

Chapter 28

The Effects of Corporate Tax Rate on the Firm Performance

Gamze Oz-Yalaman

Eskisehir Osmangazi University, Turkey

ABSTRACT

The issue of taxation is one of the key subjects that draw the attention of both policymakers and business executives. This chapter investigates the effects of taxation on the firm performance by using an extensive data set from a panel of 738 companies for 16 different countries over the years between 2000 and 2016. The results suggest that the impact of corporate tax rates on firm performance is significantly negative. The results also show that financial crisis, development levels of countries, and size of firms have a significant effect on this relationship. The results are robust in terms of combining different sets of control variables. These findings are to guide the business executives in the decision-making process, which could increase the firm performance, and the results may help to improve the implementation of fiscal policy in the field of taxation.

INTRODUCTION

The issue of taxation and its effect on firm performance is one of the key issues that draw the attention of both policymakers and firm executives. Performance management in a firm is central to increasing firm performance and achieving goals. In addition, identifying the determinants of firm performance and arranging the resources according to these determinants is also essential. It makes easier for firms to set their goals in realistic terms and timeframes more efficiently.

According to Amendola et al. (2018), firm performance is one of the critical aspects of firm welfare.

The profits of firms translate into income for shareholders and generate spillover and multiplier effects at the individual, household, and economy-wide level. Profitable firms attract more investors and raise greater amounts of capital to finance larger and more sophisticated projects. Profitable firms also tend to employ more workers and have a greater impact on growth and poverty reduction. In this respect, detecting the determinants of firm performance is a way to assess the company's survival and development capability.

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Studies in the business policy literature on firm performance can be classified into three categories. The first category focuses on the impact of firm-specific variables such as size, liquidity, leverage etc. For example, Stierwald (2009) focuses on the determinants of firm profitability using large Australian firms over the years 1995-2005 and shows that lagged profits, size and productivity level of firms have positive effects on firm profitability. In an effort to answer the question, “Does firm size affect the firm profitability?”, Dogan (2013) analyzes the 200 companies in Istanbul Stock Exchange in Turkey over the 2008-2011 period and uses return on asset as a profitability variable. The findings indicate that there is a positive relationship between firm size and profitability. While a firm’s age and leverage have a negative effect on profitability, liquidity has a positive effect on profitability. Goddart et al. (2005) focus on the determinants of profitability in Belgium, France, Spain, Italy and United Kingdom using a dynamic panel model for the years between 1993 and 2001. In the study, manufacturing and service sector firms are selected and return on asset is used for profitability variable. Their findings also show that size of firms affect profitability negatively. Liquidity and market share have a positive effect on profitability. There is a negative relationship between gearing ratio, which is defined as non-current liabilities plus loans divided by shareholder funds, and profitability. Hansen and Wernerfelt (1989) compare two different groups of determinants of firm performance. Return on asset is used for firm performance. Economic determinants are chosen as industry profitability, size of firms and market share. Organizational determinants are chosen as measures of the employee’s perception of how concerned the organization is with his welfare, work conditions and employee’s perception of relative emphasis on achieving aggressive goals or objectives. Their findings show that organizational determinants on firm performance are twice as effective as economic determinants. Also, Yurtoglu (2004) shows that, for permanent profits, firm characteristics should be taken into account rather than industry characteristics. Moreover, Degryse and Ongena (2001) examine the relationship between banks and firm profitability and conclude that firms with bilateral relationship with banks have much more profitability than those with multiple bank relationships.

The second category focuses on the impact of macroeconomic variables on firm performance such as interest rate, GDP, unemployment, inflation etc. For example, McNamara and Duncan (1995) investigate the relationship between firm performance and macroeconomic variables in Australia over the years between 1978 and 1991. They use data from 41 companies among the top 60 Australian companies and use return on asset (ROA) as a firm performance indicator. Their findings show that firm performance is affected by the prior year’s ROA. In addition, the findings show that there is a positive relationship between gross domestic product and firm performance, while there is a negative relationship between interest rate and firm performance.

McDonald (1999) examines the determinants of firm profitability in manufacturing firms in Australia over the 1984-1993 period. Their findings show that firm profitability is affected by macroeconomic variables. Especially, lagged profitability and unemployment are significant determinants of current profitability. In addition, inflation has a negative effect on firm profitability.

Kanwal and Nadeem (2013) focus on the relationship between macroeconomic variables and bank profitability in Pakistan during the 2001-2011 period using pooled ordinary least squares methodology. Return on equity (ROE), return on asset (ROA) and equity multiplier (EM) are used as firm profitability indicators. Also, inflation rate, real gross domestic product (GDP) and real interest rate are used as macroeconomic variables. They show that there is a significant and positive relationship between real interest rate and all profitability indicators (ROA, ROE and EM) while there is a negative relationship between inflation rate and all profitability indicators (ROA, ROE and EM). Moreover, there is a positive

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