Policy brief
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Taxation and Family Firms

In brief

- Countries with lower levels of development are more likely to have firms that are organized around a family network as employment of trusted individuals may serve as a substitute for contract enforcement where there are weak institutions. Such firms are typically opaque regarding tax enforcement.
- This study attempts to provide a theoretical framework for understanding efficiency implications of different choices of tax base for business taxation when issues of trust, imperfect monitoring and tax evasion are important.
- Reliance on profits taxation is optimal, but is unlikely to be feasible with agency costs.
- The authors characterize the effect that the unobservability of some types of behaviour, such as cash holdings, has on the structure of taxation and show that deviating from profit taxation by taxing/subsidizing inputs that interact with behaviour that is unobservable to tax authorities is usually optimal.
- Labor intensity interacts with activities that cannot be monitored by tax authorities and with entrepreneurial effort. Depending on which of these effects is stronger, tax policy may encourage or discourage firm labor intensity for trusted and unrelated persons.
- When relatives are employed, this reduces agency costs, and thus, optimal tax policy that relies on observable sources of information is closer to profit taxation than otherwise.
- Further work is necessary to establish values of key parameters that determine quantitative implications of the results. In particular, understanding the effect of tax evasion and agency costs associated with different kinds of labor is key.

Policy Motivation

"The focus of our article is on characterizing the optimal tax structure when agency problems are present and employing relatives or other trusted individuals is used to mitigate them"

Firms are often organized around family network and family structure is more common in countries with lower levels of development. One reason for doing so is because employing trusted individuals may serve as a substitute for contract enforcement that is hard in environments with weak institutions. At the same time, firms that rely on trusted labor are more opaque from the point of view of tax enforcement and may find it easier to engage in tax evasion and tax avoidance opportunities. Our focus is in understanding implications of prevalence of family firms for the choice of optimal (efficient) tax structure, taking into account both their role in reducing agency costs and in non-compliance.

Policy Impact

Our analysis provides rigorous framework for understanding efficiency implications of different choices of tax base for business taxation when issues of trust, imperfect monitoring and tax evasion are important. As the result, they contribute to understanding of the issues surrounding taxation in countries with weak institutions and tax enforcement problems and may be useful in evaluation of tax reform proposals in such contexts.

Audience

Policy makers, tax analysts and academics who are interested in understanding implications of various tax policy choices on economic outcomes when tax evasion and monitoring problems are important. Economists interested in understanding economic reasons for variation in tax policy across countries with different quality of institutions and trust.

Policy Implications

The focus of our article is on characterizing the optimal tax structure when agency problems are present and employing relatives or other trusted individuals is used to mitigate them. We reach a few conclusions

- Reliance on profits taxation is optimal if feasible, but in the presence of agency costs it is unlikely to be feasible.
- We characterize the effect that unobservability of some types of behavior (for example, cash holdings) has on the structure of taxation and, in particular, we show that deviating from profit taxation by taxing/subsidizing inputs that interact with behavior that is unobservable to tax authorities is usually optimal.
- Labor intensity interacts with activities that cannot be monitored by tax authorities and with entrepreneurial effort. Depending on which of these effects is stronger tax policy may encourage or discourage firm labor intensity for both trusted and unrelated individuals.

- Because employing relatives reduces agency costs holding other things constant, optimal tax policy that relies on observable sources of information is closer to profit taxation when relatives are employed than otherwise. The presence of this effect calls for weaker distortions to employing relatives than to employing other types of labor.

Implementation

"Reliance on profits taxation is optimal if feasible, but in the presence of agency costs it is unlikely to be feasible"

The analysis is theoretical in nature and hence should be used as guidance for tax policy choices rather than provide immediate policy solutions. We highlight the mechanisms at work. Further work is necessary to establish values of key parameters that determine quantitative implications of the results. In particular, implementation requires understanding the effect on tax evasion and agency costs associated with different kinds of labor. Such parameters and their implications are country-specific, reflecting quality of contract enforcement, the importance of social networks in the labor market and the extent of inefficiency from employing trusted but less qualified labor that is likely to vary depending on the extent of sophistication of the productive process.

Further readings

Recent economic literature devoted to tax issues started to analyze constraints relevant to tax policy design in countries with varying level of development, focusing on issues of tax administration and enforcement. This paper contributes to this line of work. A brief list of related papers follows.

Fisman, R. and Wei, S.-J. (2004). Tax rates and tax evasion: Evidence from 'missing imports' in China. Journal of Political Economy, 112(2):471–96.

Kopczuk, W. and Slemrod, J. (2006). Putting firms into optimal tax theory. American Economic Review Papers and Proceedings, 96(2):130–134.

Mishra, P., Subramanian, A., and Topalova, P. (2008). Policies, enforcement, and customs evasion: Evidence from India. Journal of Public Economics, 92(10-11):1907–1925.

Gordon, R. and Li, W. (2009). Tax structures in developing countries: Many puzzles and a possible explanation. Journal of Public Economics, 93(7-8):855–866

Kleven, H. J., Kreiner, C. T., and Saez, E. (2009). Why can modern governments tax so much? An agency model of firms as fiscal intermediaries. Working Paper 15218, National Bureau of Economic Research.

Kleven, H. J., Knudsen, M., Kreiner, C. T., Pedersen, S., and Saez, E. (2011). Unwilling or unable to cheat? Evidence from a randomized tax audit experiment in Denmark. Econometrica, 79(3):651–92.

Pomeranz, D. (2011), No taxation without information: Deterrence and self-enforcement in the Value Added Tax. Harvard University, mimeo.

About the authors

Wojciech Kopczuk is a Professor of Economics and of International and Public Affairs, Department of Economics at Columbia University.

Professor Joel Slemrod is the Paul W. McCracken Collegiate Professor of Business Economics and Public Policy at the Stephen M. Ross School of Business at the University of Michigan and also serves as Director of the Office of Tax Policy Research, an interdisciplinary research center housed at the Ross School. Professor Slemrod received the A.B. degree from Princeton University in 1973 and the Ph.D. in economics from Harvard University in 1980. He joined the economics department at the University of Minnesota in 1979. In 1983-84 he was a National Fellow at the Hoover Institution and in 1984-85 he was the senior staff economist for tax policy at the President's Council of Economic Advisers. He has been at Michigan since 1987, and was chairman of the Business Economics Group from 1991 to 1992, and from 1995 to 1998. Professor Slemrod has been a consultant to the U.S. Department of the Treasury, the Canadian Department of Finance, the New Zealand Department of Treasury, the South African Ministry of Finance, the World Bank, and the Organisation for Economic Co-operation and Development (OECD). He has been a member of the Joint Committee on Taxation Revenue Estimating Board, a member of the Congressional Budget Office Panel of Economic Advisers, and has testified before Congress on domestic and international tax issues. He was editor of the National Tax Journal from 1992 to 1998 and is now co-editor of the Journal of Public Economics.

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