Business taxation: the interplay of administration and tax policy

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The importance of business taxation

Efficient and equitable taxation of businesses is a vital pillar of any strong fiscal system

Well-designed policies have multiple objectives

• Cost-efficient tax revenue collection for the government
• Low compliance costs for firms
• Minimal distortions to firms’ investments and growth
• Fair distribution of taxes across firms

These objectives are constrained by country-specific features

• Economic structure, broad institutional settings, tax administration
Individuals & businesses behaviour affected by tax policy and administration

Tax policy parameters

- Tax base
- Tax rates

Tax administration parameters

- Reporting requirements/compliance costs
- Enforcement mechanisms
- Tax administration businesses interact with

All of these can vary in practice by type of business

- Size (e.g. turnover), sector, location, organisational form/ownership
- Not necessarily in line with multiple policy objectives
**TaxDev research**

**Broad questions**

- Effect of tax system (policy & administration) on businesses’ performance
- Opportunities to improve the tax system to boost revenues and economic growth

**TaxDev researchers’ work in Ethiopia**

1. How do tax factors affect businesses’ incentives to incorporate?
2. Understanding tax compliance behaviour

Both are work in progress - early stages
Project 1: Incentives to incorporate in Ethiopia

Research questions

• How important are tax factors in the decision to incorporate?
• If possible, how do ETR affect firms’ performance?

Exploit variation in benefits and costs to become incorporated to answer these questions

• Tax rate schedule for profit tax
  – Inflation means it changes over time
• Tax administration taxpayers deal with
  – Federal office if incorporated/regional offices if non-incorporated
  – Merger of regional and federal in Addis Ababa gives variation over time
Profit tax by business type in Ethiopia

- **Federal tax office**
- **Regional tax offices (lower capacity)**

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Profits (Thousands of Birr)

Birr 27/£1
Project 2: Understanding tax compliance

Firms may have incentives to locate below/above relevant thresholds to minimise tax related costs

- Thresholds are pervasive generating changes in
  - tax bases & rates
  - compliance costs/enforcement intensity
- E.g. manipulate reported turnover so that it is just below the registration threshold of VAT to avoid paying VAT → observe excess bunching of turnover below the threshold

Understand trade-offs between compliance, administration & efficiency costs and tax revenue when moving specific thresholds

- E.g. Increasing a registration threshold may decrease compliance & administration costs and tax burden, but decrease tax revenues
Thessholds and bunching analysis in Ethiopia

Ethiopia

- Enforcement: LTO threshold (corporations and individuals) – Birr 35 million annual (£1.3million) turnover since 2015
- Compliance costs: Reporting requirements are looser below Birr 500k
- VAT registering threshold: Birr500k (£18.5k); below which firms pay 2% turnover tax to regional offices

Research questions

- How do firms respond to these thresholds?
- How do these responses affect tax revenues?
Contribute to a growing empirical literature on the interplay between tax policy and tax administration for business taxation

• nascent in low and middle income countries

Administration and collectability becomes very relevant in developing countries

• Tax bases and administrations are less modern
• Policy prescriptions may be different to those in high-income countries