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# Why the bias for debt over equity is hard to dislodge

With the preference for debt deeply rooted in financial markets, wholesale reform is risky

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THE NICETIES of corporate finance rarely attract the attention of activists. It is rarer still that those at either end of the political spectrum agree on the need for change. When it comes to the tax system's preferential treatment for debt over equity, however, both the left-wing Tax Justice Network and the fiscally conservative Tax Foundation agree that the "debt bias" needs correcting. But the degree of consensus belies the difficulty of getting it done.

Most countries that levy taxes on corporate profits treat debt more favourably than equity, largely because they allow interest payments, like other costs, to be deducted from tax bills. That gives companies a huge incentive to borrow, rather than to fund themselves through equity. In America, Britain, Germany and Japan, debt-based finance is taxed at rates that are 3.8-6 percentage points lower than those on equity investments, according to the OECD. The result is more indebtedness than would otherwise have been the case. According to the Securities Industry and Financial Markets Association, the value of outstanding debt securities amounts to \$123trn, exceeding the \$106trn in listed equities globally. The IMF estimated in 2016 that the debt bias explained as much as 20% of investment banks' total leverage.

The bias affects a swathe of firms, from small and unlisted family affairs to the world's biggest public companies; and higher debt loads in general leave them more exposed to economic shocks. But, because trouble at highly leveraged lenders can easily throw the rest of the financial system into turmoil, researchers have tended to concentrate on the effects on banks. Total earnings are often thin relative to the large flows of interest payments made to and by lenders, and removing the tax deductibility of interest could make some of them unprofitable.

The debt bias grows as corporate taxes rise, posing headaches for governments hoping to shake down profitable companies to plug fiscal holes. It has therefore not gone unnoticed by the authorities—though recent attempts to restore balance have been marginal. A rule that came into effect this year in America caps debt-interest tax-deductibility at 30% of a company's earnings before interest and taxes, as part of President Donald Trump's 2017 tax reforms. The EU is mulling a "debt-equity bias reduction allowance", the details of which are yet to be made public.

What would wholesale reform look like? In a paper published in 2017, Mark Roe of Harvard Law School and Michael Tröge of ESCP Business School put forward some ideas. One is to treat debt less preferentially. They imagine a bank with \$50bn in gross profits and \$40bn in interest payments. With full deduction for interest and a corporate-tax rate of 20%, the bank would pay tax of \$2bn, and have an incentive to rack up debt. But if the interest deduction were removed altogether, a tax rate of 20% would wipe out the bank's entire net profit. One solution would be to withdraw deductibility, but to lower the tax on gross profits. A rate of 7% in that scenario would yield as much to the taxman, and pose the same burden to the bank, as a 35% tax on net profits.

Another option, which may be more politically viable than cutting tax rates, is to make issuing equity more attractive. The researchers propose a version of an allowance for corporate equity (ACE),

5% would reduce its taxable profit by \$5bn, the same way that \$100bn in debt with an interest rate of 5% would be treated. The principle could be applied just as easily to non-financial firms.

Indeed, some European countries, such as Italy and Malta, have introduced ACE schemes for a wider set of companies. The OECD reckons that Italy's tax bias in favour of debt is now less than a percentage point. The European Commission finds that the country's scheme has reduced the leverage ratio of manufacturers by nine percentage points, with a larger effect on smaller firms.

Reducing the bias, then, is not impossible. But working out whether reform will upset the vast edifice of debt financing will be much harder to do, especially in the larger markets of America or the wider EU. (Italy's scheme covers only newly issued equity for this reason.) The preference for debt is deep-rooted enough that ripping it out could have large, enduring effects on portfolios around the world. Serious change may not come as quickly as the activists hope.

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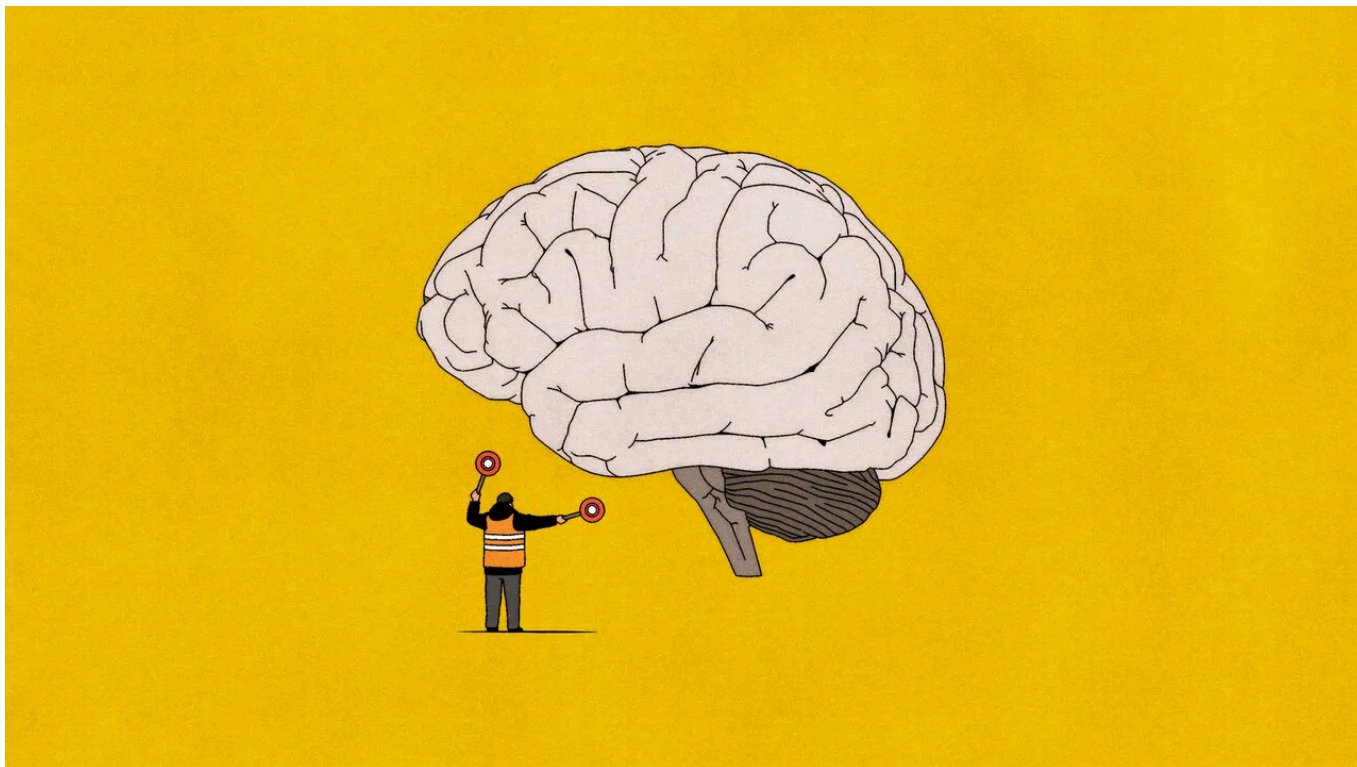


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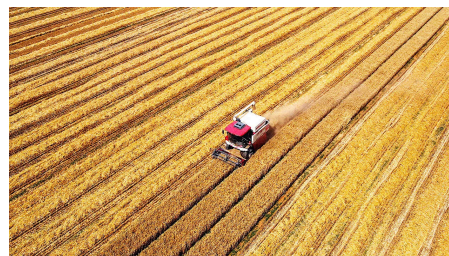
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