

Institutional Determinants of Equity Financing in Austria

This study examines which institutional determinants are chiefly responsible for the fact that the capital structure of Austrian companies is dominated by debt. An international comparison shows that company taxation is generally not financing-neutral and, given the observed differences in equity ratios between countries, cannot be the primary factor influencing capital structure choice. Instead, the nature of creditor protections, which determine the position of investors and lenders in the event of bankruptcy, is probably a far more decisive factor. Equity ratios decline in parallel with creditor-friendly provisions across countries. Because of the predominance of small and medium-sized enterprises (SMEs) in Austria, the “Hausbank” principle plays an important role in determining capital structure. The associated intensive exchange of information between banks and companies allows borrowings to take on the functions usually performed by equity. In the future, financial market innovations and the transfer of severance pay and pension entitlements to outside institutions could have an influence on capital structure.

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Introduction

The level of equity of Austrian companies is a recurring issue in the economic policy debate in Austria. Most recently, it has once again gained relevance through discussions regarding the possible implications of the overhauled capital adequacy framework, Basel II for short, for corporate financing.

In all industrialized countries, internal funds are by far the most important source of financing for companies. Companies cover only a comparatively small portion of their net financing needs by taking out loans, issuing bonds or issuing stock to outside investors. Nevertheless, the level of equity within an economy’s corporate sector is closely linked to the smooth functioning and the stability of the financial markets. As permanent or at least long-term financing, equity performs a key financing function. Carrying risk, it forms a liquidity cushion, particularly in economic downswings, does not require regular interest payment and bears liability in the event of loss.

However, the economic policy debate generally ignores the fact that the functions (that can be) fulfilled by equity and debt in the corporate

(and overall economic) financing process are not fixed or absolute. Rather, debt can also take over functions of equity (and vice versa), at least to a certain extent. The extent to which this is possible is largely dependent on the relevant economy’s rules and norms, that is, its institutional framework. For instance, it is conceivable that, in a financial system characterized by strong relationships between companies and banks, debt could take on a larger share of the functions mentioned above that would usually be covered by equity than in a purely capital market-oriented financial system.

The implications for financial stability are not insignificant. When the specific conditions in Austria allow debt to take over the functions of equity to a greater extent than would be possible in another institutional setting, a lower level of equity within the corporate sector compared with other countries must be viewed differently in terms of risk. This study takes a closer look at the institutional conditionality of the financing and liability functions of equity and debt with respect to the specific situation in Austria.

From an accounting perspective, balance sheet equity represents the

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company's net worth as on a specific reporting date.² Beyond the legal definition, "equity" is related to the function that it performs within the company (and, at the aggregate level, in the economy as a whole).

The starting point for all considerations regarding capital structure is the seminal article by Modigliani and Miller (1958), which states that, given perfect capital markets and a neutral tax system, capital structure has no influence on firm value and the cost of capital. Under this premise, arbitrage processes would restore the original balance if different capital structures were to result in different firm values. If we loosen the restrictive assumptions on which this theory is based, we can identify the individual factors that influence corporate financing structures. For instance, the trade-off theory stresses that companies set a target leverage at which the tax advantages resulting from the additional debt just offset the costs arising from potential financial distress. The pecking order theory (Myers and Majluf, 1984; Myers, 1984) highlights the influence that asymmetrical information between investors or lenders and company management can have on capital structure. Because asymmetrical information increases financing costs, companies prefer internal over external financing. And because debt financing entails lower costs and no outside shareholders, companies prefer

debt over equity if external funds are necessary.

Viewed generally, the Modigliani-Miller theory and the literature on capital structure that builds on this theory suggest that there are different "optimal" capital structures or equity ratios depending on the "sources of market friction," that is, the institutional framework in which companies operate. Earlier international comparative analyses (and studies that focused on a single country, usually the U.S.A.) concentrated on differences in company characteristics as explanatory variables³ while recent work on capital structures since the mid-1990s has revealed the influence of institutional factors on corporate financing.⁴ These factors include the countries' tax regimes, accounting and valuation rules, bankruptcy laws, financial structures, corporate-sector ownership structures, and many other factors that cannot be covered in detail here.

Comparative studies are generally limited to the major industrialized countries and usually do not include Austria.⁵ This paper attempts to help fill the gap by taking up the key findings of international studies on this topic and examining whether and how they apply to Austria. More specifically, we have selected and examined three institutional factors that have proven to have considerable explanatory power in previous studies

² Pursuant to the Austrian Commercial Code (HGB), equity comprises the capital stock, which is referred to as share capital, nominal capital or subscribed capital, depending on the company's legal form, plus capital reserves, retained earnings and net income or loss for the year.

³ For an overview of these studies, see e.g. Harris and Raviv (1991).

⁴ The initial impetus for this greater emphasis on institutional factors came from Rajan and Zingales (1995). For a comprehensive comparative analysis of financing structures in Germany and France from an institutional perspective, see Friderichs et al. (1999). A more recent study that places special emphasis on the institutional perspective is Fan, Titman and Twite (2003).

⁵ One exception is Delbreil et al. (2000), which compares five European countries including Austria.

and for which the necessary data were available regarding their possible influence on capital structures compared with other European countries.⁶ The factors studied here are:

- Corporate tax rates,
- creditor protection provisions under the bankruptcy laws, and
- the influence of the *Hausbank* principle that characterizes the relationship between banks and companies in Austria.

With this approach, we have not taken into account differences in capital structures that result from different uses of capital (for instance, due to differences in capitalization ratios or industry structures). For this reason alone, we cannot determine whether the level of equity is “sufficient” with this paper.

This paper is structured as follows: The next section presents the level of equity of Austrian companies in an international comparison. The following section builds on this by taking a closer look at the institutional determinants of the level of equity. The final section contains concluding remarks and discusses implications for financial stability in Austria.

Equity Ratios – An International Comparison

The general tenor of the economic policy debate in Austria is that Austrian companies have a far lower level of equity than companies in other countries. However, an international comparison does not confirm this view.

The data used are drawn from the financial accounts compiled in accordance with the European System of Accounts (ESA), which contain balance sheets of the nonfinancial corporate sector⁷ (and other sectors). However, it should be noted that the financial accounts do not cover the claims of equity investors on nonfinancial assets and thus underestimate the absolute level of equity. The financial accounts approximate the share of equity with the ratio of shares and other equity to liabilities. New Cronos, the Eurostat database, contains comparative data on a harmonized basis for eleven European countries.⁸ However, data are only available through the year 2002. International comparisons of balance sheet data are plagued by numerous methodological problems. Therefore, extreme caution should be exercised when interpreting such comparative values. Another factor that should be borne in mind, particularly when analyzing internationally harmonized data sets, is the fact that, given the many difficulties involved in creating the data set, numerous revisions will inevitably have been made.

The recalculation of equity in the financial accounts for 2004 in Austria illustrates the effect of such revisions.⁹ The ratio of equity to total liabilities is now reported at around 35% instead of the previous 23%. Thus, Austria no longer has the lowest level of equity among the countries for which such data are available in New Cronos. According to these findings, the ratio of shares and other equity to total lia-

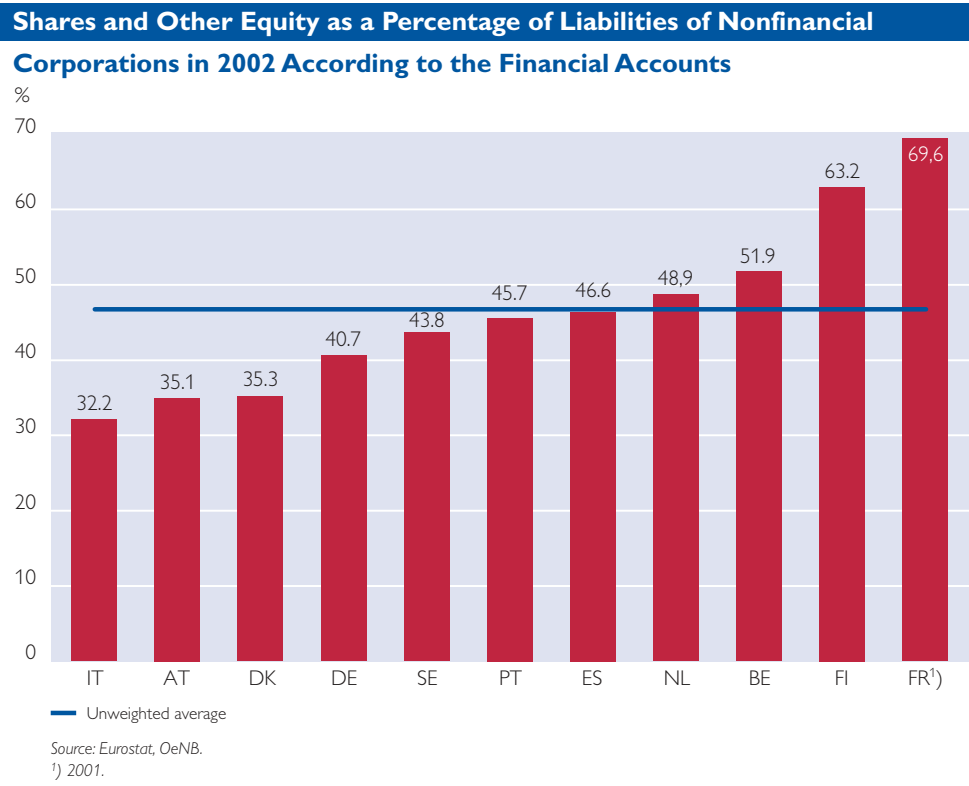
⁶ Such data are available for nine euro area countries as well as for Denmark and Sweden. See also the section “Equity Ratios – An International Comparison.”

⁷ Nonfinancial corporations pursuant to the European System of Accounts 1995 (ESA 95). These include all institutional entities that produce goods and nonfinancial services for the markets as their primary activity.

⁸ Austria, Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands, Portugal, Spain and Sweden.

⁹ Under this revision, shares and other equity held by companies and private households that are not deposited with Austrian banks were included in the survey. In addition, listed stocks are now presented at market values.

Chart 1



bilities of Austrian companies in the aggregate is still below the (unweighted) European average of 47%, but – in the light of all of the reservations associated with the interpretation of the data – it is not low (see chart 1).

A variety of company data (for the same EU Member States for which financial accounts data are available in New Cronos¹⁰ can also be found in

the BACH database.¹¹ These data are drawn from company balance sheets. Due to considerable methodological and conceptual differences,¹² the BACH database provides equity ratios¹³ for the individual countries that differ considerably from the financial accounts values in terms of absolute levels although the BACH database does not contain aggregate data for the entire corporate sector but rather

¹⁰ The database also includes data for the U.S.A. – which, however, are classified according to a different size structure – and for Japan.

¹¹ Bank for the Accounts of Companies Harmonised. Compiled by the European Commission (DG ECFIN) in collaboration with the European Committee of Central Balance Sheet Offices.

¹² The valuation is based on book values. In addition, although the accounting rules of the EU Member States are already partially harmonized, accounting standards in the individual countries are not fully comparable without reservation. Thus, the survey methods still vary considerably due to the differing legal and tax situations. Finally, for most of the countries, the BACH database is based on samples of companies – some more representative than others – which are prepared in accordance with a harmonized concept.

¹³ Defined as net assets plus shares and other equity as a percentage of the sum of net assets and liabilities.

only for various industry sectors¹⁴ and size classes.¹⁵ These data are also available only for 2002 or earlier for most countries.

Bearing in mind that the values in the BACH database must necessarily differ considerably from those of the financial accounts, we can use them to show equity ratios by sector and size class. At the sector level, there is nothing particularly distinctive about the figures for Austria. However, what does stand out is the striking

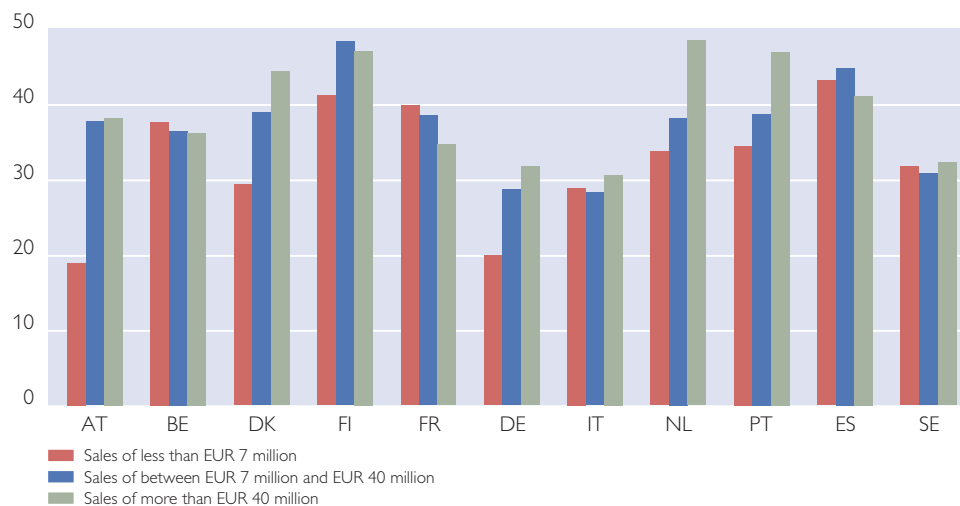
difference in the capital structures of large and small companies in Austria. This difference is not apparent in all countries, as chart 2 illustrates for the manufacturing sector. The situation is similar in other sectors of economic activity. In some other European countries, the difference between large and small companies is minimal. In France, Spain and Belgium, the equity ratios of small companies are even higher than those of large companies.¹⁶

Chart 2

Equity Ratios in the Manufacturing Sector

in 2002 or earlier (depending on data availability)

% of balance sheet total



Source: EU, BACH database.

We can derive two things from this: First, small companies do not necessarily have less equity than big ones. Second, the relatively low level of equity in the Austrian economy as compared with other countries applies primarily to small companies – if it applies at all. Among small companies, the difference between Austria and

the unweighted mean of the countries presented here is nearly 14 percentage points, whereas the difference among large companies is only slightly more than 1½ percentage points (the value for mid-sized companies is even somewhat above the unweighted mean). Thus, the equity ratios of large companies are in the middle range of the

¹⁴ At present, it contains aggregate data from annual financial statements for 23 sectors and subsectors, of which 10 are in manufacturing.

¹⁵ Sales of less than EUR 7 million, of between EUR 7 million and EUR 40 million, and of more than EUR 40 million.

¹⁶ However, it should be noted that these differences may be due in part to the different sample sizes.

Table 1

Tax Burdens at the Company Level – A European Comparison for 2001

in % Countries	Statutory tax rates for corporations ¹⁾	Effective average tax burden of investment projects using	
		New equity ²⁾	Debt
Belgium	40.17	39.10	25.80
Denmark	30.00	30.70	21.00
Germany	39.35	38.70	27.70
Spain	35.00	35.20	23.30
France	36.43	39.00	26.80
Italy	40.25	28.70	25.50
Netherlands	35.00	35.20	23.30
Austria ³⁾	34.00	30.70	22.60
Portugal	35.20	34.80	23.00
Finland	29.00	30.00	20.20
Sweden	28.00	26.00	17.10

Source: European Commission (2001).

¹⁾ Including surcharges and local taxes.

²⁾ Self-financing and equity financing.

³⁾ Beginning in 2005, the corporation tax rate is 25%. The tax burden of investment projects that are financed using equity is thereby reduced.

European countries examined here. Therefore, the question to be studied here can be specified as follows: To what extent do institutional characteristics make lending to small companies easier and/or make injecting outside equity into SMEs more difficult?

Institutional Factors

Company Taxation

The irrelevance theory postulated by Modigliani and Miller (1958), that firm value is independent of capital structure, was put forward under the assumption that companies are not subject to taxation. Consequently, many studies have focused on examining the influence of the tax regime on capital structure choice (for an overview of these studies, see Graham,

2003). In general, the results of these studies suggest that taxes are a significant determinant of the costs associated with equity and debt and, therefore, exert an influence on a firm's value. In order to maximize firm value, companies try to keep the costs of capital as low as possible by choosing forms of financing that entail the lightest tax burden.¹⁷

In Austria, company taxation is not neutral in terms of financing. Corporate borrowing is given preferential treatment over equity financing, as the interest paid on borrowed funds can be deducted from earnings for tax purposes. This narrows the company's tax base and, thus, reduces the tax burden. Similar provisions for equity do not exist.¹⁸ Dividends and retained

¹⁷ Aside from company tax, personal income tax should also be taken into account. This applies primarily to small and mid-sized companies that generally do not have access to the international capital markets as a source of financing due, among other things, to the small demand volume and must therefore depend on the domestic supply of capital. In such cases, domestic income taxes influence the costs of capital and companies must minimize not only taxes on earnings but also taxes on investors' capital gains by making the right capital structure choice. Since the shareholders could be subject to different tax rates, it is usually not possible to take this factor into account to the extent necessary. However, for Austria, see also footnote 25.

¹⁸ The tax reform in 2000 introduced the deductibility of interest from increases in equity as an expense, but this provision was eliminated again with the 2004/05 tax reform. For more on this topic, see the section "The Impact of Changes in the Institutional Framework on the Level of Equity."

earnings do not narrow the tax base and, thus, the company pays higher taxes.

The lack of neutrality of taxation when it comes to corporate financing is not unique to Austria. According to a study on company taxation conducted by the European Commission (European Commission, 2001), debt is the most tax-efficient source of financing for corporations throughout the EU. Table 1 presents a comparison with company taxation rates in EU Member States. The first column shows the corporation tax rates for each country and the subsequent columns show the effective tax rates for the different forms of financing.¹⁹

In this comparison for 2001, Austria has the lowest nominal tax rate (34%) after Sweden, Finland and Denmark while Italy, Belgium and Germany have the highest rates. As is evident from Table 1, debt is the optimal form of financing for investments. In all countries, the effective average tax burden on debt is lower than that on equity financing. Sweden has the lowest tax burden in the case of debt financing (17.1%) while Germany has the highest effective tax rate at 27.7%. In Austria, the effective tax rate for debt financing is 22.6%. When new equity is used as the source of financing, Belgium has the highest effective tax rate (39.1%) and Sweden the lowest (26%). With an effective rate of 30.7%, Austria is slightly below the mean when it comes to this form of financing.

In general, a high corporate tax rate should promote debt financing. However, it is important to bear in

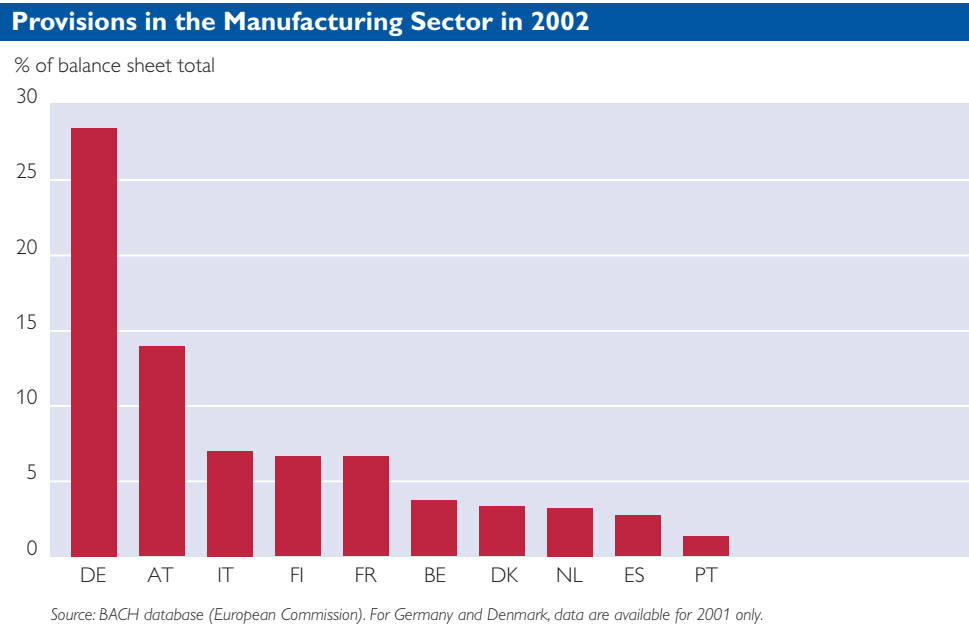
mind that a high tax rate usually goes hand in hand with a narrower tax base (European Commission, 2001). Moreover, growing debt entails tax savings as well as costs since the probability of bankruptcy increases as the debt ratio rises. Thus, there are different optimal capital structures depending on the country-specific corporate situations and, so, the influence of company taxation on financing decisions is relative. The international comparison of capital structures, in which equity ratios in some countries are over 50% despite the general tax advantages of debt, suggests the same.

The significance of the tax advantages of interest on borrowed funds declines when other options for tax deductions are available to a company. For instance, transfers to provisions are viewed as an expense for tax purposes and, thus, reduce taxable earnings. Under tax law, provisions are contingent liabilities to third parties and, thus, debt. As chart 3 shows, transfers to provisions for severance pay and pensions, as provided for under tax law, have a considerable influence on the shape of capital structures within Austria's corporate sector. At least in manufacturing, the sector of economic activity with the greatest value added, Austria has the highest level of provisions after Germany. In other sectors for which comparable data are available, such as energy or transport, Austria has a lower level of provisions than other countries.

Pension provisions play a special role in capital structure. They are available to the company for the long term, without interest, and thus come

¹⁹ The effective tax burden of hypothetical investment projects is used to permit comparison of the tax burdens at the international level. Both the relevant statutory tax rates and the most important tax provisions regarding the determination of taxable earnings are used to calculate the effective tax rates.

Chart 3



close to equity in this respect.²⁰ However, in Austria, provisions are concentrated on mid-sized and large-scale companies. For example, according to the OeNB's financial ratio analysis for 2003, provisions among large-scale enterprises in the manufacturing sector accounted for 13.4% of the balance sheet total while they accounted for only 4.4% among small enterprises. The main reason for the sharp size-specific differences in provisions is likely to lie in the differing importance of pension provisions. Small companies are not large enough to establish direct, employer-based pension schemes (Kaufmann, 1997).

Creditor Protection Provisions under the Bankruptcy Laws

Some comparative analyses of capital structure have highlighted the differ-

ing legal positions of investors and lenders in the event of a company's insolvency as an important factor for the differences in the levels of equity in various countries.²¹ Creditors' legal position in insolvency proceedings ultimately reflects the economic policy aims of bankruptcy laws.²² A country's bankruptcy laws provide for both the reorganization and the liquidation of bankrupt companies. However, the importance placed on one or the other solution varies considerably by country (Smith and Strömberg, 2004), so that we can differentiate between debtor-friendly and creditor-friendly bankruptcy laws.

In countries with debtor-friendly bankruptcy laws, the focus is on maintaining the company that is threatened with insolvency as a going concern. Here, satisfying creditors is a lesser

²⁰ Pension provisions do not entail interest charges with a direct impact on liquidity. However, to determine the present value of the future receivables, a discount rate has to be used.

²¹ See Rajan and Zingales (1995), Friderichs et al. (1999), Delbreil et al. (2000), Rivaud-Danset et al. (2001) among others.

²² However, the economic policy aims do not say anything about the likelihood or number of bankruptcies, which vary widely by country.

priority. This form of bankruptcy law is especially pronounced in France, where secured creditors are not only not given priority in bankruptcy proceedings but creditors' rights can even be suspended temporarily in order to prevent the premature liquidation of the insolvent party's estate (Smith and Strömberg, 2004, Delbreil et al., 2000). In addition, creditors' possibilities of realizing loan collateral are severely limited, which means that such securities are practically worthless in the event of bankruptcy (Friderichs et al., 1999). In countries where bankruptcy laws put less emphasis on creditor rights, banks react to this lack of protection for collateral by granting only small loans and diversifying their loan portfolios as widely as possible (Friderichs et al., 1999).

Austria (and Germany), on the other hand, have very creditor-friendly insolvency laws. Here, the primary aim is to "bring about the fair and best possible satisfaction of the creditors" (Jahn, 1998). In bankruptcy proceedings in Austria, secured cred-

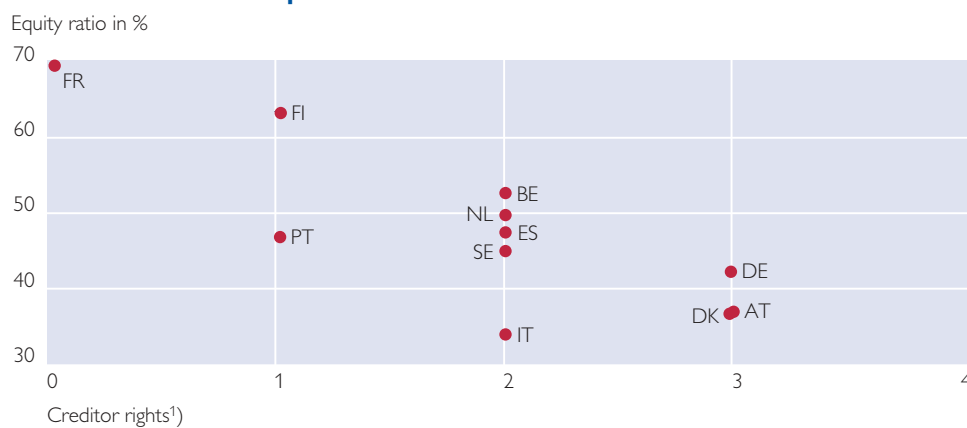
itors have preferential rights to assets in the bankrupt's estate that are encumbered with rights in rem (e.g. liens, pledges) (Jahn, 1998). Thus, for example, the assignment of receivables represents a greater security than it would under a legal regime in which creditor rights are subordinate to company reorganization and banks can therefore accept levels of debt that would be deemed excessive in countries whose laws provide for less creditor protection. At the same time, debt can take over more of the financing and liability functions of equity and bank loans can be expected to play a greater part in corporate finance in countries where the creditor's position is well secured.

Whether an insolvency regime is more creditor-friendly or more debtor-friendly can be assessed qualitatively more so than it can be measured quantitatively. As part of a highly regarded study on the legal factors determining financing structure, La Porta et al. (1998) developed an index that attempts to illustrate the legal

Chart 4

Equity Ratios of Nonfinancial Corporations and Creditor Rights –

An International Comparison



Source: La Porta et al. (1998), Eurostat.

¹⁾ Scale from 0 to 4, with 4 denoting the highest level of creditor protection.

protection of elementary creditor rights in the event of a company's insolvency and the reorganization procedure based on four features.²³ The work revealed a broad correspondence between the values of this index and the share of the companies' balance sheet total that is accounted for by equity (see chart 4). France, with its particularly debtor-friendly insolvency laws, has the highest equity ratio of all the countries studied while Austria, Germany and Denmark are at the other end of the spectrum.

The Hausbank Principle

The third factor that should be studied with respect to its implications for capital structure in Austrian companies is the *Hausbank* principle, which characterizes the relationship between banks and companies in Austria (and Germany). A close, long-standing relationship between a company and the financing bank can contribute significantly to reducing the agency costs that result from asymmetrical distribution of information between financiers and companies both before and after the financing decision is reached. Before providing funds, banks that have a close relationship with their customers can better tell good risks from bad. After funds are provided, the close relationship between bank and customer reduces the company's information disclosure costs. The account relationship alone supplies the bank with telling information; and regular contacts and reports further reduce the costs of information and often make information about the company's current situation and develop-

ment accessible in the first place. This regular exchange of information not only gives the bank better, less cost-intensive insight into the company's financial situation but may also give the bank access to collateral that does not appear on the balance sheet. Closer monitoring and control provided by banks could make more debt financing available to companies (Rajan and Zingales, 1995).

At the same time, the implicit ties that develop between banks and companies also make it easier to establish arrangements that cannot be made contractually *ex ante*. Thus, the bank can render services that can be described as crisis or liquidity insurance according to Hackethal and Schmidt (2000). If a company's internal funds are not sufficient to finance an investment or if insolvency is looming, the bank can come to the company's aid by injecting liquidity or supporting the company's reorganization.²⁴

Although it is difficult to directly observe the existence of a *Hausbank* relationship from the outside – particularly because it works through informal relationships – the practice of long-standing loyalty to one bank (or banks' loyalty to their customers) can be assumed in Austria. Empirical evidence suggests that *Hausbanks* have a higher degree of continuity in their financing behavior. Valderrama (2001) interprets a company's taking out a high share of loans from a single bank as an indication of the existence of a *Hausbank* relationship and concludes that companies that have at least half of their total debt through a single bank are noticeably less affected by

²³ (1) No automatic stay on assets; (2) secured creditors paid first; (3) restrictions for going into reorganization; (4) management does not stay in reorganization.

²⁴ What is more, this type of "exclusive" financial relationship also makes it difficult for companies to switch to a different form of financing (or even simply to a different bank) (Kaufmann, 1997). This could also be a factor keeping equity ratios down in countries with a strong "Hausbank" system.

monetary policy measures. Similarly, Elsas and Krahnert (2004) show, for Germany, that banks with *Hausbank* status tend to increase their lending considerably when a borrower's credit standing deteriorates moderately whereas banks that do not have close relationships with their customers tend to maintain or reduce their lending to such borrowers.

The way banks perform their financing function also influences which aspects of financing a loan can fulfill. In countries with a less pronounced *Hausbank* principle, equity must always be held available so that it can quickly be used to adjust liquidity in a crisis situation. In countries like Austria and Germany, companies can fall back on short-term loans or overdraft facilities as needed (Friderichs et al., 1999). In this way, long-term loans in Austria can partially perform the function of equity as a long-term financing instrument and, to the extent to which the bank stands by a company in a crisis situation, even the risk-bearing function. For this reason, the solvency of companies in countries, like Austria, that have a strong *Hausbank* tradition is less dependent on the balance sheet than it is in countries with a capital market-oriented financial system. This, in turn, increases companies' creditworthiness and, thus, their ability to borrow.

Thus, in countries with a pronounced *Hausbank* system, a lower equity ratio on the one hand and a sharper difference between small and large enterprises on the other hand is to be expected. The financing of smaller enterprises is especially favored by the regular exchange of information between borrowers and banks. Very little public information is usually available about smaller firms and, due to the firms' small size, it is

usually relatively expensive to obtain information. Moreover, in the case of smaller, owner-operated companies, banks often view their business relationship to the company and the owner as a single entity and value the owner and the company as a whole. In such cases, banks will evaluate the owner's personal financial circumstances (including those assets that are not brought into the company) and accept assets that are the owner's private property and/or personal guarantees as collateral (Berger and Udell, 1998). This supports the notion that smaller companies tend to report less equity on their balance sheets when there is a particularly intensive relationship between the company and the lending bank.

The Impact of Changes in the Institutional Framework on the Level of Equity

In recent years, changes have been made to the institutional framework. New tax rules are aimed at treating equity and debt equally while the increased establishment of pension and severance funds is reducing the importance of pension and severance pay provisions on the balance sheet. Austria's integration into the European capital market is making new sources of financing available to Austrian companies. At the same time, Basel II could place the traditional financing relationships between companies and banks on a different foundation. It seems almost inevitable that these changes will leave their mark on the capital structure of Austrian companies.

In Austria, lawmakers have recently taken several steps in an effort to eliminate some of the differences in the taxation of the forms of capital. For example, as part of the tax reform

in 2000, the deductibility of interest on debt was complemented by the deductibility of fictitious interest from increases in equity capitalization, but this provision was eliminated again with the 2004/05 tax reform. At the same time, as of the start of 2005, the corporation tax rate was reduced from 34% to 25%, which improves the tax treatment of equity financing for corporations in absolute terms but does not alleviate the less favorable treatment of equity compared with debt.²⁵

The reduction of the tax rate on retained earnings of up to EUR 100,000 per year by one half for sole proprietors and partnerships that was introduced with the first stage of the 2004/2005 tax reform will temper the lack of financing neutrality in the Austrian tax system (Breuss et al., 2004), but a long-term increase in equity will not likely result. First, the change is limited to sole proprietors and partnerships that obtain their income from agriculture and forestry or from trade or business and practice balance sheet reporting. The liberal professions are excluded from applying these provisions. Second, the new provisions only promote internal financing, not borrowing or equity financing (Staringer, 2003). Moreover, it is doubtful whether the small companies targeted by this provision have the necessary earning power. The effectiveness of fiscal instruments for strengthening self-financing power in this segment is necessarily limited as the owner-managers must use a considerable portion

of their earnings to finance their own living (Breuss et al., 2004).

Stronger effects on the capital structure of Austria's corporate sector are likely to come from changes in severance pay and pension provisions. The establishment of severance and pension funds affords companies an opportunity to transfer their employees' claims to severance pay and pensions to institutions specifically designed for this purpose. For example, the Act governing employee retirement and severance pay (*Betriebliches Mitarbeitervorsorgegesetz*) eliminates severance pay for employment relationships that are established after 2002 and replaces it with ongoing payments by the employer into a severance fund. For employment relationships begun after 2002, no provisions are therefore established for severance pay. At the same time, it was made possible to transfer entitlements to severance pay from employment relationships established before 2003 to a severance fund. In the case of company pensions, another trend reversal is observable. Company surveys show that the importance of pension funds is increasing (Url, 2003). As a result, the new legal framework for severance pay and the replacement of direct benefit commitments in the form of pension provisions with an increased use of pension funds outside the company are reducing the balance sheet totals and will likely result in a lower debt ratio in the long term.

In addition, the *Hausbank* system may also undergo changes. In the past few years, Austria's increasing integra-

²⁵ If we also take income tax into account, equity and debt financing are now placed on an equal footing from the perspective of the investor/lender if the company does not pay dividends and the shareholders do not sell their shares within the period of capital gains tax liability for short-term gains (Frühwirth and Schwaiger, 2005). However, since non-tax factors such as agency costs and the signaling effect of dividends continue to prompt companies to pay dividends, equal treatment of the forms of financing is likely to be relevant only to a few companies.

tion into the international financial markets and the resulting trend toward disintermediation has already changed financing behavior, for example, in that Austrian companies have increasingly issued corporate bonds (Waschiczek, 2004). At first view, one might expect the financing of small and mid-sized companies to be less affected by these changes because of the companies' size and because selecting new forms of financing would entail high research and information-gathering costs. However, it should be borne in mind that financial innovations could also open the capital markets to small and mid-sized companies (Mooslechner, 1999).²⁶

Finally, Basel II could also change the relationships between companies and banks. Lending to small and mid-sized companies may not be influenced directly since allowances are made when calculating the capital position for loans with a volume of up to EUR 1 million and for companies that report annual sales of up to EUR 50 million. But if the assessment of a company's creditworthiness is focused more keenly on financial data than before and qualitative areas of credit assessment that have formed the core of the *Hausbank* relationship until now begin to recede into the background, lending could nevertheless be affected.

Conclusion

This article has attempted to examine the level of equity of Austrian companies under institutional considerations. Taking into account the high level of uncertainty with respect to the data available, an international comparison shows that, in the aggregate, the level of equity in Austria is not above aver-

age but not low, either. A considerable difference between Austrian firms and firms in comparable European countries can be identified only among small companies. Furthermore, we have shown that the capital structure of a corporate sector is the product of several institutional factors. In all likelihood, the tax system in Austria does not disadvantage equity financing any more than the tax systems in other countries. Rather, an overview of company taxation shows that no country within the EU has a tax system that is neutral in terms of corporate finance.

More important is the influence of the specific provisions of bankruptcy law and the *Hausbank* system in Austria, which make it easier for firms to borrow funds (without making it harder for them to issue common stock). The result is that the equity ratio reported by (primarily smaller) Austrian companies provides only an incomplete picture – especially in an international comparison. The equity ratio does not show the private assets of company owners, which banks can access more easily in Austria than in countries with debtor-friendly bankruptcy laws. It also does not reveal the greater willingness of *Hausbanks* to continue to provide financing even in crisis situations. In this respect, the institutional circumstances reduce Austrian companies' need for equity compared with that of companies in other countries.

Thus, the relevance of a below-average level of equity becomes relative, particularly with respect to financial stability in Austria. When, owing to the more favorable position of banks in the event of insolvency and to the strong *Hausbank* system, loans

²⁶ For example, asset backed securities with small lending volumes or the bundling of small bond issues.

are not immediately called due in a crisis situation, debt can take over at least some of the financing and liability functions that could be only performed by equity in a different institutional environment. According to the pecking order theory, we can expect companies to prefer debt over the infusion of equity from outside. Because the institutional framework facilitates lending and borrowing, it also increases companies' financing options. Since equity is the most expensive form of (external) financing given its specific performance components, cost considerations are also affected.²⁷

At the same time, *Hausbanks* help smooth fluctuations in the provision of funds to the corporate sector. In macroeconomic terms, the result is a smoothing of business cycles.

Finally, we should point out that all statements should be viewed with the reservation that only a few of many institutional factors could be analyzed within the scope of this paper.

For example, we have not looked at the impact of interest group-related influences on financial market developments. Hahn (2002) concludes that, in the past, Austria lacked a critical mass of companies capable of tapping the capital markets that would have been needed to more forcefully promote the risk capital market as a source of corporate finance among policymakers. Instead, the market is dominated by small and mid-sized companies that are critical of equity financing because they rather avoid the influence of third parties on their

management and therefore prefer the external financing offered by the credit market.

Another factor that was not examined here was the effect of different accounting and valuation rules. For example, the principle of prudence established under Austria's accounting rules stipulates that assets must be valued at historical cost, which favors the buildup of hidden reserves and tends to underestimate the equity reported on the balance sheet.

The intended use of the funds was also completely left out of this analysis. However, there is no doubt that it plays a significant role in determining the capital structure of a company (or, at the aggregate level, of an economy). Companies operating internationally are likely to have a different risk profile than companies that are focused primarily on the local market. Research-oriented market leaders are likely to be financed differently than mass producers that are in the process of catching up at the international level.

Also, we have not looked at the influence of the capital supply in any detail. However, at the latest since Austria's participation in EMU, the capital supply is now hardly subject to Austria-specific restrictions and the growing importance of institutional investors is likely to have had similar effects. A more detailed examination of all of these factors is needed before the question of what is a suitable level of equity for Austrian companies can be answered conclusively.

²⁷ Of course there is, on the other hand, at least the theoretical risk that companies will cover their need for equity through borrowing.

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