THE WORLD BANK GROUP FINANCIAL AND PRIVATE SECTOR DEVELOPMENT VICE PRESIDENCY DECEMBER 2011

NOTE NUMBER 330

viewpoint

PUBLIC POLICY FOR THE **PRIVATE SECTOR**

Reforming Business Taxes

What Is the Effect on Private Sector Development?

Miriam Bruhn

Miriam Bruhn (mbruhn@worldbank.org) is an economist in the World Bank's Development Research Group.

This Note was written as part of the Investment Climate Impact Project, a joint effort of the World Bank Group's Investment Climate Department, IFC's Investment Climate Business Line, and the World Bank's Development Research Group, in collaboration with IFC's Development Impact Department, the Development Impact Evaluation Initiative, the FPD Chief Economist's Office, and the Global Indicators and Analysis Unit. The project is funded by the U.S. Agency for International Development and the World Bank Group's Investment Climate Department.

THE WORLD BANK

IFC International Finance Corporation World Bank Group

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 tax regime. Although less is known about the effects of reducing compliance costs, evidence suggests that this too can lead to more formal firms and higher sales.

The tax regime is one of the most prominent aspects of a country's business environment. In many countries most formal firms are required to file and pay taxes repeatedly throughout the year and must dedicate substantial staff time to the process. Thus it is unsurprising that in the World Bank Enterprise Surveys businesses consistently rank tax rates and the tax administrative process among the most important constraints they face (figure 1). Tax policy and administration are a key part of a country's private sector development strategy. They are also often a political minefield, subject to conflicting objectives.

The regulatory burden of taxation has been increasingly highlighted in surveys on doing business, and country case studies suggest that high compliance costs can contribute to the decision of businesses to operate informally—that is, to not register with the tax authority at all (see, for example, Thiessen 2003). This is particularly relevant for small and medium-size firms, which tend to face disproportionately high compliance costs.[1]

Corporate tax rates have been almost universally reduced over the past decade as a result of the competition for increasingly mobile capital. Yet important differences remain across countries.[2] The World Bank's *Doing Business* report, which collects data on statutory tax rates around the world, finds significant variation, with rates ranging from 0 percent in Moldova to 40 percent in Chad in 2010 (World Bank 2011).

But statutory tax rates do not necessarily represent the taxes that firms actually need to pay. The reason is that deductions, depreciation, and other factors influence how much of corporate income is taxable. A more meaningful measure of corporate taxes is the effective tax rate, which measures the actual taxes paid (after taking into account deductions, depreciation, and other factors) as a percentage of profits. Djankov and others (2010) report both statutory and effec-