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# The Impact of Corporate Income Tax on Bank Profitability

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***Abstract***

*This article examines theoretical and empirical research on the impact of corporate profit tax on bank profitability. In the conducted empirical studies, it was determined that there is a positive correlation between the corporate tax and the profitability of commercial banks, and its statistical significance is high. It has been confirmed that corporate income tax paid by banks will be passed on to their counterparties and affect pre-tax profits. As a result of the analysis, relevant conclusions were formed.*

***Keywords:*** *bank, profit, profitability, taxation, corporate income tax,*

## 1. Introduction

In modern conditions, taxes are one of the main instruments for ensuring the development of the priority directions of economic sectors and increasing the competitiveness of enterprises. Modern taxation should help not only to collect the necessary funds for public expenditure, but also to redistribute income, to stabilize the distribution of resources, and at the same time to support economic growth. Tax efficiency and especially tax structure play an important role in achieving economic growth and fiscal consolidation (Desislava, 2017). Looking at a simple production function, it turns out that taxation affects economic growth through its effects on capital, human capital, and total factor productivity.

Taking into account the financial intermediation activities of commercial banks, both wholesale consumers (firms) and retail consumers (individuals) are connected, the negative consequences of the imbalances in the taxation of banks' profits are related to the loss of efficiency and who actually bears the financial burden. The main channel of impact of corporate income tax on banking activity is the fact that this form of taxation applies directly to bank shareholders.

For this reason, the study of the effect of corporate tax on the profitability of banks is important for the effective regulation of their activities by means of taxes.

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## 2. Literature review

Ramsey's research is considered the foundation of the scientific literature on optimal taxation. Ramsey pointed out that effective taxation requires the introduction of a whole set of taxes, not just one tax. However, it is also important in the taxation of interest income. Ramsey (1927) considered consumption and savings as two different goods and argued that capital should be taxed at a much lower rate than wages. Also, according to Chamley (1986), based on theories of optimal taxation of capital, tax policies that directly affect capital should be avoided, including taxes on capital growth, dividends, and interest income. Atkeson, Chari, and Kehoe (1999) argue that, in the stationary state, taxing capital gains at a zero rate is optimal if the additional constraints are independent of capital, and vice versa. A flat-rate taxation of capital gains is not a distortion if capital expenditures are allowed to be deducted from the tax base of the purchasers of capital. However, even though this specification of capital gains tax imposes a zero effective capital tax rate, capital gains tax can generate significant revenue (Andrew, 2007). The financial sector is mainly a direct source of income from capital, and they benefit by providing a variety of financial services. It is clear that taxation of capital gains has a direct impact on the value and profitability of financial services. When tax rates rise, banks pass on their fiscal costs (tax burden) to their customers by raising interest rates on loans and lowering interest rates on deposits. Schandlbauer (2017) argues that an increase in the corporate income tax rate will affect banks' financing and operating choices, that is, banks with high capitalization will try to take advantage of the extended tax shield by increasing long-term nondeposit loans, while banks with low capitalization will reduce lending because of the high tax As interest rates increase the cost of financing, the loan margin turns into a loss. As a result of scientific research, it has been found that the value of financial intermediation services is relatively higher when compared to the imposition of VAT on financial services or the partial accounting of VAT paid to suppliers of goods (work) services. This problem is considered as "non-refundable VAT" and is accepted as a hidden cost by the banking sector (Yilmaz and Baydur, 2018.). In the results of the analysis, it was found that direct and indirect taxes have a significant impact on the interest spread and profitability of banks, and that direct taxes are transferred to bank customers to a certain extent, leading to an increase in the pre-tax profit of banks (Demirgüç-Kunt, Huizinga (1999). In other empirical studies conducted by banks, It is found that the profit taxes paid and VAT lead to an increase in the value of bank products, that is, an increase in the rate of profit tax and VAT paid by banks leads to an increase in the price of banking services. Thus, there is a positive relationship between the profitability of commercial banks and corporate profit tax, an increase in the rate of corporate profit tax it has been determined that it leads to an increase in profitability.

## 3. Research methodology

The methods of scientific abstraction, analysis, induction and deduction, expert assessment, descriptive statistics, scientific approach to theoretical and empirical literature were used in the research work.

## 4. Analysis and results

According to the current tax legislation, commercial banks pay the following main taxes and mandatory payments as a large taxpayer under the general procedure: profit tax; value added tax (when carrying out activities other than exempt financial transactions); property tax; land tax; tax for the use of water resources; social tax. In general, although the amount of taxes and mandatory fees paid by commercial banks has increased in recent years, different trends can be observed in their share of state budget revenues (Table 1).

**Table 1.** Information on taxes and mandatory payments paid by commercial banks to the state budget[1] (billion soum)

| | Indicators | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|
| I | Total tax revenue | 1 126,3 | 1 332,8 | 1 385,1 | 1 835,2 | 2 650,0 | 3 220,5 |
| | *including:* | | | | | | |
| | corporate income tax | 282,5 | 252,1 | 377,6 | 746,6 | 1 272,3 | 1743,7 |
| | VAT | 25,3 | 18,8 | 28,3 | 49,5 | 85,4 | 144,0 |
| | property tax | 47,7 | 64,7 | 77,.3 | 72,7 | 33,5 | 46,0 |
| | land tax | 7,2 | 7,8 | 9,6 | 10,1 | 11,8 | 12,5 |
| | income tax | 172,6 | 201,5 | 284,5 | 356,3 | 444,0 | 544,6 |
| | Social tax | 287,5 | 340,7 | 467,2 | 622,4 | 802,9 | 522,3 |
| II | Share of budget tax revenue (in %) | 3,1 | 3,2 | 2,8 | 2,3 | 3,2 | 3,1 |
| | *including:* | | | | | | |
| | corporate income tax | 23,9 | 20,7 | 25,6 | 21,3 | 8,4 | 6,1 |
| | VAT | 0,2 | 0,2 | 0,2 | 0,2 | 0,4 | 0,7 |
| | resource and property tax | 1,1 | 1,4 | 1,3 | 0,7 | 0,2 | 0,3 |
| | income tax | 4,5 | 4,9 | 5,8 | 5,6 | 3,5 | 3,7 |
| | social tax | 4,1 | 4,3 | 5,1 | 5,1 | 3,9 | 2,6 |

In particular, in 2020, compared to 2015, the amount of profit tax paid by commercial banks increased by approximately 2.86 times, but its share in the total profit tax revenue decreased by 6.1 percent. This includes the increase in the general profit tax rate (12% in 2018, 15% in 2020), the cancellation of tax benefits and a sharp increase in the number of profit tax payers in 2019 (the number of profit tax payers was 49,420 in 2019 or 2018 increased by 41,845 compared to the year) can be cited as the main reasons. Property tax, land tax, tax on the use of water resources, and social tax paid from the profits of commercial banks are part of operating expenses and lead to an increase in the cost of banking services. However, over the past 5 years, the share of these taxes in operating expenses has decreased, which is mainly due to changes in the base and rates of social tax and property tax.

[1]It was compiled by the dissertation student based on the information of the Ministry of Finance of the Republic of Uzbekistan and the State Tax Committee.

In general, the share of interest income in the total income of commercial banks is high (75.47%), and the main part of this income is contributed by loan interest. In non-interest income of banks, commission income (9.97%) and other received income (8.59%) make up a significant share, and the share of income from investments in securities (0.37%) is very low. The share of interest expenses in the total expenses of commercial banks is high (54.05%), and the main part of these expenses is interest payments on the resources involved and deposits. Operating expenses include wages (12.96%), the percentage of reserves for possible loan losses (13.63%) (Table 2).

According to the results of scientific studies, corporate profit tax of banks (tax on bank capital) is equivalent to tax on loans, and due to prudential regulation, banks are required to have sufficient capital. An increase in the corporate income tax rate has a positive effect on the interest rate on loans and a negative effect on loan activity, and the effect on the net interest margin can be any number of cases

**Table 2**. Composition of income and expenses of banks[2] (%)

| Composition of earnings | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|
| **Interest income** | 60.97 | 61.23 | 52.49 | 67.44 | 72.49 | 75.47 |
| **Non-interest income, of which:** | 39.03 | 38.76 | 47.52 | 32.56 | 27.51 | 24.53 |
| ***commission income*** | 27.49 | 27.97 | 22.78 | 16.94 | 12.56 | 9.97 |
| ***foreign currency income*** | 5.20 | 4.24 | 18.58 | 9.15 | 5.91 | 5.59 |
| ***investment returns*** | 0.71 | 0.83 | 0.78 | 0.54 | 0.53 | 0.37 |
| ***other income*** | 5.63 | 5.73 | 5.38 | 5.93 | 8.51 | 8.59 |
| **Cost structure** | | | | | | |
| **Interest expenses** | 39.49 | 39.97 | 34.18 | 44.85 | 50.57 | 54.03 |
| **Interest-free expenses** | 5.75 | 8.56 | 16.51 | 8.00 | 10.36 | 8.62 |
| **Operating expenses** | 44.75 | 40.80 | 33.00 | 33.30 | 24.08 | 20.01 |
| ***including: salary*** | *24.10* | *23.60* | *19.39* | *19.59* | *15.82* | *12.96* |
| ***other operating expenses, including taxes*** | *20.65* | *17.20* | *13.61* | *13.72* | *8.27* | *7.05* |
| **Other expenses** | 10.01 | 10.67 | 16.31 | 13.85 | 14.98 | 17.34 |
| ***of which, provision for losses on loans*** | *5.33* | *5.43* | *11.45* | *8.95* | *11.78* | *13.63* |
| ***income tax*** | *3.74* | *4.13* | *2.80* | *3.75* | *3.21* | *2.84* |

**Table 3.** Regression analysis results

| | Pooled OLS | Random effect | Fixed effect | OLS with Hetero & Serial Correlation |
|---|---|---|---|---|
| Constant | -1.257**<br>(-2.02) | -2.184***<br>(-3.04) | -2.334***<br>(-3.03) | -1.257<br>(-1.17) |
| Ln CIT | 0.427***<br>(6.09) | 0.300***<br>(4.96) | 0.275***<br>(4.42) | 0.427**<br>(3.04) |
| Ln Asset | -0.064<br>(-0.96) | -0.052<br>(-0.74) | -0.047<br>(-0.62) | -0.064<br>(-0.55) |
| Ln Form | 0 | 0 | 0 | 0 |
| Breusch-Pagan LM test | 27.30*** | | | – |
| Hausman test | – | 3.36 | | – |
| Observations | | 73 | 73 | |
| Multicollinearity (vif<10) | – | – | 1.07 | – |
| Heteroscedasticity ($\chi^2$-stat) | – | – | 2461.16*** | – |
| Serial correlation (F-stat) | – | – | 0.893 | – |

Standard errors in parentheses ***p<0.01,**p<0.05,*p<0.1

The effect of corporate income tax on other revenues is always negative, and it can be concluded that a high level of income tax reduces investment from the corporate sector and reduces the demand for banking services. Also, the effect of the increase in the corporate profit tax rate on the required reserves for operating expenses and possible loan losses is negative, mainly reflecting the effect on the amount of loans and services provided. Finally, according to the results of the empirical analysis, it was confirmed that approximately 90% of the significant part of the corporate profit tax burden paid by the banks can be transferred to the customers (Albertazzi & Gambacorta, 2010).

Abdullaev (2022) estimated the effect of corporate profit tax on the profitability of commercial banks through the Pooled OLS model. In this model, if the estimated probability value (p-value) is less than 5% significance level, regression analysis was performed using Random effect and Fixed effect method (Table 3).

[2]Rating Agency Ahbor-Reyting (2021). Analytical overview of the banking sector of Uzbekistan 2015-2020.

As a result of the performed regression analysis, it was determined that there is a positive relationship between the profitability of commercial banks and the profit tax, and its statistical significance is high. An increase in the profit tax paid by commercial banks leads to an increase in bank profitability. Empirical research on the impact of corporate profit tax on banks' profitability found that corporate profit tax paid by banks is transferred to their counterparties and has a positive effect on pre-tax profit. This means that the profit tax paid by banks increases the costs of legal entities and individuals who consume banking services and products (in the form of interest on loans and income from other services) and leads to a decrease in their profits. Especially if we take into account that business entities mainly use loans from commercial banks as a source of financing investment projects, the continued negative impact on the general economy may increase.

## 5.Conclusion

Theoretically, the impact of the bank tax can fall on various parties: in particular, shareholders, customers, employees, suppliers of bank resources and the state itself, including the payment of VAT on the resources received by the bank.

As a result of the empirical analysis, the increase in the corporate profit tax rate has a positive effect on the interest rate of loans and a negative effect on the volume of loans in the conditions where the deposit market has not changed. The overall impact on the net interest margin on loans varies, with a positive (negative) trend at relatively low (high) tax rates. It has also been found that banks have the ability to transfer a large part of corporate income tax, approximately 90% of the tax burden, to clients.

In the conducted analysis, it was confirmed that the corporate profit tax paid by banks is transferred to their counterparties and affects the profit before tax, determined as a result of scientific and empirical research on optimal taxation of income from capital.

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