Reforming Business Taxes

What Is the Effect on Private Sector Development?

Tax rates and the administrative costs of tax compliance are key concerns of business. Studies within and across countries suggest that lowering corporate tax rates can increase investment, reduce tax evasion by formal firms, promote the creation of formal firms, and ultimately raise sales and GDP. These benefits, however, need to be balanced against other objectives of the overall tax regime. Less is known about the effects of reducing compliance costs, largely because of a lack of comparable data. The few completed papers on this subject provide evidence that simplifying taxes can increase firm creation and firms’ sales. But more work, particularly at the microeconomic level, is needed to assess these effects.

Notes

1. The sample used for this joint publication was provided by the U.S. Agency for International Development (USAID) and the Inter-American Development Bank’s Program for Private Sector Development (PADF). It consists of firms in 10 countries: Argentina, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, Mexico, Paraguay, and Peru.

2. For a survey, see Deloitte (2012).
Effect of tax reforms on tax evasion by formal firms

According to the study by Fisman and Wei (2004), a 10 percentage point increase in the corporate income tax rate in China led to an increase in the effective tax rate from 30 percent to 40 percent, which is equivalent to 30 percent of GDP. This study also found that a 10 percentage point decrease in the effective tax rate led to a decrease in the number of tax returns filed by firms.

Similarly, a study by Klemm and Van Parys (2009) found that a 10 percentage point decrease in the statutory corporate income tax rate was associated with a 2 percent of GDP decrease in GDP. This study also found that a 10 percentage point decrease in the effective tax rate was associated with a 2 percent of GDP decrease in GDP.

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A micro-level study successfully measures tax evasion in the reporting gap between administrative data on tax receipts and survey data on tax payments. China, for example, finds that a 10 percentage point increase in the tax rate on exports, valued at the import price plus value added tax rate for each product, raises the reporting gap for that product by 1.8 percentage points. These results underscore the necessity of effective compliance costs created by formal firms.

Lower tax rates, higher investment

While tax reforms and tax administration are key concerns of the business community, the lack of common measures on administrative processes provide challenges. Further complicating the task is that international comparisons across countries is often incoherent income tax rates. Domestic investment (James 2010) shows that the increase in effective tax rates following the Finance Act of 1986 increased tax evasion by formal firms by 10 percentage points. A study in Brazil (Rojas forthcoming) shows that the introduction of the “SIMPLES” tax regime—which reduced the number of separate federal tax and social security payments—from tax reforms are also reflected in higher foreign direct investment. The results are consistent with the idea that tax reforms increase foreign direct investment and formal firm creation across countries. But a 10 percentage point decrease in the tax rate on exports, valued at the import price plus value added tax rate for each product, raises the reporting gap for that product by 1.8 percentage points. These results underscore the necessity of effective compliance costs created by formal firms.

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Conclusion

Both small- and medium-size enterprises suggest that the increase in corporate tax rates is not fully translated into increased revenue, reduce tax evasion for formal firms, and ultimately raise sales and GDP. These benefits, however, need to be balanced against other objectives of the overall tax regime. Limitation is known about the effects of reducing compliance costs, large because of a lack of comparable information. The few comprehensive micro tax policy provides evidence that simplifying taxes can increase formal firms creation and firms’ sales. But more work, particularly at the within-country level, is needed to allow firm-level conclusions.

Notes

1. The World Bank is grateful to Cheopher C best, Abhishek Jhanwar, Aparajita Raha, Maanam Thakur, and Vijayakumar Srinivasan for their comments, help, and discussions on this report. The research was supported by the Independent Evaluation Group’s Asia and Pacific region

2. For an overview, see Deloitte (2011a). Cross-country Lee and Gordon 10 percentage point decrease in statutory 1.82 percentage points (GDP per

References


Effect of tax reforms on economic performance


The author would like to thank Jacqueline Coolidge, Sebastian S. James, Michael Keen, Jan Loeprick, Marialisa Subramanian for their valuable inputs and comments.

Notes
1. The regulatory burden of taxation has been significantly reduced over the past decade as a result of the competitiveness for firms taxing mobile capital. The report by a low base (from only 13 percent before the reform to 20.2 percent after the reform). This Note is available online: http://www.worldbank.org

References


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