Heterogeneous Investment Behavior in China's 2009 VAT Reform

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Abstract

This paper studies the heterogeneous investment responses of small and large firms to China's 2009 value-added tax (VAT) reform. I first document empirically that small firms responded more than large firms at both the extensive and intensive margins. Then I show the heterogeneous responses were due to small firms' higher marginal benefit of investing, which I call the size effect. This explanation relies on a size distribution where firms were not at their efficient sizes pre-reform. Estimating a dynamic investment model shows adjustment costs can rationalize the pre-reform size distribution, and the model can reproduce the empirical facts. I further look at how financial frictions affected the heterogeneous investment behavior. To identify which firms in the sample were financially constrained, I estimate a Chinese version of the Whited-Wu (2006) financial constraint index and show investment responds less to the reform the more constrained the firm is. The fact that small firms were more likely to be constrained but invested more indicates the size effect dominated the financial frictions during the 2009 VAT reform. (JEL D22, D25, E22, H25, H32)

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