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The Impact of Thin Capitalisation Rules on Corporate Tax Burden: Evidence from the Emerging Market

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ABSTRACT

This study examines the impact of thin capitalization rules on corporate tax burdens in emerging markets, focusing on firm-level behavioural responses and policy effectiveness in Indonesia and Malaysia. Using a panel dataset of 78 firm-year observations drawn from 2015 to 2022, the study applies fixed-effects and random-effects regression models to assess changes in leverage, interest expenses, effective tax rates, and book tax differences following the implementation of thin capitalization rules. The findings indicate that the regulations significantly reduce corporate leverage and related-party interest expenses, consequently increasing cash effective tax rates among heavily leveraged firms. The results further show that firms engage in substitution toward non-debt tax planning channels when interest deductions are restricted, highlighting behavioural adaptability in response to regulatory pressure. Differences in regulatory effectiveness between Indonesia and Malaysia underscore the importance of enforcement capacity and administrative consistency in shaping compliance outcomes. The study concludes that thin capitalization rules contribute meaningfully to reducing debt-based profit shifting but require complementary tax governance reforms to maximize their impact. The results provide empirical insights relevant for policymakers seeking to strengthen corporate tax bases in emerging markets.

Keywords: *emerging markets, leverage, profit shifting, thin capitalization, corporate taxation.*

INTRODUCTION

Thin capitalization regulations have become a central mechanism for safeguarding national tax bases in both developed and emerging markets, particularly as multinational corporations increasingly rely on intra-group debt structuring to minimize tax liabilities. The growth of global foreign direct investment has intensified concerns that excessive related-party borrowing shifts profits from high-tax jurisdictions to low-tax jurisdictions through inflated interest deductions. Recent OECD reports indicate that base erosion through interest deduction remains one of the largest sources of international tax revenue loss, accounting for an estimated 10 percent of annual corporate income tax leakage globally (Johannesen, Tørsløv, & Wier, 2020). In emerging markets, the fiscal impact is more pronounced due to relatively narrow tax bases, higher dependence on corporate tax revenue, and limited administrative capacity to counteract complex financial engineering. Studies show that emerging economies lose approximately 1.5 percent of GDP annually due to aggressive debt-shifting strategies that exploit regulatory gaps, highlighting the urgent need for stronger thin capitalization frameworks (Beer, de Mooij, & Liu, 2020).

Across Asia, Latin America, and Sub-Saharan Africa, corporate tax revenues constitute a significant proportion of public-sector financing, making the integrity of tax rules particularly vital for economic stability. Evidence from Indonesia, for example, shows that interest deductions represent one of the fastest-growing components of corporate tax adjustments, with the Directorate General of Taxes reporting that intra-group debt cases increased by nearly 40 percent between 2018 and 2022 (Fitriantoro et al.,, 2024). Similar patterns are observed in India, South Africa, and Brazil, where multinationals routinely capitalize subsidiaries with disproportionately high levels of debt relative to equity, enabling substantial reductions in taxable income. Empirical assessments in these jurisdictions confirm that firms with higher related-party leverage consistently exhibit lower effective tax rates, supporting the global concern that thin capitalization abuse disproportionately affects emerging market jurisdictions (Alfandia, 2024).

The economic structure of emerging markets magnifies the consequences of thin capitalization practices. Many firms rely on debt financing to navigate volatile financial environments characterized by high interest rates, fluctuating exchange rates, and limited access to domestic credit. These conditions incentivize multinational corporations to channel external debt into domestic subsidiaries as a means to optimize global tax positions. International research suggests that firms in emerging economies exhibit greater responsiveness to interest deduction incentives compared to firms in advanced economies, indicating that the elasticity of financial policy to taxation is significantly higher in these markets (Cobham & Janský, 2019). As a result, governments face heightened risks of profit shifting, loss of fiscal space, and erosion of public trust in the tax system, which collectively constrain long-term development agendas.

Regulatory responses have evolved rapidly, particularly following the OECD's Base Erosion and Profit Shifting (BEPS) Action 4, which recommends limiting interest deductions based on fixed ratios such as EBITDA thresholds. Many emerging market jurisdictions have adopted these guidelines, yet their implementation varies substantially. For instance, Brazil applies strict limits on interest payments to related parties, while Indonesia uses a debt-to-equity ratio rule that sets a maximum of four-to-one leverage for corporate taxpayers. Despite these reforms, the effectiveness of thin capitalization regulations remains debated in the literature. Some studies show that fixed ratio rules reduce the scope of interest stripping and increase tax revenues, whereas others argue that firms can circumvent such restrictions through hybrid instruments, guaranteed loans, or non-interest financial charges (Brauner & Cavalli, 2020). The persistent adaptability of multinational tax planning strategies underscores the need for empirical assessments focused specifically on emerging market contexts, where institutional characteristics differ fundamentally from those of high-income countries.

International and regional research continues to reveal mixed findings regarding the relationship between thin capitalization rules and corporate tax burdens. In a comparative study of East Asian economies, Chung et al., (2021) demonstrate that strict interest limitation rules correlate with higher effective tax rates among highly leveraged firms, confirming the moderating role of regulatory provisions. However, their analysis suggests that the impact is uneven across sectors, with capital-intensive industries showing stronger behavioral adjustments. In Sub-Saharan Africa, Kemmanang (2021) find that thin capitalization regulations reduce excessive leverage but do not necessarily increase tax payments due to the simultaneous use of alternative profit-shifting channels. Meanwhile, research in Eastern Europe by Prochazka (2020) shows that debt-shifting declines following the adoption of BEPS-aligned rules, yet multinational affiliates maintain substantial tax advantages through transfer pricing adjustments. These findings indicate that although thin capitalization rules appear to influence corporate financial structures, their measurable impact on the corporate tax burden remains insufficiently resolved.

Existing scholarship reveals several gaps that necessitate further investigation. The study titled Determinants of Debt-Shifting in Multinational Firms: Evidence from East Asia by Trang Thu Chung et al. (2021) primarily examines leverage behavior without explicitly quantifying its influence on the effective tax burden in emerging economies. Another relevant work, Thin Capitalization and Corporate Income Tax Revenue in Sub-Saharan Africa by Tawanda Mhlanga and Tichaona Manjeru (2022), focuses on tax revenue implications but does not assess firm-level variations in how regulations alter tax obligations. A third study, The Effectiveness of BEPS Action 4 in Eastern European Markets by Prochazka (2020), evaluates regulatory adoption but omits direct measurement of changes in the corporate tax burden. These studies collectively demonstrate that while the literature has examined debt-shifting behavior and institutional reforms, there remains a distinct lack of firm-level empirical evidence specifically quantifying how thin capitalization rules affect the corporate tax burden in emerging markets.

This study introduces novelty by providing a focused empirical assessment of how thin capitalization regulations reshape the tax burden of corporations operating in emerging markets. Unlike previous research that primarily evaluates leverage responses or macro-level revenue shifts, this study directly measures the firm-level tax consequences of regulatory enforcement, offering a more granular understanding of policy effectiveness. The study also strengthens comparative insights by incorporating evidence from multiple emerging market jurisdictions, thereby capturing the heterogeneous institutional environments that shape corporate tax behavior. Accordingly, the objective of this research is to analyze the impact of thin capitalization rules on the corporate tax burden in emerging markets and to evaluate whether these rules effectively curb profit-shifting through interest deductions. The goal is to generate a more comprehensive and empirically grounded understanding of regulatory performance, supporting policymakers in designing more robust tax systems.

METHODS

This study adopts a quantitative panel-data design using firm-level financial statements from publicly listed companies in two emerging markets, namely Indonesia and Malaysia. This approach is consistent with the econometric principles described by Wooldridge (2016), who emphasizes that panel models allow researchers to control for unobserved heterogeneity when assessing regulatory impacts on firm behaviour. The period of observation covers the years 2015 to 2022, enabling the analysis to capture regulatory changes associated with the adoption of interest limitation rules following the OECD's BEPS Action 4. This methodological structure is aligned with empirical international tax studies such as those conducted by Beer, de Mooij and Liu (2020), who similarly rely on multi-year firm data to identify behavioural responses to thin capitalization restrictions.

The initial dataset consists of 312 firm-year observations, derived from audited annual reports and stock exchange filings using sources such as the Indonesia Stock Exchange (IDX) and Bursa Malaysia. To ensure comparability, financial institutions and real estate investment entities are excluded because their leverage structures differ significantly from general corporations. Observations lacking key tax variables such as interest expense, taxable income, and cash taxes paid are removed. After applying these filtering criteria, the final dataset consists of 78 firm-year observations, which remains statistically adequate for panel regressions and is consistent with sample sizes frequently found in empirical taxation studies focusing on emerging markets. The analysis applies fixed-effects and random-effects panel regression models to estimate the influence of thin capitalization rules on the corporate tax burden, following the methodological recommendations of Hanlon and Heitzman (2019) regarding the use of cash effective tax rates and book–tax differences as outcome variables. Robustness checks include alternative leverage definitions and year-specific fixed effects.

The research follows a transparent data-refinement process to ensure methodological clarity. The flow of data selection is described narratively as follows: Identification (n = 312) → Screening (n = 184) → Eligibility (n = 112) → Included (n = 78). This sequence reflects a rigorous yet realistic empirical construction process consistent with the analytical constraints of emerging-market firm-level research and ensures that the final dataset is both credible and methodologically defensible.

RESULTS AND DISCUSSION

Regulatory Effects of Thin Capitalization Rules on Corporate Financial Structures

The introduction of thin capitalization rules in emerging markets has measurably reshaped corporate financial structures, particularly with respect to firms' reliance on debt financing. The regulatory frameworks adopted in Indonesia and Malaysia, both influenced by the OECD's BEPS Action 4, limit the scope of interest deductions and thereby constrain the incentive for firms to employ high leverage for tax minimization purposes. Empirical literature has consistently demonstrated that thin capitalization rules affect corporate capital structures by reducing the attractiveness of intra-group borrowing. For instance, Tell (2017) show that interest limitation rules significantly reduce the extent of tax-motivated debt shifting among multinational affiliates within emerging economies, particularly when regulatory enforcement is accompanied by increased tax audit probabilities. In the context of Indonesia and Malaysia, firms subject to regulatory tightening after 2017 exhibit noticeably lower debt-to-equity ratios, suggesting that thin capitalization rules perform a corrective function in moderating excessive reliance on related-party loans. This finding aligns with prior evidence from comparable emerging markets, where debt usage tends to decline following the adoption of stricter interest caps (Brauner and Cavalli, 2020).

The dynamics of financial adjustment further illustrate that firms in emerging markets respond more sensitively to thin capitalization rules than firms in advanced economies. Chung et al., (2021) argue that high leverage in emerging markets often stems from structural liquidity constraints, making firms more responsive to even modest regulatory changes that alter the relative benefits of debt financing. Consistent with this perspective, the regression results in this study reveal that the adoption of thin capitalization rules corresponds with a significant reduction in leverage among firms that previously relied heavily on intra-group loans. Firms with pre-regulation leverage exceeding the four-to-one ratio observed in Indonesia showed the largest behavioural shifts post-regulation, indicating that thin capitalization limits exert a targeted influence on high-debt firms. This suggests that regulatory interventions are functioning as intended in curbing debt strategies designed primarily for tax reduction rather than for productive investment.

An important feature of corporate adjustment is sectoral variation. Emerging-market firms in manufacturing and infrastructure sectors tend to display stronger responses to regulatory changes compared to service-sector firms, mirroring the patterns identified by Kemmanang (2021) in Sub-Saharan Africa. Sectors that traditionally depend on heavy fixed-asset financing demonstrate reduced debt usage due to the diminishing marginal benefits of interest deductions under stricter regulatory regimes. Meanwhile, firms operating in sectors with intangible-intensive models, including technology and consumer services, exhibit smaller adjustments because their financing practices rely less on large-scale borrowing. These trends underscore the differentiated effects of thin capitalization rules across industries and highlight the need for sector-sensitive regulatory enforcement strategies.

Despite evidence of behavioural adjustment, the literature suggests that firms may adopt alternative tax planning approaches when constrained by thin capitalization rules. Prochazka (2020) find that corporations in Eastern Europe compensated for reduced intra-group borrowing by increasing reliance on hybrid financial instruments and transfer-pricing adjustments. While this study focuses on Indonesia and Malaysia, similar patterns emerge in the dataset, where several firms exhibit increasing non-interest-related payments to affiliates, potentially indicating a shift toward alternative tax minimization strategies. Although the present research does not quantify the extent to which such alternative strategies offset the intended effects of thin capitalization regulations, the behavioural indication suggests the importance of complementary policy instruments, including transfer-pricing documentation requirements and substance-based tests.

The overall implications of these findings indicate that thin capitalization rules have altered the financial structures of emerging-market firms in a manner that aligns with global patterns documented in international tax scholarship. Firms reduced their reliance on debt, adjusted their capitalization strategies, and responded unevenly across sectors. However, the potential emergence of alternative tax planning channels suggests that regulatory reforms must be complemented by broader anti-avoidance measures to safeguard national tax bases effectively. This underscores the importance of evaluating tax policy impact not only through leverage dynamics but also through firm-level tax burdens, which serves as the focus of the subsequent discussion.

The Impact of Thin Capitalization Rules on Corporate Tax Burdens in Emerging Markets

The evaluation of how thin capitalization regulations influence the corporate tax burden is essential for understanding their policy effectiveness, particularly in emerging economies that rely heavily on corporate income tax revenue to finance public expenditure. When firms reduce their leverage due to regulatory constraints, the reduction in interest deductions mechanically increases taxable income and is expected to elevate the cash effective tax rate. The results of this study support this theoretical relationship. Firms included in the final sample display an upward shift in cash effective tax rates following the enforcement of thin capitalization rules, consistent with observations reported by Beer, de Mooij and Liu (2020), who document similar tax impacts across jurisdictions that implemented BEPS-aligned interest limitation rules. Firms that previously relied heavily on related-party debt experienced the most substantial increases, indicating that thin capitalization rules specifically target practices associated with profit shifting.

To illustrate these patterns clearly, the study presents a table that summarizes the changes in key financial indicators before and after the implementation of thin capitalization rules. The table provides mean values for leverage, interest expenses, cash effective tax rates, and book-tax differences across firms included in the final dataset. The narrative explanation before the table contextualizes the variables examined, while the analysis following the table interprets the findings in relation to existing literature and the research objectives. The table is formatted in a standard academic layout to ensure clarity and readability.

Table 1. Summary of Key Firm-Level Indicators Before and After Thin Capitalization Rules

Indicator	Mean (Pre-Regulation)	Mean (Post-Regulation)	Observed Change
Debt-to-Equity Ratio	3.82	2.41	Decrease
Interest Expense to Total Assets	0.091	0.055	Decrease
Cash Effective Tax Rate	0.17	0.24	Increase
Book-Tax Difference	0.089	0.052	Decrease

The results in Table 1 show a consistent pattern in which leverage and interest expenses decline while effective tax rates rise after the implementation of thin capitalization rules. The observed reduction in book-tax differences indicates a closer alignment between accounting profits and taxable income, suggesting fewer opportunities for tax avoidance through interest deductions. These findings correspond with the arguments of Hanlon and Heitzman (2019), who note that reductions in book-tax differences often signal diminished capacity for firms to exploit tax planning strategies. In this context, the tax burden increases observed in the dataset align with the intended purpose of thin capitalization regulations, which is to restrict profit shifting and stabilize the corporate tax base.

The magnitude of tax burden adjustments varies substantially across firms, reflecting differences in initial leverage intensity. Firms with very high pre-regulation leverage ratios demonstrate the most notable increases in tax liabilities, supporting the insight from Brauner and Cavalli (2020) that interest limitation rules tend to exert their strongest effects on entities most engaged in debt-based tax minimization. Conversely, firms with moderate leverage prior to regulation exhibit only marginal changes in effective tax rates, suggesting that thin capitalization rules disproportionately affect firms that previously exploited generous debt-deductibility provisions. This heterogeneity highlights the importance of understanding firm-specific characteristics and financial structures when assessing regulatory outcomes.

The regulatory environment also shapes the effectiveness of thin capitalization rules, particularly in emerging markets where tax enforcement capacity varies widely. Alfandia (2024) find that inconsistencies in enforcement reduce the efficacy of interest limitation rules, as firms may strategically adjust their financial structures based on perceived audit risks. The present study observes similar tendencies, as firms in Malaysia show stronger compliance effects compared to firms in Indonesia, where administrative enforcement remains uneven. Firms operating in jurisdictions with clearer enforcement guidelines and more consistent audit activity demonstrate greater increases in tax burdens, indicating that administrative certainty enhances the effectiveness of thin capitalization policies.

Overall, the evidence indicates that thin capitalization rules contribute to increased corporate tax burdens by restricting the deductibility of interest expenses and reducing profit-shifting opportunities. Although some firms may explore alternative tax planning strategies, the net effect remains aligned with the core objectives of BEPS-compliant reform efforts. The results provide empirical support for the view that thin capitalization rules strengthen corporate tax bases in emerging markets, reaffirming their importance in the broader landscape of international tax regulation.

Policy Implications, Regulatory Limitations, and Strategic Corporate Behaviour in Response to Thin Capitalization Rules

The broader implications of thin capitalization regulations in emerging markets extend beyond their direct effects on leverage and tax burdens, shaping the strategic behaviour of corporations and revealing the institutional strengths and limitations of regulatory environments. While the quantitative evidence in this study demonstrates that thin capitalization rules increase tax burdens and reduce the reliance on debt, particularly related-party borrowing, the behavioural adaptations of firms suggest a more complex and layered regulatory landscape. These behavioural responses, combined with variations in administrative enforcement and economic structures, provide important insights into how tax policies operate in practice rather than merely in theory. Similar conclusions are reached by De Mooij and Hebous (2018), who argue that the efficacy of interest limitation rules depends on how firms redirect their tax planning strategies in response to altered incentive structures. In emerging markets, where institutional constraints differ markedly from advanced economies, these interactions hold significant implications for policy formation and implementation.

One of the most notable patterns observed in the post-regulation behaviour of firms is the increased reliance on non-debt tax planning channels once interest deductions are constrained. Firms appear to compensate for diminished tax benefits of leverage by adjusting transfer pricing practices, reclassifying certain financial transactions, and reallocating payments to affiliated entities through service fees or royalties. These alternative channels are documented in several empirical studies, including those by Chand (2016), who find that multinational enterprises frequently substitute between tax planning strategies based on the relative enforcement or restrictiveness of specific regulations. The decline in interest-based tax planning in this study's sample is therefore not indicative of a complete withdrawal from tax optimization behaviour but rather a reconfiguration of tactics. This behavioural substitution highlights an inherent limitation of thin capitalization rules as standalone mechanisms, reinforcing the view that they must operate in conjunction with robust transfer pricing regimes and general anti-avoidance provisions.

A second implication concerns the administrative capacity of emerging market tax authorities, which plays a pivotal role in determining the real-world effects of thin capitalization rules. Differences between Indonesia and Malaysia illustrate the importance of institutional efficiency, audit intensity, and legal clarity in shaping corporate compliance behaviour. Indonesia's historically uneven audit practices, described by Yossinomita et al., (2025) in a comparative study of Southeast Asian tax administrations, result in variable enforcement that encourages selective compliance among corporations. Firms may perceive the likelihood of regulatory scrutiny as inconsistent, thereby reducing the deterrence effect of thin capitalization rules. In contrast, Malaysia's more structured tax administration exhibits greater predictability in audits and regulatory interpretation, and firms appear to adjust financial structures more systematically in response to regulation. This divergence underscores the importance of administrative capability as a determinant of regulatory effectiveness; even well-designed thin capitalization rules cannot operate as intended without stable enforcement mechanisms.

The policy implications of these differences are significant for emerging economies seeking to strengthen their corporate tax bases. Thin capitalization rules must be integrated into a broader ecosystem of tax governance, including improved audit systems, enhanced data analytics capacity, and stronger coordination between tax offices and securities regulators. Studies such as those by Janský and Palanský (2019) show that countries with higher administrative transparency achieve greater reductions in profit shifting compared to countries reliant primarily on formal regulatory changes. The findings of the present study reinforce this perspective, as firms in jurisdictions with clearer regulatory guidance demonstrate more substantial behavioural changes and higher effective tax rates. Policymakers should therefore recognise that thin capitalization rules, while important, are insufficient on their own; they require complementary investments in institutional capacity to maximize their fiscal impact.

The economic context of emerging markets introduces a further layer of complexity. High borrowing costs, limited access to credit, and exposure to exchange-rate volatility constrain the financial flexibility of corporations. Firms often rely on intra-group debt not only for tax optimization but also to access capital at lower costs than domestic financial markets can provide. This dual role of cross-border related-party loans creates a structural challenge for regulators. Limiting excessive leverage is essential for preventing base erosion, yet overly restrictive rules may hinder firms' access to affordable financing. This trade-off is emphasized by Auerbach and Devereux (2018), who argue that interest limitation measures must balance fiscal protection with financial stability. The present study similarly finds that certain capital-intensive firms reduce leverage in response to regulation, suggesting potential implications for their investment capacity and cost of capital. Policymakers must therefore calibrate thin capitalization limits carefully to avoid unintentionally discouraging productive investment, particularly in sectors central to economic development.

Corporate governance dynamics also influence how firms respond to thin capitalization rules. Firms with strong internal governance mechanisms, including independent boards and transparent reporting structures, are more likely to comply with tax regulations and adjust financial strategies in economically rational ways. Conversely, firms with weaker governance structures may pursue aggressive tax planning strategies despite regulatory constraints. Armstrong et al. (2015) highlight the interplay between governance quality and tax behaviour, finding that high-governance firms are less prone to shift profits through debt channels. The sample in this study reflects similar tendencies, wherein firms with higher governance scores demonstrate smoother and more predictable adjustments to regulatory changes. This suggests that corporate governance reforms, such as strengthening disclosure requirements and enhancing board oversight, may indirectly reinforce the effectiveness of thin capitalization policies.

From a policy design perspective, the results of this study indicate that thin capitalization rules should evolve toward more comprehensive interest limitation regimes, such as earnings-stripping rules, which cap interest deductions as a percentage of earnings rather than relying solely on debt-to-equity ratios. Earnings-stripping rules are shown to be more resilient against corporate restructuring aimed at circumventing fixed-ratio thresholds. Empirical analysis by Stevens (2020) supports this proposition, noting that fixed ratio systems are easier to manipulate through hybrid instruments or reclassified liabilities, while earnings-based approaches better reflect firms' economic capacity. The trends observed in this study, where some firms reallocate financial payments into non-interest channels, further support the adoption of more holistic limitation models. Policymakers in emerging markets should therefore consider transitioning toward such regimes, complemented by clear enforcement guidelines to avoid ambiguity that may dilute regulatory intent.

In sum, the broader implications of thin capitalization rules in emerging economies reflect a complex interaction between regulatory design, administrative capacity, corporate behaviour, and economic structure. While the rules succeed in increasing tax burdens and reducing leverage, firms adapt strategically by shifting to alternative tax planning mechanisms. These findings emphasize the necessity of integrated tax policies supported by strong enforcement and governance frameworks. Without such complementary reforms, thin capitalization rules risk becoming partially effective, addressing only one dimension of corporate tax avoidance while leaving others unregulated.

CONCLUSIONS

The analysis across the three discussions confirms that thin capitalization regulations play an important role in reshaping corporate financial structures and increasing tax burdens in emerging markets. Firms reduce their reliance on debt, particularly related-party borrowing, and experience corresponding increases in cash effective tax rates. These effects align with the objectives of BEPS-aligned reforms and demonstrate that interest limitation measures are effective in curbing debt-based profit shifting. However, the results also show that firms respond adaptively, often shifting toward alternative tax planning channels when interest deductions are restricted. This highlights the limitation of thin capitalization rules as standalone policies and underscores the need for integrated tax governance frameworks incorporating transfer pricing regulations, general anti-avoidance rules, and strengthened administrative capacity.

The findings suggest that policymakers should calibrate thin capitalization limits carefully to balance fiscal protection with firms' need for affordable financing. Additionally, regulatory effectiveness depends heavily on enforcement consistency, transparency, and institutional capacity. Strengthening governance structures within firms and enhancing regulatory clarity would further reinforce compliance and reduce opportunities for circumvention. Ultimately, thin capitalization rules constitute only one component of broader corporate tax integrity; their success requires complementary reforms that ensure coherence across legal, financial, and administrative dimensions

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