Comments on Alstadsaeter, Jacob and Vejsiu, ESO 2014:2

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This presentation

- Some general remarks on taxation of entrepreneurs
- Overview of the study
  - Background
  - Approach
  - Results, suggestions
- Comments
  - On what is done
  - And what ramains to be done
- Practice and debate in Finland
- Conclusions

Background

- Sweden’s tax reform in 2006 (TR2006)
  - Double taxation of distributed profits
  - Many other countries have single taxation or partial double taxation
  - TR2006 lowered dividend taxes for CHCs and WHCs
  - Aim: to improve incentives to entrepreneurship and firms’ growth
- The purpose of the study:
  - To evaluate whether the tax cut increased entrepreneurial activity
- Difficult challenge both for theory and empirical analysis
  - No generally accepted economic model of entreneurship
  - Few empirical studies have been able to establish a credible causal link between tax rules and SME behaviour
  - => there is no solid ground for welfare analysis of SME tax rules

Goals, approaches and results (1)

- The studies the effcts of TR2006 on
  - Investment,
  - job creation and
  - The establishment and growth of new corporations
- For investment and jobs:
  - Main approach is to compare investment ja jobs between financially constrained and unconstrained firms, a'la Becker et al. (2013)
  - Financial constraints measured using cash holdings
  - The results show a clear relative increase in investments among f-constrained CHCs and WHCs
  - Investments of unconstrained firms decreased
  - They also show an increase in wage income (but not in the number) of employees among f-constrained CHCs

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Goals, approaches and results (2)

- Hence, something positive occured on the real side
  - Why just among financially constrained firms? And why an increase in wages?
  - The authors explain the first issue by improved incentives to new equity financing (in line with old vs. new view of dividend taxation)
  - The second issue is explained by referring to literature on incidence of corporate tax which has found that part of tax burden is shifted to wages.
- The effects on new corporations were assessed by considering
  - Aggregate statistics of firms in different org. forms
  - Changes in org. form
  - Finally the success of firms that had changed org. form.

Goals, approaches and results (3)

- The results show
  - TR2006 did not increase the total number of new firms
  - but triggered changes in org. form of old firms.
  - Most new corporations seem to be ”passive” with only little real activity.
  - The new corporations were generally more profitable than teir counterparts among partnerships and self-employed.
  - but the marginal entrant was less profitable after reform.
- The last result was explained as follows: the tax rebate lowered the threshold to incorporate and therefore less profitable firms choose this option
- No answer to the question (?): did firms that changed org. form, grow faster after reform; because no easily available counterfactual exists

Comments

- Useful study but raises some remarks
- The approach when studying investment and job creation:
  - Compares constrained to unconstrained firms
  - The division to these groups is far from exogenous
  - Therefore no causal evidence, but rather suggestive evidence that something changed in allocation
  - Future work could try other research designs; why not compare to WHCs or partnerships
  - Little discussion on changes among unconstrained firms
- Incentive effects: more analysis of incentive changes welcome
  - General Rule and Simplification Rule likely to affect differently
  - Ceiling of SR low => reduces AETR but not necessarily METR => should we still expect a change in equity financing among f-constrianed frims?

Comments (2)

- Instead GR affects incentives on the intensive margin at all income levels
- => Did GR and SR firms respond differently?
- Wage component in income splitting:
  - it affects the METR of new employment;
  - differently among CHCs and WHCs; future research could focus on this?
  - May explain the no effect on wages among WHCs

- Assumed effect through new equity capital raises questions
  - Little or no information on the effects on financing
  - Did you find an increase in new equity? Among which firms, GR vs. SR?
  - Who was the financier?

Comments (3)

- The analysis of effects on incorporation and the creation of new businesses seems quite convincing
- Draws a credible picture: TR2006 affected the changes in org. form but created very little new entrepreneurial activity
- To sum up
  - Challenging theme
  - Adds to the understanding of the effects of TR2006
  - Suggestive evidence of effects on investment and job creation, and more convincing evidence that little effect on new business creation
  - Future research could try to find new research designs to establish a causal link between the reform’s tax changes and real behaviour and improve the understanding of the current results

Some experiences from Finland (1)

- Dual income tax 1993
  - Progressive taxation of labor income (20%-65%)
  - Proportional taxation of capital income and corprorate profits (25 %)
  - Splitting system: splits entrepreneur’s income into capital income and labor income based on a presumptive rate of return (=> normal dividend and excess dividend)
- Taxation of dividends: full imputation system => single taxation
- Tax reform in 2005
  - From single taxation to partial double taxation of dividends
  - Main rule: 70 % of dividends is taxable incomei n the hands of the owner
  - ”Normal” dividend from a non-listed company was left tax exempt upto 90 000 €.
  - Corprate tax reate 29 => 26 %, capital income tax rate 29 => 28 %

Some experiences from Finland (2)

- Closer look at the splitting system
  - Base: net assets of the firm (total assets – debt)
  - Splitting rate: originally 10-11 %, after TR2005 9 %
  - Tax rate gap at the top (2005): about 30 %
  - Creates a strong incentive not only to collect new equity but also to accumulate profits in the firm. The required rate of return on investment was and may still be negative for high tax rate owners.
  - Reflects strong incentives to tax planning
  - Favours tangible non-depreciating capital such as real estates and financial assets
  - May well cause efficiency losses (low quality of investments)

Some experiences from Finland (3)

- Hetemäki commission (2008-2010)
  - A cut in corporate tax rate 26% = > 22%, an increase in the tax rate on capital income 28% => 30/32%
  - Changes in dividend taxation
    - Taxable share of dividend income 70 % => 85% (general rule)
    - Normal dividend from non-listed comany: taxable share 0 % => 35 % (no more exempt)
    - Splitting rate: 9 % => 3-4%
  - Abolishing the 90 000 € threshold
  - After these changes fairly neutral with respect to financing and investment; no opprtunities to income shifting
  - Still preferential treatment for SME:s; but favors capital intensive firms (observe: no wage element in the splitting base)

Some experiences from Finland (4)

- Net assets as the capital base
  - Is broader than in Sweden but is not necessarily a bad idea
  - if splitting rate at correct level, produces a broadly neutral treatment of retained earnings, new equity and debt
  - But low splitting rate is a necessary requirement
- Finland has no carry forward of unused allowances
  - This produces an incentive to take benefit of the allowance every year => distributions too high => potential efficiency losses
  - Evidence: We observe strong bunching at the ceilings in Finland
  - Carry forward was discussed but not proposed by the commission; Finnish experts and politicians seem to prefer simple tax rules
  - Discussions concerned to the normal return
  - To apply carry forward to a lump sum allowance was out of question

Some experiences from Finland (5)

- Committee proposed that of the normal return on shares only 35 % is included in taxable capital income
  - Using this share the combined tax rate on normal return is 30 % => tax rate on normal return corresponds to the general capital income tax rate
- When corporate tax is cut further, the taxable share can be raised => equality between the rates maintained
- Solves the problem with dividends but not with capital gains
- In any case, this parameter helps in adjusting the tax system to the globalized world where tax comperition is an important aspect

Some experiences from Finland (6)

- The new government, led by Jyrki Katainen, which took office in june 2011, has implemented only some elements of Hetemäki proposal
- Tax rates have been changed even more than proposed; the splitting system has been changed to the same direction but less than proposed by the committee

Concluding words

- The ESO report adds to the understanding of the effects of TR2006
- Suggestive evidence on some real responses and convincing evindence on tax planning (change in org. form)
- Still room for future research
  - Comparison between CHCs and WHCs
  - The effect of the wage element; use the difference between CHC and WHC
  - Better understanding of the responses of cash rich and cash poor firms
- The policy discussion and suggestions in chapter 5 seem well placed
  - As an example, the current option to accumulate unused allowances in fims without any activity looks unwarranted (point 3 in ch. 5)