

# Impact of Public Policy on Business Environment and Corruption

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New Economic School: 2014-2015

These projects are stated as general research directions. Students are strongly encouraged to develop their own research ideas along these dimensions. Your projects can be theoretical, empirical, or both. We also encourage students to pursue research related to Russian regions, broadly including central Asian countries, for several reasons including that very few strong research papers have been written about the Russian regions, the large amount of *underused* available data, and the increasing need for reform in Russian bureaucratic and market systems.

During the first semester, all students in this group will be required to write a detailed review of another student's term paper / master thesis in this group. We expect all students to provide us with a literature review of their choice (beyond the references listed below) by July 31, 2014, and general ideas for research by August 15, 2014. During our first meeting in September, we will provide you a broad overview of the project and its implementation throughout the academic year, and we will discuss a sub-sample of your research proposals. We hope that the dynamics of this group will encourage you to pursue a Ph.D. Above all, please **do not** choose this project if you do not expect to start working on it during the summer.

# Introduction

Productivity and competitiveness in developing countries strongly rely on governments' commitments to incentivize investment and ensure a stable and healthy socio-economic environment for businesses. With a declining growth rate combined with increased corruption, Russia is no exception. In recent years and according to worldwide governance indicators, Russia ranks among the top fifth of most corrupt countries, along with far poorer parts of the world.<sup>1</sup> Economists agree that Russia's long term outlook strongly depends on regaining a sustained positive shift in businesses and consumers' confidence.<sup>2</sup> Improvement in regulatory and market institutions is critical to sustain market confidence, reduce inefficiencies in the allocation of labor in the private sector, and reduce distortions in government services.

## 1 Tax evasion and offshoring of investment

In advanced economies, a large part of tax revenue comes from corporations.<sup>3</sup> Business tax evasion has been extensively studied by the literature (Clausing, 2009; Hines, 2009, 2010; Desai et al., 2009). The most common way to evade taxes is simply declaring less profits than the amounts actually earned, or overstating deductions. Recent studies find evidence of this misreporting behavior from firms' reaction to policy discontinuities (Almunia and Lopez-Rodriguez 2014) or experiments (Pomeranz 2013). Tax evasion distorts private investment decisions at the expense of productive projects and erode the tax base (Dharmapala and Hines, 2009).

One avenue for future research is to further explore how the decision to evade corporate taxes depends on other elements of business environment. For instance, as compared to individual tax evasion, firms often need to persuade their employees, suppliers and/or clients to coordinate on misreporting transactions, by for instance, making under the table payments. A good understanding of this mechanism is critical to designing effective anti-avoidance measures. Indeed, De Paula and Scheinkman (2010) and Pomeranz (2013) emphasize the key role of information for effective tax enforcement, particularly through the self-enforcing mechanisms related to the VAT.

Multinational businesses increasingly use tax haven in order to minimize tax payments (Clausing, 2009; Hines, 2009, 2010; Desai et al., 2009). Although economists do not systematically associate tax haven with offshore centers, offshore possessions tend to be located in countries with low tax rates, making these two groups generally similar. Both tax haven and offshore centers tend to be well governed, less corrupted, richer than average, and smaller than other countries (Hines, 2010). All in all, there is still no clear understanding in the literature about how tax minimization affect firm value (Hanlon and Slemrod, 2009; Desai and Dharmapala, Desai and Dharmapala, 1995, 2009), and tax haven and offshore centers attract

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<sup>1</sup>“Corruption has laid waste to the Russian economy,” Sergei Guriev, Financial Times, April 2, 2014.

<sup>2</sup>“Russia Overview.” World Bank. <http://www.worldbank.org/en/country/russia/overview>

<sup>3</sup>However, one should also account for the fact that most personal income and sales income derive from corporate profits, making tax revenues essentially dependent on business income. For example, in the United States, businesses (incorporated or not) remit 84 percent of taxes (Christensen, Cline and Neubig, 2001).

investments from all types of countries, well governed or not, and more or less corrupted.<sup>4</sup>

Another avenue is to explore how the interactions between corruption, governance laws, and characteristics of tax systems affect firms' decisions (e.g., investment) as well as firms' performance. For instance, governance laws and corruption affect inward foreign direct investment (Egger and Winner, 2005) although the impact of domestic governance reforms has virtually no effect on investment from off-shore countries (Kuzmina and Volshkova, 2014). However there is mixed evidence on how corruption affects firms' efficiency. Gorodnichenko et al. (2014) find that corruption does not affect the efficiency of domestic firms in several Central European countries, and Kuznecovs and Pal (2012) investigate the impact of T&D rules on firm value among publicly traded Russian firms but find small and insignificant effect on their performance.<sup>5</sup>

Students could also investigate the extent to which deregulation reforms and improvement in governance laws affect tax evasion and offshoring of investment. Between 2001 and 2004, Russian regions implemented major reforms that simplified procedures to do business by reducing administrative and compliance costs for new businesses (registration, licensing) and for exiting businesses (less inspections), such that changes in regulatory burdens were clearly identifiable. Yakovlev and Zhukarevskaya (2012) show that these deregulations improved growth rates of small businesses. They also find a great variation across regions, with less corrupted, more transparent, more autonomous regions and regions with independent media more likely to benefit from the reforms. Gorodnichenko et al. (2009) use micro data on personal income and find strong evidence that the 2001 tax reform in Russia, which greatly simplified the tax system and reduced the personal income tax rate, reduced tax evasion by Russian individuals. One way to extend this line of research is to investigate the impact of corruption and regulatory reforms on corporate tax evasion decisions. Another possibility is to investigate the presence of Russian firms in tax havens and offshore financial centers (e.g., Ruslana database can be easily linked to corporate ownership databases).<sup>6</sup>

## 2 Quality of judicial systems

Contracting parties are sometimes uncertain about the ability of legal courts to enforce the real intents of their contract. Agents can improve the enforceability of their contracts by investing ex-ante in increasing the verifiability of the contracted actions (e.g. by improving the contract specifications) as in Kvaloy and Oslen (2009). In countries where courts are very inefficient and corrupt, like in Russia, new choices can be explored such as the one of influencing the courts decision.

A usual way out for parties who cannot resort to courts to enforce their contracts is to

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<sup>4</sup>The traditional view predicts that evasion increases investors' valuation of firms because it implies more retained earnings to reinvest. However, the empirical literature is unclear. Agency models predict that corporate governance is an important factor that mitigates the impact of evasion on firm value.

<sup>5</sup>See also Dharmapala and Khanna (2011) and Black et al. (2010) for evidence on the positive impact of governance laws on firm valuation by investors in India and Korea.

<sup>6</sup>Kuzmina and Volshkova (2014) show that weak governance rules negatively affect inward FDI from on-shore countries.

rely on self-enforcing relational contracts. Repeated transactions between the parties make it costly for each other to breach the contract, by letting breach ruin future trade. See Malcomson (2012) and Lafontaine and Slade (2012) for recent surveys. Hebous and Lipatov (2011) develop a model where corruption plays a similar role as taxation with the exception that the former implies informal and unguaranteed enforceability while the latter results from the rule of law. They test their model using data on German firms with affiliates in several countries (with various degrees of corruption, and countries with high or low tax rates) and find supporting evidence for their model. Is this the way Russian firms enforce their contracts? For instance, the provision of supplier trade credit has been associated with relational contracts as its repayment is very difficult to enforce in courts (see McMillan and Woodruff (1999), Cuñat (2007) and Troya-Martinez (2014) for example). The Worldbank enterprise survey (see section 4 below) contains information on inter-firm finance as well as upward and backward linkages in trade relationships.

The quality of judicial systems, together with other determinants of the business environment (e.g., investors protections such as governance rules, patent laws, etc.) are also likely to affect incentives to innovate. Students can investigate the extent to which regulatory reforms, tax reforms, corruption, transparency affect business innovations (e.g., as measured by spending in R&D, patents, new product development, process innovations, improvements in business organization, etc). In this respect, variation in Russian regions' business environment provides a great empirical platform.

### **3 Knowledge spillovers**

Gorodnichenko et al. (2014) show that foreign-owned firms (MNEs) operating in 17 central european countries, and domestic businesses that trade with them are more efficient than firms that are not exposed to MNEs. However, knowledge spillovers can appear not only through the presence of foreign businesses and the extent to which domestic businesses trade with them, but also through the presence of domestic firms in research intensive foreign countries. Griffith et al (2006) use patent data to show that spillover effects on domestic UK firms from outward R&D in the United States are significant and larger than domestic spillovers of inward R&D. Chen and Dauchy (2014) extend this analysis to 34 OECD countries and confirm these results among advanced nations. They also find, however, that while outward R&D spillovers from advanced countries to emerging countries are large and significant, they are inexistent in the opposite direction. Once again, students could extend this line of research to central European countries and Russian regions.<sup>7</sup>

### **4 Examples of databases**

Students can find databases on their own based on the referenced economic literature. Below, we provide information on some of the databases that students are strongly encouraged to use.

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<sup>7</sup>See World Bank's rich microeconomic survey data (e.g., Enterprise Survey, the Management, Organization and Innovation Survey).

1. European Bank for Reconstruction and Development: BEEPS data <http://ebrd-beeps.com/>. Survey of firms in 37 Russian regions: informs on variation of regulatory environment and entrepreneurs' perceptions.
2. World Bank:  
The World Bank provides access to a rich source of other microeconomic survey data of entrepreneurs and consumers. (including, for Russia, the Enterprise Survey, the Management, Organization and Innovation Survey, the Global Financial Inclusion survey). <http://microdata.worldbank.org/>
3. CEFIR: Survey of Russian Officials in 20 Russian regions (CEFIR, 2009)  
RUSLANA: database on financial statements/income statements, balance sheets, cash flow statements/for all businesses (private or traded on stock exchanges) in Russia, Ukraine, and Kazakhstan. Students should also have access to the RUSLANA database through CEFIR. For more information, see <https://ruslana.bvdep.com/>
4. Russian official statistics: Modern Russian official statistics both at national and regional level available at official Rosstat website <http://www.gks.ru/wps/wcm/connect/rosstat/rosstatsite/main/>
5. Patents and trademark: See FIPS data (several countries, including developing and developed). For Russia: [http://www1.fips.ru/wps/wcm/connect/content\\_en/en/informational\\_resources/databases1](http://www1.fips.ru/wps/wcm/connect/content_en/en/informational_resources/databases1)  
More countries: <http://tmclass.tmdn.org/ec2/?lang=en>  
Bureau van Dijk's ORBIS database also provides a rich and user-friendly worldwide database on patents which students are \*strongly\* encouraged to use if they find access to them. Orbis contains information on over 6.5 million patents linked to 585,000 companies (see <https://www.bvdinfo.com/en-us/products/company-information/international>).

Other potential data sources of interest:

1. Surveys of governance and public officials:  
The World Bank conducted two survey panels, a panel of district and settlement level public officials carried out in 2005 ( a year preceding the enactment of the reform legislation) and 2007 and a survey of rural households carried out in the beginning of 2006 and in 2007 in the same randomly selected rural districts and settlements of three regions of Russia, the Republic of Adygeya, Penza, and Perm Oblast.  
NGOs / NPOs (see Volshkova et al. 2014): Survey of small firms' directors and small of medium Russian firms in 2011, from Eurasia Competitiveness Institute (think tank)– provides data on governance quality data (“Opory data”) and from Opory Rossii (also a NPO that supports small businesses). Covers about 6,000 firms.

2. Corruption, economic freedom: Country level time series of indicators describing the extent corruption and degree of individuals' freedom have been developed by several institutions, including Heritage Foundation, Index of Economic Freedom. <http://www.heritage.org/index/explore>  
See also <https://www.cesifo-group.de/ifoHome/facts/DICE/Business-and-Financial-Market-Enterprise-Environment/Conduct-Regulations/economic-freedom-composit-index.html>
  
3. Households well-being, local public goods, infrastructure: The World Bank: A series of nationally representative surveys that contain very detailed information on households' well-being as well as information on local public goods and infrastructure (other countries are also available) <http://iresearch.worldbank.org/lsmsslsmssurveyFinder.htm>  
Professional experience during the transition: The Life in Transition survey evaluates personal and professional experience during transition, including individual perceptions and attitudes. See <http://www.ebrd.com/pages/research/analysis/publications/transition/data.shtml>

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