospect to serve as a gateway to converge toward a permanent efficient rent tax in lieu of the corporate income tax. General unilateral (temporary or permanent) EPTs would face the same international pressures from profit shifting and tax competition as the existing corporate income tax, calling for international coordination. A coordinated EPT on MNEs can take the form of a formulary apportionment approach that allocates the EPT base using sales by destination.

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