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Comment on “Company Taxation and Growth: The Role of Small and Large Firms”

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It is with great pleasure that I comment on Professor Keuschnigg’s interesting proposals for a tax reform to boost economic growth through enhanced entrepreneurial activity and the accumulation of human and physical capital. As a researcher in the field of corporate finance, my views on the subject matter are of course not those of a specialist in public finance. Instead, I will comment on those aspects of Keuschnigg’s proposal that are more in the realm of my own field. From this perspective, two points seem particularly noteworthy. The first of these concerns the proposed reform of the taxation of dividend income and capital gains. Keuschnigg proposes to harmonize the taxation of dividends and capital gains in order to induce profitable firms to pay out higher dividends, thus allowing for the firms’ profits to be reinvested into the equity of other firms with more valuable growth options than those of the dividend-paying firms. This argument is obviously built on the premise that dividends enable investors to supply capital to young firms with valuable growth options. Investors of publicly listed companies could however also realize capital gains in order to free up financial resources. Thus, it is quite unclear whether the supply of capital to young and growing firms depends more on the taxation of dividends than on the taxation of capital gains. The answer to this question depends on the ease with which investors can realize capital gains, given the liquidity of the relevant financial markets. However, it seems that investors would have to realize only a small fraction of their gains on the ATX in the year 2004 in order to cover the entire demand for capital of Austrian start-ups.

In addition to the above-stated argument, there is also another case to be made against raising the tax levied on capital gains. This argument is based on the fact that equity investors of start-up companies realize most of the returns on their investments in the form of capital gains. Dividend income is a relatively minor part of these investors’ returns since the need to finance growth typically bars start-ups from paying any dividends. It could thus seriously hamper the supply of equity capital to start-ups if the capital gains tax were raised in order to set this tax equal to the tax on dividend income.

The second comment of mine concerns the proposal to eliminate tax-induced distortions of firms' capital structures towards debt financing. I agree that it would be highly desirable to treat debt- and equity financing more symmetrically in order to avoid the potentially high costs of firms' excessive reliance on debt financing. However, it is important to recognize that the introduction of more stringent capital adequacy regulation (Basel II) discourages debt financing even in the absence of a tax reform since the costs of bank loans increase for many firms. The firms affected are however rarely in the position to issue equity, irrespective of the way equity financing is taxed. Instead, these firms would have to settle for close substitutes to debt financing, such as Mezzanine financing and the financing through profit-participation certificates or preferred stock. This insight motivates my suggestion: to make the tax system more neutral with respect to firms' choice between *similar* forms of financing. Such a tax reform would be a very desirable first step towards a tax system that is completely neutral with respect to all forms of financing. Relative to the tax reform required to achieve the latter goal, the success of my proposal would also depend less on the validity of views about the way firms choose between different forms of financing.[1]

Besides raising the points stated above, I would also like to add a comment concerning the question whether the Swiss SDIT proposal could serve as a leading example for a similar tax reform in Austria. It is not clear to me whether the Austrian tax system is sufficiently comparable to the Swiss system. There are in fact some striking differences, such as the relatively high Swiss wealth tax. It would be important to check how the consequences of a tax reform along the lines proposed by Keuschnigg depend on specific features of the Swiss tax code. This is not only important in order to assess the redistributive consequences of a tax reform. Instead, the specifics of the Swiss tax code may matter also for the efficiency of taxation after the reform. In fact, the Swiss wealth tax may be motivated by the insight that certain economic decisions are distorted less by the taxation of wealth than by the taxation of capital income (dividends, interest payments).

[1] It is widely documented that many firms cannot issue equity, mostly due to fixed costs. A so-called "equity-gap" exists in many countries; in Austria the problem is particularly acute since many Austrian firms are small and fall into the equity gap.