Tax avoidance by capital reduction: Evidence from corporate tax reform in Japan

Kaoru HOSONO (Gakushuin University)
Masaki HOTEI (Daito Bunka University)
Daisuke MIYAKAWA (Hitotsubashi University)

Abstract

Using the pro forma standard taxation system introduced in Japan on April 1, 2004, as a natural experiment, we empirically examine how firms reacted to this exogenous institutional change, which burdened all firms holding stated capital larger than 100 million JPY with additional tax payments. Then, we determine whether such a reaction (if any) systematically resulted in firm growth. Our results are as follows. First, firms that originally held capital above the threshold became more likely to reduce their capital to the threshold level, or below, after the announcement of the new tax system. Second, firms that exhibit losses, hold smaller assets, have lower liquidity, and/or would benefit more from a tax point of view by reducing their capital are more likely to do so. Third, firms that reduced their capital showed a higher exit rate and ex-post lower growth in size, measured by total and tangible assets, number of employees, and sales. Quantitatively, firms that reduced their capital decreased their assets, employment, and sales by 15%, 11%, and 4%, respectively, on average, within two years of the capital reduction, as compared with those that did not reduce their capital. Fourth, while the debt-to-total assets ratio of firms that reduced their capital did not change in comparison with firms that did not do so, the former firms did show a relative increase in the share of total assets made up of liquid assets. These results imply that the policy-induced capital reduction had substantial negative impacts on firm growth, and resulted in firms changing the balance of their asset holdings in favor of liquid assets.

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