

# EFB Position Paper: Institutional Publications on the Debt Bias in Tax Codes



In the context of Europe's continuing sovereign debt crisis, new banking regulations in the form of Basel III and the Capital Requirements Directive (CRD IV), and the urgent need to create economic stability and boost growth in Europe, European Family Businesses believes that urgent action is needed to reform tax systems across Europe that have contributed to excessive leverage in Europe's economies.

Many National, European, and Global Institutions have recently performed studies on the impact of tax codes and their role in financing decisions. These have shown that most tax codes contain a bias to the advantage of debt finance and to the disadvantage of equity. Put simply, income from equity finance is taxed more heavily than income from debt finance in most countries in the European Union.

This review is a compilation of the conclusions and recommendations of these recent studies. It is in no way a complete overview of recent research, but rather a compilation of studies that have all identified the debt bias in tax codes as a theme that needs to be addressed.

European Family Businesses is of the belief that there is an urgent need for reforms of European tax codes to encourage equity driven investment. This would stimulate economic activity, reduce systemic risk and restore balance in the European economy.

For further information on the importance of Equity Finance, please see European Family Businesses' policy paper '**Time for a Level Playing Field between Debt and Equity**'.

## The Organisation for Economic Co-operation and Development (OECD)

The OECD regularly publishes reports on the potential fiscal reforms that could boost growth in OECD countries. As a preamble for the rest of the paper, the below quote aptly describes the changing nature of our western economies and how the fiscal environment needs to adapt to compensate from the fall out of the economic and financial crisis.

### Tax Policy Reform and Economic Growth (2010)

'The crisis has weakened the credit-driven economic growth which many countries experienced before the crisis. The higher capital requirements of banks and other financial institutions imply that it will be very unlikely that the same borrowing patterns will be observed again in the near future, either because less credit will be available or higher interest rates will be asked. However, these high levels of borrowing, both by businesses and households, have led to high growth rates in the past. Moreover, many financial institutions, businesses and households are still deleveraging. Economic growth might therefore have to come from increased business investment, innovation and entrepreneurship...'<sup>(1)</sup>

Indeed, deleveraging in the financial sector is likely to continue for years to come. This will decrease the availability of debt finance in the real economy. To safeguard access to finance for investment and growth, debt finance will need to be replaced with equity finance, be it in the form of retained earnings or in the form of additional paid-in capital.

## International Monetary Fund (IMF)

The International Monetary has published two notable reports on the debt bias in most national taxation codes. Both papers have underlined the difficulty in justifying this reality and both propose Allowances for Corporate Equity (ACE) as a possible counter measure to restoring the role of equity.

### Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy (2009)

'Corporate-level tax biases favouring debt finance, including in the financial sector, are pervasive, often large and hard to justify given the potential impact on financial stability. There is a strong case for dealing more decisively with this bias; for example, by also allowing a deduction of an imputed equity cost (which for regulated financial institutions would be akin to an allowance for Tier 1 capital).'<sup>(2)</sup>

### Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions (2011)

'Most tax systems today contain a "debt bias," offering a tax advantage for corporations to finance their investments by debt. This has grown increasingly hard to justify. One cannot compellingly argue for giving tax preferences to debt based on legal, administrative, or economic considerations. The evidence shows, rather, that debt bias creates significant inequities, complexities, and economic distortions. For instance, it has led to inefficiently high debt-to-equity ratios in corporations. It discriminates against innovative growth firms, impeding stronger economic growth. Debt bias also threatens public revenues, because it enables companies to reduce tax liabilities by using hybrid financial instruments as well as by restructuring their finances internally, moving debt between affiliates.'<sup>(3)</sup>

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(1) OECD (2010), Tax Policy Reform and Economic Growth, OECD Publishing, p.103

(2) IMF: Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions, Ruud A. de Mooij, May 3, 2011, Executive Summary

The IMF makes a strong statement in the above mentioned reports and it goes on to consider the economic effect of a potential system based on the so-called Allowance for Corporate Equity (ACE). Mooij (2011) concludes that, 'Its direct fiscal cost estimated at around 0.5 per cent of GDP on average can be reduced in the short run by restricting the allowance to new investment alone. The long-run fiscal costs would be lower to the extent that the allowance induces favourable behavioural responses, leading to higher investment and employment. The main beneficiaries of the allowance for corporate equity are likely to be employees who see their wages increased.'<sup>(4)</sup> Finally, it is clear that this issue is high on the agenda of the IMF's work, and it is considering performing a follow-up study on how a potential ACE system could be designed. In Sum, the IMF recognises that the short-run cost will be incurred by introducing an ACE, but, the long-run effect would ultimately benefit the economy that introduces an allowance for equity.

## European Commission

Much in the same ways as the IMF, the European Commission in recent years, undoubtedly in response to the crisis, has started to put emphasise on the importance of a growth friendly fiscal environment. Again it must be noted that the below references do not represent a comprehensive review of the Commission's work on the subject matter, but rather, some pertinent literature that should be looked at more closely.

### Effects of Tax Systems on the Retention of Earnings and the Increase of Own Equity (2008)

Indeed the summary of the Expert Group Report from September 2008 makes specific reference to the fact that equity positions in companies are weakening. In addition, the report also directly performed analysis using in-depth interviews with business owners and tax experts.

'The own equity base of many enterprises in Europe, especially smaller enterprises, is rather weak. This makes them vulnerable during recessions and also aggravates the problems of structural changes and re-orientations. It has become even more important for SMEs to build up equity due to the increased use of rating systems and the revision of banks' capital requirements (Basel II).'

<sup>(5)</sup>

Although the paper does not primarily focus on the debt bias in taxation, it does however focus on how to promote the retention of earnings and increasing own equity in SMEs. Once again an ACE system is noted as being a way of encouraging this practice.

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<sup>(3)</sup> idem, p.19

<sup>(4)</sup> European Commission, Summary Report of the Expert Group: Effects of Tax Systems on the Retention of Earnings and the Increase of Own Equity, September 2008, Executive Summary

'Corporate tax systems discriminate in favour of debt financing since they allow the deduction of interest, but do not take into account the cost of capital in the form of equity financing. This discrimination or commonly known as the "interest tax shield" encourages debt financing since it lowers the relative cost of debt. ACE increases the attraction of investment and neutralises tax competition as far as own equity is concerned.'<sup>(6)</sup>

Unfortunately, this study went relatively unnoticed and much of the best practices and solutions to promoting retained earnings were ignored. Many of the suggestions and recommendations still ring true today, especially when one considers the need to promote access to finance for SMEs. Ultimately, promoting retained earnings would increase equity and a company's capacity to access external debt.

### **Tax Reforms in the EU Member States - 'Tax policy challenges for economic growth and fiscal sustainability' (2011)**

Another very encouraging publication to come out of the European Commission is the '2011 Tax Reforms in the EU Member States' working paper. 'The debt bias in direct taxation affecting both corporate and housing financing is also an issue concerning most euro-area Member States, which needs to be addressed in order to reduce the risk of macroeconomic instability. A debt bias may aggravate unsustainable patterns in credit growth in good times and contribute to growth-adverse credit tightening in bad times.'<sup>(7)</sup>

'Viable policy options to solve the debt-bias issue in corporate taxation in most Member States are either to eliminate interest deductibility from taxes via a comprehensive business income tax (CBIT) or to introduce an equivalent allowance for corporate equity (ACE), or a combination thereof.'<sup>(8)</sup>

Once again, the ACE system is proposed as a potential method of levelling the playing field between debt and equity financing.

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(5) Idem, p.35

(6) Tax Reforms in the EU Member States, Working Paper No. 28 2011, p.12

(7) Idem, p.12

(8) Annex 4 Growth-Friendly Tax Policies in member States and Better Tax Coordination in the EU, COM(2011) 815 final, p.7

## Annual Growth Survey (2011)

The Annual Growth Survey (AGS) is one of the most important documents from the Commission with regard to setting out Europe's priorities in the coming year at both EU and Member State level. The 2012 AGS' Annex on growth friendly tax policies derived its findings from the aforementioned 'Tax Reforms in the EU Member States 2011.'

Corporate income tax systems and the taxation of housing investments in Member States lead to a 'debt bias' in the financing of investment. The debt bias in corporate taxation mirrors the fact that interest payments on corporate debt are deductible from taxable profit, while the return on equity is not. The welfare costs related to this debt bias might not be negligible. More importantly, excessive debt levels increase the probability of default and the recent financial crisis has proved that the costs of adjustment can be substantial.<sup>(9)</sup> 'Debt biases lead to households' and businesses' financial decisions in favour of increased leverage being driven by tax incentives and not based on economic grounds.'<sup>(10)</sup>

The AGS was launched together with the 'European Semester', a cycle of economic policy co-ordination in the European Union intended to support economic growth and fiscal sustainability. European Family Businesses concurs with the aims of the European Semester and would actively encourage that the debt and equity issue be placed high on the agenda in any future meetings.

## The Small Business Act (2008) and Small Business Act Review (2011)

The well-known report originally published in 2008 and later reviewed in 2011 which provides a comprehensive SME policy framework for Europe, makes specific reference to the need to improve the access to finance issue.

'New initiatives are needed to improve SMEs' access to finance, including via capital markets and encouraging investment through fiscal policies. High indebtedness has made many SMEs vulnerable to difficult financial market conditions. Therefore, Member States should provide incentives for investing revenue in equity, keeping in mind that the needs of entrepreneurial growth companies and established mainstream European SMEs are different.'<sup>(11)</sup> In addition, the original SBA states that the Commission invites the Member States to, 'ensure that the taxation of corporate profits encourages investment.'<sup>(12)</sup>

Although the European SBA and its subsequent review make formal recognition of the need to strengthen the role of equity in company financing, it does not however set out any official actions or specific recommendations. However, as has been stated, encouraging investment of corporate profits must mean that they are not subject to high levels of taxation compared with debt.

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(9) Idem, p.7

(10) Review of the 'Small Business Act' for Europe, COM (2011) 78 final, p.8

(11) A 'Small Business Act' for Europe, COM (2008) 394 final, p.12

(12) Review of Family Business Relevant Issues: Research, Networks, Policy Measures and Existing Studies, November 2009, p.14

## **Overview of Family Business Relevant Issues: Research, Networks, Policy Measures and Existing Studies (2009)**

A 3 year action performed by the DG Enterprise “Overview of family business relevant issues” ended in 2009. During this time a European study on family business was produced and an expert group discussed the topic and exchanged good practices. Indeed the report is an excellent source of information on the specific challenges of running a family company. None more than the issue of taxation, in this instance, equity vs. debt financing.

**‘In countries where the taxation system favours debt financing, family companies are at a disadvantage.’<sup>(13)</sup>**

The expert report clearly underlines the importance of family businesses, but importantly it shows that they must be considered as an own business entity. Indeed, in the context of this report, because of the long-term nature of family businesses, they generally favour using own equity when financing an investment. But as has been shown above, using equity is often treated less favourably by the tax codes when compared with debt.

## **Member States**

### **The Mirrlees Review, Institute for Fiscal Studies (2011)**

The UK Mirrlees Review, performed by the Institute for fiscal studies is equally as important as the reports that have been presented above. On the section, entitled ‘taxing corporate income’, the author concludes with many of the sentiments that have been expressed above.

**‘The difference in the treatments of corporate investment financed by debt and by equity is something of an anomaly.’<sup>(14)</sup>**

**‘The ACE provides an explicit deduction for the cost of using equity finance, similar to the existing deduction for the cost of interest payments on debt finance. This levels the playing field between different sources of finance.’<sup>(15)</sup>**

The Mirrlees Review is holistic look at the tax system in the UK. This enormous study effectively calculates the cost of an ACE system on the UK. The review estimates a long-term increase 6.1 per cent in investment, 1.7 per cent in wages, 0.2 per cent in Employment, and 1.4 per cent in GDP.

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<sup>(13)</sup> The Mirrlees Review - Tax by Design Chapter 17, Mirrlees et al., September 2011, p.427

<sup>(14)</sup> Idem, p.427

<sup>(15)</sup> The Financial Times, ‘Forget Fred and focus on the real banking scandal’, Nigel Lawson, February 5th 2012

## Further Reading

### **'Forget Fred and focus on the real banking scandal,' The Financial Times (2012)**

The Former chancellor of the exchequer of the United Kingdom, Nigel Lawson rightly points to the destabilising factor that the deductibility of debt has had on the banking sector. Indeed, it cannot be ignored that this system has also the same effect on non-financial companies.

'The tax deductibility of debt interest, coupled with the non-tax-deductibility of dividend payments, gives banks a strong incentive to finance themselves via debt rather than equity, wholly contrary to the interests of banking stability. And the practice of basing bank bonuses on the (notional) return on a wholly inadequate equity base further exacerbates the quasi-Ponzi nature of the current banking culture.'<sup>(16)</sup>

### **'Taxation and class war - Hunting the rich,' The Economist (2011)**

The need to remove double taxation of equity investments has also been raised in the Economist magazine, in their editorial 'Hunting the Rich' of 24 September 2011:

'Imagine a tax system which made the top rates on wages and capital more equal, and which eliminated virtually all deductions. To avoid taxing investments twice, such a system would get rid of corporate taxes. It would also allow for a much lower top rate of income tax.'<sup>(17)</sup>

### **'Time for a Level Playing Field,' Philip Aminoff, Family Business Wiki (2010)**

The president of EFB outlines in practical terms the inherent inequalities of fiscal systems in Europe that favour credit driven financing, as opposed to fostering growth in Net Profit and Retained Earnings. Indeed, the article is essential reading for a clear explanation of the need to level the playing field between debt and equity.<sup>(18)</sup>

## Conclusions

Due to the continuing crisis in Europe, there is need for the European Union and its Member States to start encouraging the design of growth friendly tax policies. It is encouraging that numerous institutions have identified one of the root causes of the crisis and also seem reasonably unified in their recommendations on how to remove the problem.

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(16) 'Taxation and class war - Hunting the rich', The Economist, Sep 24th 2011

(17) <http://www.economist.com/node/21530093/print>

(18) <http://familybusinesswiki.ning.com/profiles/blogs/time-for-a-level-playing-field>

The discrimination of equity in most of Europe's tax codes has affected the economic decisions of millions of family business owners **who would ideally prefer to invest and re-invest equity in their companies for the long term**. Indeed, tax codes that favour leverage and treat equity less favourably than debt have caused European companies to be much more vulnerable to economic downturns than they would be if there was a level playing field for equity finance.

European Family Businesses believes that the introduction of tax codes that use the concept of an Allowance for Corporate Equity (ACE) would be an ideal way of delivering some much needed private investment in Europe. The numerous studies that have been presented in this paper show that a system that puts equity on the same level as debt in terms of taxation bears strong potential to bring about increased growth, private investment, and employment. A reform of this nature, albeit gradual, has recently been introduced in Italy by the government under ex-commissioner Mario Monti (see Annex).

The arguments for the creation of a level playing field for equity compared to other forms of finance have gained momentum and are gaining adherents at considerable speed. The concept has also found a simple way of being expressed; it exists when the total efficient tax rate (TETR) of income from equity is no higher than the total efficient tax rate on income from debt finance.

European Family Businesses sees every reason for the material presented in this review to be actively disseminated and discussed in Europe. By type of ownership, family businesses are the largest source of employment in the private sector in Europe, and thus key to the economic recovery. Their ability to grow and invest would be considerably improved if tax codes were to be adjusted such that long term equity finance was not at a tax disadvantage to debt finance.

European Family Businesses believes that an environment which is conducive to long term entrepreneurship can be forged out of this crisis. A key change would be political decisions that would put long term investment of patient equity finance at an equal fiscal footing with debt finance. European Family Businesses will promote this concept towards the Council's High Level Working Party on taxation, the Taxation Policy Group, the European Parliament, the European Council's ECOFIN network, the Economic Policy Committee, and other institutional channels

#### **Post-script note:**

It should be noted that there are supporters of the concept of a level playing field between different forms of capital who have an agenda that differs considerably from that of European Family Businesses. This other agenda is based on the idea that a level playing field should be created by removing the tax deductibility of interest expenses, i.e. the cost of debt finance. European Family Businesses believes that such initiatives are of negative impact to economic growth. Debt finance is an important source of funds for investment and growth and interest on debt finance is a true expense.



## ANNEX

### ITALY - Corporate Taxation Reforms

'Starting from fiscal year 2011, a deduction from corporate income tax base is allowed equal to the notional yield of qualifying equity increases compared to the equity resulting from the balance sheet as at 31 December 2010.

#### Qualifying increases are:

- Contributions in cash; and
- undistributed profits.

For the first three years (2011-2013), the notional yield is fixed at 3%. From 2012 onwards, a decree of the Ministry of Finance will establish the yield on yearly basis based on the remuneration of State bonds plus a premium risk.'

(source: Report from Emanuela Santoro, IBFD Senior Research Associate, 02 January 2012)

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European Family Businesses is a federation of 11 national family businesses associations. Our aim is to make political decision makers aware of the contribution of family businesses to society at large and to promote policies that are conducive to long term entrepreneurship. Our members represent turnover in excess of one trillion Euro, 9% of European GDP.