

Abstract

This paper provides comprehensive analysis how firms, workers and local labor markets adjust to changes in business tax rates. We focus on Germany where taxes on profits that apply to both incorporated and unincorporated firms are set at the municipality level, and where there is considerable variation in tax rates both across municipalities and over time. We show that an increase in the business tax rate by 1% reduces municipality employment by 0.12%, municipality wages by 0.05%, and the number of establishments operating in the municipality by 0.15%. Establishment exit is primarily driven by smaller, lower-paying establishments, whereas among surviving establishments, larger, higher-paying establishments show the largest reductions in employment, primarily because of reduced hiring. Higher business tax rates lower worker mobility between establishments, in particular to larger, higher-paying establishments higher up the job ladder. This leads to a reduction in between-establishment wage growth of workers in affected municipalities, thus suggesting disruptions in movements up the job ladder as an important factor in explaining wage reductions of affected workers.