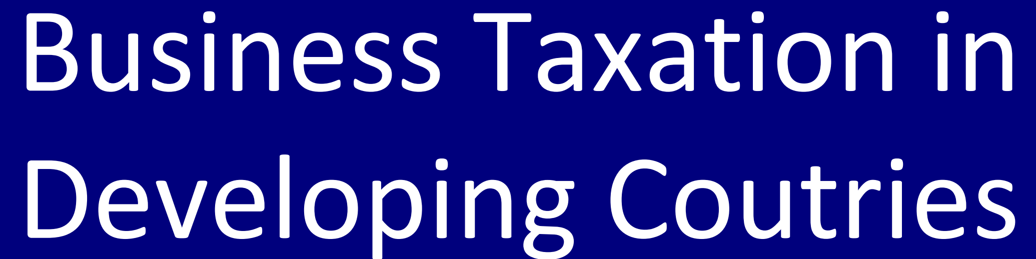


Business Taxation in Developing Coutries

Roger Gordon

UCSD

Initial Perspective

- Corporate income taxes in developing countries are broadly similar to those in developed countries
  - Similar statutory tax rates on average
  - Broadly similar tax bases
  - Collect roughly the same fraction of GDP
- What makes research on corporate taxes in developing countries different??
- What potential research topics seem feasible and worthwhile?

Elasticities presumed to be much higher

- In developing countries,
  - Much larger informal sector
  - Presumption of higher avoidance and evasion among formal firms
  - Aside: this suggests a much higher underlying pre-tax rate of return
- Could still focus on estimation of ETI
- But, "Tax policy in developing countries is tax administration"
- Separate measures of informality, avoidance, and evasion responses useful for tax administration
- Focus initial discussion on each of these behavioral responses

Larger informal sector

- Schneider estimates the hidden/informal/cash economy averages a third of GDP in developing countries, vs. around 15% in developed countries
- Why so high?
  - Weaker tax administration
  - Many more self-employed in developing countries, and small firms likely to be informal
- Given its large size, effects of tax reforms on the size of informal sector a key issue

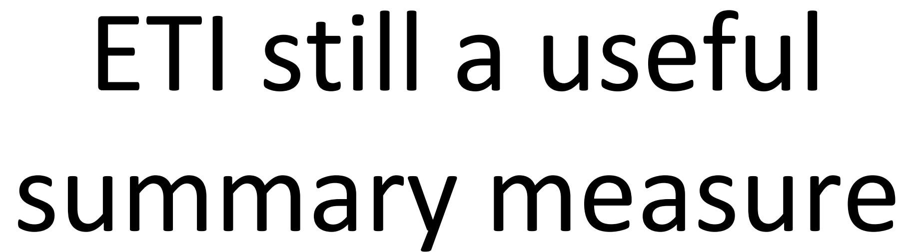
Taxes and Informal Activity

- Can we estimate how policy changes affect this informality choice?
  - By construction, data on informal activity a challenge!
  - But administrative data sets include information on entry to the formal sector and potentially on acquisitions of previously unobserved firms
  - Larger and more profitable entrants likely coming from informal sector
  - Some household surveys also have information on informal activity of household

Higher avoidance among formal firms

- Chinese anecdote on income shifting to non-state firms
- One likely explanation is the smaller role of the personal income tax or other taxes on non-corporate firms
- When personal income untaxed, strong incentives favoring income shifting from business to household
  - Pay out profits in a deductible form, e.g. wages, interest, rents, royalties, lease payments. (Debt vs. equity finance)
  - Schedular taxes on each of these forms of payout weaken distortions
- Aside: Clear advantage of a VAT, where deductions allowed only when payments taxed elsewhere

- With administrative tax data, can study the impact on each of these business line items of
  - Changes in schedular tax rates
  - Changes in personal income tax rates



- e.g. Devereux, Liu, Loretz (2014)
- Captures informal/formal choice, income shifting, and also changes in evasion (e.g. use of cash sales)
  - Little concern with effects of behavioral responses on personal income tax revenue, given limited use
  - There are a variety of other concerns, though

- Low in state-owned firms and in large capital-intensive firms
- High in service sector and retail trade
- Elasticity likely depends as well on existing tax rates and state of development

Other policy responses when effective tax rates differ by firm

- Efficiency gain from shifting activity towards firms facing higher effective tax rate, e.g.
  - Tariffs, to protect high-tax sectors
  - Use state-owned banks to shift lending to high-tax firms
  - Land use
  - Industrial policy, to enable these firms to collude, to raise their taxable profits, while protecting them from competition
- This interference with market allocations is a signal of a less developed economy, and a key concern to say the IMF
- Possible empirical studies to estimate differential impact of such policy changes on sectors facing high vs. low tax rates
- Induced changes in these policies complicate ETI studies

- One major problem is hidden (cash) sales
  - Many creative policies have been tried to detect such evasion
  - Potential focus of empirical work

Striking recent evidence raises deeper questions

- Not just cash sales hidden
- Carillo, Pomeranz, and Singhal (2017) look at the impact of third-party reporting of sales, e.g. by credit-card companies
  - Reported revenue does go up, to the figure in third-party reports
  - But reported taxable profits effectively unchanged (reported costs go up to fully compensate), an intriguing finding
  - Slemrod et al (2017) find same result for sole proprietorships in U.S.
- That it is easier to monitor revenue than costs has led to frequent use of presumption taxes on revenue for smaller firms
- Best et al (2015) then finds that a "presumptive" tax on revenue dominates a tax on profits

How are business taxes enforced?

- Use of third-party information to monitor a firm's income limited due to extensive use of cash.
- Anecdotes from Peruvian head of taxation
  - Compensate by collecting related information, e.g. on value of business PPE, electric usage, value of vehicles, phone usage, imports, airline ticket purchases, extending the tax base to firms whose existence but not income known
  - Implicit "presumptive" tax based on available data
- Resonates with findings in Carillo et al (2017) and Slemrod (2017)
- Similar anecdote from Price-Waterhouse in Egypt

Implicit presumptive taxes

- To work, need deference of tax court to government, or at least a costly appeals process
- Income tax returns must then be adjusted to generate "presumptive" tax liabilities, leading to noisy accounts, as seen in Hsieh and Klenow (2009)
- Indirect evidence of implicit presumptive taxes through unusually low use of observable inputs, and empirical link between tax payments and observable inputs
- How do implicit tax rules respond to statutory changes? Hard to interpret ETI estimates.

Treatment of multinationals

- Striking difference here between China and India
  - Difference in ability to tax MNE's vs. domestic firms?
  - Differences in information spillovers from MNE's?

Role of fiscal federalism

- An important issue in China
- Conflicting incentives of Federal vs. Provincial governments
  - Initially under reforms, state-owned (non-state) firms paid taxes to the Federal (Provincial) government
  - Federal government then favored state over non-state firms, and conversely
  - Key additional issue was the jurisdiction in charge of auditing. Provincial auditors underreported taxable income when revenue went to Federal government

Stages of development

- Continuum of country x years, rather than developing vs. developed
  - Since 1980’s, China’s tax system has gone step-by-step from one typical of the poorest countries to one more typical of the richest countries
  - What observable indicators can we come up with to guide when a country is ready to update its tax systems?
  - Let me suggest degree of uniformity of effective tax rates across firms as one key indicator of level of development
  - When effective tax rates uniform, no incentive to interfere with market allocations across industries

Summary

- I've tried to focus on issues that have been relatively neglected in the literature on business taxes in the U.S. and Europe
- These issues (informality, income shifting, cash economy, presumptive taxation) do seem more important in developing countries
- But same issues, even if less salient, still exist in developed countries, as seen in Slemrod et al (2017), and certainly existed in the past