Tax Policy and Lumpy Investment Behavior: Evidence from China’s VAT Reform

Zhao Chen Xian Jiang Zhikuo Liu
Fudan University Duke University Shanghai University of Finance and Economics
Juan Carlos Suárez Serrato Daniel Yi Xu
Duke University Duke University & NBER & NBER
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Abstract

How do firms respond to fiscal incentives for investment when investment is lumpy? This paper shows that different tax instruments (e.g., depreciation policies, investment tax credits, input taxes, income tax rates) have heterogeneous interactions with different forms of adjustment costs (e.g., fixed, convex, and partial irreversibility). Policies that have similar effects on the user cost of capital can therefore have different intensive- and extensive-margin effects on capital investment. We demonstrate the empirical importance of these results by studying a recent tax reform in China that changed the deductibility of fixed asset expenditures under the value-added tax (VAT) regime. We provide reduced-form evidence that firms respond to the reform by increasing investment in equipment capital. We use estimates of the intensive- and extensive-margin effects of the reform in addition to cross-sectional patterns of investment to estimate a dynamic model of investment. The model clarifies that the VAT reform reduced the partial irreversibility of investment, leading to a relatively larger extensive margin response. Finally, we use the estimated model to simulate the distributional effects of potential tax reforms in China that may be enacted in response to the recent tax reform in the United States.

Keywords: VAT, China, investment, corporate taxes

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