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

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Abstract

A universal fact of firm-level data is that investment is lumpy: firms either replace a considerable fraction of their existing capital (spike) or do not invest at all (inaction). This paper incorporates the lumpy nature of investment into the study of how tax policy affects investment behavior. We show that tax policy can directly impact the lumpiness of investment and that the effectiveness of tax incentives in stimulating investment depends crucially on interactions with investment frictions. We illustrate these results by studying one of the largest tax incentives for investment in recent history: China's 2009 VAT reform. Using administrative tax data and a difference-in-differences design, we document that the reform increased investment by 36% and that this effect is driven by additional investment spikes. We then simulate the fiscal cost of stimulating investment through different tax policies using a dynamic investment model that is consistent with the reduced-form effects of the reform. Policies that directly reduce the likelihood of firm inaction (e.g., investment tax credits) are more effective at stimulating investment than policies that only reduce the tax cost of investment (e.g., corporate income tax cuts).

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