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Do Corporate Tax Cuts Boost Small Firms?

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Background

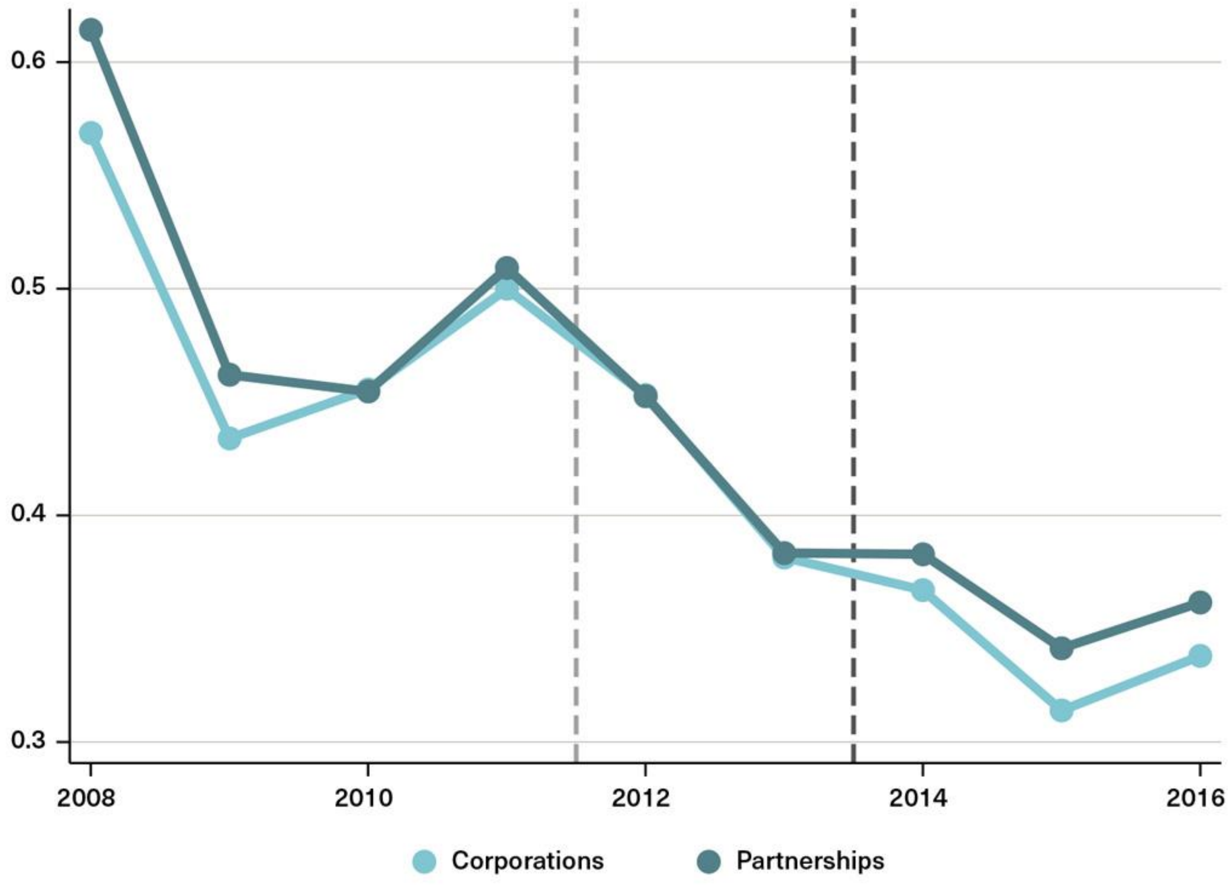
- Cutting business taxes is often viewed as a relevant policy tool to boost firm investments and growth.
- Many developed countries have reduced their corporate taxes over the last decade.
- The discussion around corporate tax cuts has lately evolved around the international tax competition and the impact of corporate taxes on e.g. profit shifting and investment of MNCs.
- Small firms and entrepreneurs play a vital role in creating new jobs and innovations that would not otherwise exist, leading to greater welfare for society.
- So what is the impact of cutting corporate taxes on small and growing firms?

Our study

- Our report summarizes and discusses the effects of large corporate tax rate cuts implemented in Finland over the period 2012–2014.
- The corporate tax was cut from 26 % first to 24.5 % and finally to 20 %.
- The cut was implemented together with a dividend tax increase, keeping the owner-level effective tax rate unchanged.
- We focus on the impact on the investments and economic performance of small and young firms.
- We use data covering all Finnish firms and take partnerships as a control group as they were not affected by the corporate tax cut.

How did investment of small corporations respond to the tax cuts?

Figure 1. Development of investments relative to existing capital assets, 2008–2016.



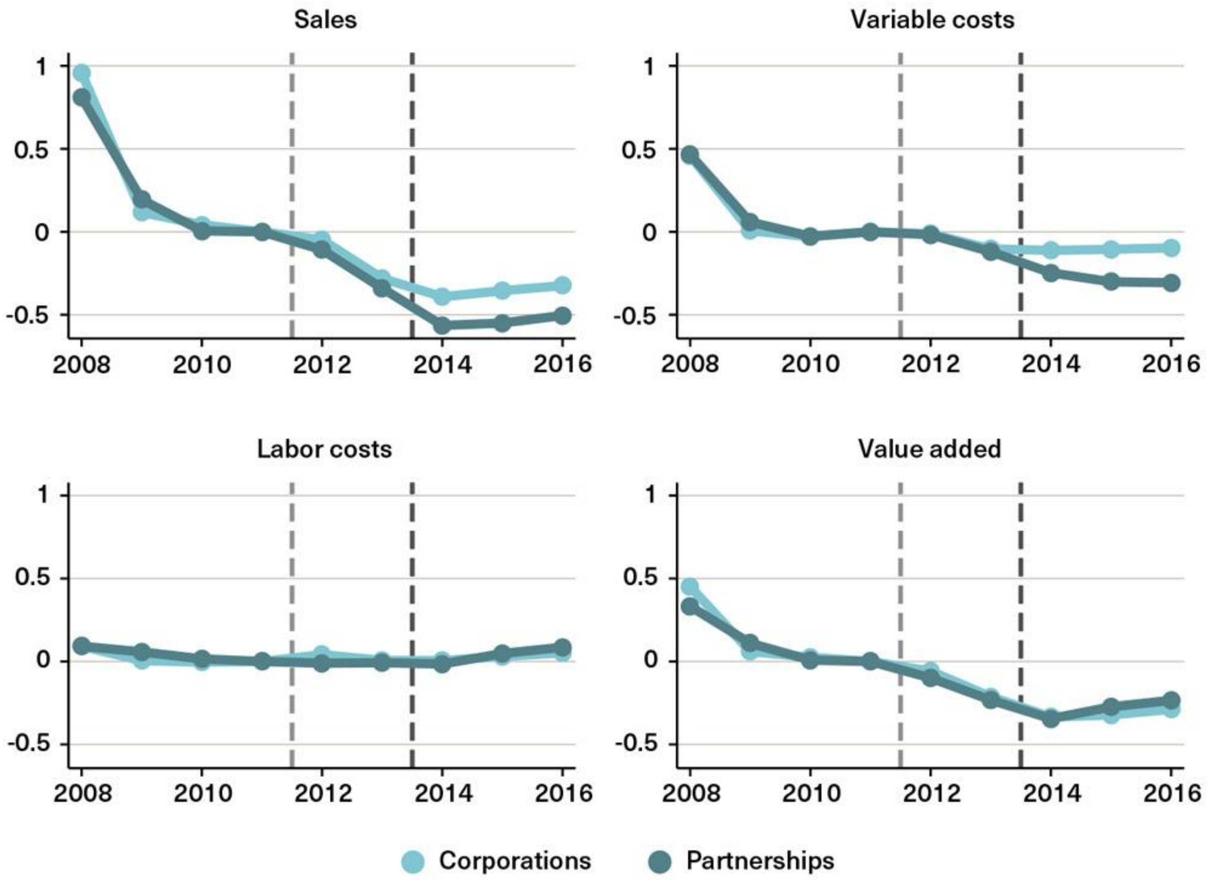
Note: The figure plots the rate of investments (investments per lagged capital assets) for corporations and partnership firms. The first vertical line denotes the smaller tax cut in 2012 from 26% to 24.5%, and the second line the larger tax rate cut from 24.5% to 20% in 2014. Source: Harju, Koivisto, and Matikka 2022.

Investment effects

- We find no significant investment response to the tax cuts among small firms. In addition, we find no impact on the share of firms with new investments.
- However, we find a positive response (3.8 percentage points) for younger firms below the age of ten in our sample compared to older firms.
  - This suggests that younger firms can be more responsive to increasing their investments when their corporate tax burden is reduced compared to more mature businesses.
- Moreover, we find a small positive effect (3.4 percentage points) for firms with less available cash resources compared to firms with more cash resources before the reforms.
  - This suggests that the cash injection induced by the corporate tax rate cut could alleviate cash constraints among these firms.

How did other business outcomes respond to the tax cuts?

Figure 2. Development of sales, variable costs, labor costs, and value added for corporations and partnership firms, 2008–2016.



Note: The figure shows the development of sales, variable costs, labor costs, and value added scaled by firm-level sales in 2011. The first vertical line denotes the smaller tax cut in 2012 from 26% to 24.5%, and the second line the larger tax rate cut from 24.5% to 20% in 2014. Source: Harju, Koivisto, and Matikka 2022.

Sales effects

- We observe an average 1.6-percent increase in sales and a 2.0-percent increase in variable costs relative to sales in 2011.
- We do not observe statistically significant effects in labor costs or value added.
- We find that the responses are clearly larger among firms with active owner-managers compared to firms with more passive owners. Investment rate did not differ between these groups.
- We observe slightly larger responses in sales and variable costs for more cash-constrained firms compared to less cash-constrained firms.

Discussion

- An increase in sales without an increase in investments may seem unintuitive especially given that there was no change in the owner-level tax burden.
- The corporate tax rate cut creates a mechanical cash injection into the firm through increased net-of-tax retained earnings.
- Additional cash resources may be particularly relevant for smaller firms that may have limited opportunities to acquire funding but can still have new business opportunities to utilize.
- However, our evidence suggests that cutting the corporate tax rate is not a particularly effective tool for increasing investments among small firms.