3

Taxation and Entrepreneurship

3.1 General Principles

With a scope seven times that of Fyodor Dostoyevsky's *War and Peace*, the US tax code should leave nothing to chance. However, as shown by Sull and Eisenhardt (2015), authors of *Simple Rules: How to Thrive in a Complex World*, when 45 tax professionals took up the task of calculating one fictional family's tax bill, they came up with 45 different estimates, with differences ranging in the tens of thousands of dollars. No wonder that "to navigate this (tax) labyrinth, U.S. citizens employ 1.2 million [tax professionals], more than all the police and firefighters in the country combined" (Sull and Eisenhardt 2015, p. 23). The example reveals how complexity can spiral out of control; in our context, it highlights William Baumol's (1990) fundamental insight that society's rules of the game give rise to a "social structure of payoffs" determining whether individuals devote their time and energy to productive, unproductive, or destructive purposes. The European situation regarding corporate and personal income taxation appears to be comparable in that respect (PwC 2019). Complex rules, especially in an area of such immense importance for entrepreneurial venturing as taxes, will likely limit the scope of productive entrepreneurial activity and the workings of collaborative innovation blocs.

Any analysis of the effects of taxes on entrepreneurship is further complicated by the fact that no specific tax on income from entrepreneurial efforts exists in practice in the USA, Europe, or anywhere else. Governments tax entrepreneurial value creation in several ways, notably as labor income, business income, current capital income (dividends and interest), or capital gains. The complex interactions among these taxes shape incentives. To disentangle

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these effects, we begin by focusing on the three main theoretical ways in which the tax system affects entrepreneurial activity (Henrekson and Sanandaji 2016).

First, an *absolute effect* influences the supply of potential entrepreneurs and the effort they exert in the economy, as an increase in the taxation of entrepreneurial incomes lowers their (expected) after-tax reward, adversely affecting entry, growth, and liquidity. Second, there is a *relative effect* influencing the relative returns for different activities; for example, a tax system favoring certain forms of savings and investments over others can have considerable indirect consequences for entrepreneurship. Likewise, a higher relative tax on formal employment may encourage income shifting and push more people into self-employment; whether it is the "right" people and whether they are choosing self-employment for the right reasons are different matters altogether. Lastly, the tax system (and regulation in general) can be so opaque and complex that it puts potential productive entrepreneurs at a disadvantage relative to individuals able and willing to game the system to their advantage. As such, the *complexity effect* benefits rent seekers, lobbyists, and tax arbitrageurs to the disadvantage of new entrants and productive ventures.

Bearing these effects in mind, we choose moderation as a first guiding principle: tax rates should be low to promote an entrepreneurial society. Perhaps more important still is to espouse the second principle of neutrality and aim for as small a bias as possible with regard to taxes across different owner categories, sources of finance, and economic activities (Elert et al. 2017). Finally, adherence to the principle of transparency is vital to make the tax system less opaque and exception-ridden.

Tax systems tend to grow increasingly complex and opaque over time because politicians, often prompted by vocal interest groups in society, continually tinker with the system at the margins. This corrosion highlights the need for an occasional overhaul of the tax code to do away with the exceptions and loopholes typically introduced to fix imbalances caused by changes elsewhere in the tax code. Because such a tax code reform requires a strong political mandate and momentum, the optimal moment of implementation is hard to predict; but when an opportunity presents itself, policymakers should embrace it.

The EU's tax competencies are quite limited, meaning that most of the proposals presented below are directed to member states individually. That said, the EU can play a role by "nudging" national governments in the right direction and has several policy instruments at its disposal to do so. Such instruments include recommendations, policy statements developed by the Council, and nonbinding agreements between member states, which could be coupled with regular assessments, peer pressure, and the exchange of best practices between member states. The EU is entitled to take such supporting and coordinating actions whenever tax reforms touch upon the proper functioning of the internal market. This is arguably the case for taxes with a bearing on the efficient allocation of capital in the EU, such as corporate income taxation, dividend and capital gains taxation, and the fiscal treatment of debt, equity, and stock options (Suse and Hachez 2017).

3.2 Proposals

Given the complexities inherent in the relationship between taxes and entrepreneurship, we present reform proposals for the major tax categories in EU member states one at a time: labor, corporate, dividend, and capital gains, wealth, and stock options taxation. These proposals should primarily be considered at the member state level, either in isolation or, preferably, as part of a comprehensive tax reform.

3.2.1 Labor Taxation

While some entrepreneurs (such as owner-managers in incorporated businesses) are employees in their own companies, they seldom pay themselves a high salary, especially in early phases when liquidity tends to be constrained. Nevertheless, the emphasis on key personnel in the collaborative innovation bloc underscores the central role of labor taxation for successful entrepreneurial venturing. EU member states differ substantially in this respect.

While the top marginal tax rates on labor income range from 15% in Hungary to 60% in Sweden, the total marginal tax wedge is in many ways a more informative measure, with more relevant effects on entrepreneurial venturing. Defined as the share of total labor cost at the margin, it consists of the sum of mandatory social security contributions paid by the employer and/or the employee and the marginal income tax rate. In a country such as Belgium, as much as two-thirds of total labor cost consists of income taxes and social security contributions, while the share in Poland is only about half as large (see Table 3.1). In part, the differences reflect the diversity in political preferences and cultures across Europe. Generally, labor taxation is high, both on average and at the margin, in the old member states and the Nordic welfare states. Rates are much lower in the East, where tax codes are more recent, and in the Anglo-Saxon countries, with their less extensive welfare states.

Table 3.1 Top marginal tax rate on labor income, and marginal rate of income tax plus employee and employer contributions less cash benefits (tax wedge), 2017

		Tax wedges		
Country	Top marginal tax rate on labor income	Single no child, 100% AW	Single, no child, 167% AW	Married, 2 children, 100 and 67% AW
Austria	48.0	59.7	42.2	59.7
Belgium	46.0	66.4	68.5	65.6
Czech Rep.	20.1	48.6	48.6	48.6
Denmark	55.8	42.0	55.8	42.0
Estonia	19.7	41.2	41.2	41.2
Finland	49.0	55.6	58.3	56.4
France	53.9	58.5	59.9	60.4
Germany	47.5	60.4	44.3	57.9
Greece	55.0	49.1	61.6	49.1
Hungary	15.0	46.2	49.0	46.2
Ireland	48.0	54.0	55.8	35.9
Italy	42.3	54.7	63.3	55.3
Luxembourg	41.4	55.5	55.5	52.1
Netherlands	49.7	51.6	52.7	51.6
Poland	22.1	37.0	37.2	37.0
Portugal	50.0	51.1	60.8	51.1
Slovakia	21.7	46.4	46.5	46.4
Slovenia	39.0	51.0	60.4	43.6
Spain	43.5	48.3	37.0	48.3
Sweden	60.1	48.3	67.3	48.4
UK	45.0	40.2	49.0	40.3
USA	46.3	43.6	43.6	34.3

Note: The marginal tax wedge refers to the principal earner with an income of 100% of average wage (AW) and the secondary earner with an income of 67% of AW in the rightmost column

Source: OECD, *Taxing Wages 2016–2017*

To offset the negative impacts of high marginal and average labor taxation on labor supply, policymakers have tied many of the valuable transfers and welfare state services that these taxes finance (e.g., child care and pension rights) to employment. Moreover, taxation and social security have often been individualized to stimulate female labor participation (Lindbeck 1982). Such individualized conditionality explains why a country such as Sweden has the EU's highest employment rate despite high marginal and average taxes on labor. However, if systems are poorly designed, they push people away from small, risky, and innovative ventures into secure, salaried employment in the public sector or in incumbent firms. More often than not, these high-taxation–high-conditionality systems violate our principles of moderation, neutrality, and transparency.

For Sweden, it has been argued that a reform to lower the marginal tax in the top bracket would probably more than finance itself (Sørensen 2010; Holmlund and Söderström 2011). The situation is different in the new eastern member states: despite low labor income tax rates, they exhibit little improvement-driven opportunity entrepreneurship and couple low employment with large underground economies. These circumstances suggest that factors other than high labor taxes are binding constraints for this cluster of countries and that lowering such taxes more would merely result in a harmful loss of tax income and the deterioration of public sector effectiveness. In contrast, labor taxation seems to be a clear impediment to venture creation and growth in the Mediterranean countries, as well as in Belgium and France. There, high taxes and the employment-related obligations of employers penalize both the employment of people and attempts to realize growth. Reforms in these countries should aim to combine lower labor taxes with more universal access to public services and social security, such as childcare and pension rights. We return to these issues when discussing the organization of labor markets and social security systems in Chap. 5.

Regarding labor taxation, we contend that countries with high marginal labor tax rates should refrain from following the Swedish model. Instead, they should reduce their marginal labor tax rates where possible because conditionality always benefits well-defined, existing forms of employment. Policymakers should not try to offset imbalances caused by high taxation by introducing additional layers of complexity. Instead we propose:

Proposal 5: Reduce high tax burdens on labor instead of making subsidies, pension rights, and social benefits more conditional on employment status.

The proposal would ensure tax neutrality between different types of labor market engagement, reducing the disproportionately high penalty small employers face when hiring workers. Moreover, the proposal serves the principle of transparency by reducing the roundabout method of taxing labor income to finance transfers and to provide subsidized services to those that paid the tax.

3.2.2 Corporate Taxation

Corporate taxation has significant ramifications for the interplay between entrepreneurs and financiers in the collaborative innovation bloc; specifically, a high tax rate on business profits discourages equity financing and encourages

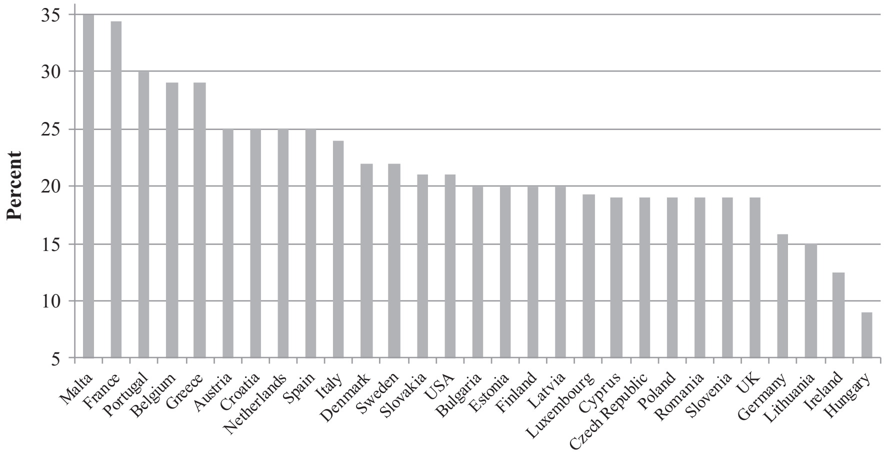

Fig. 3.1 The statutory corporate tax rate in EU countries and the USA, 2018. Source: OECD and Eurostat

debt financing if interest payments are tax-deductible (Desai et al. 2003; Huizinga et al. 2008). Because debt financing is less costly and more readily available to larger firms, high corporate tax rates coupled with tax-deductible interest payments put smaller firms and potential entrepreneurs at a disadvantage (Davis and Henrekson 1999) while also reducing the retained earnings that can be used to expand ventures after start-up. Consequently, taxing profits can be expected to affect growth negatively, especially in small firms (Michaelas et al. 1999).

In the EU, the statutory corporate tax rate ranges from 35% in Malta to 9% in Hungary (Fig. 3.1). While healthy institutional competition among member states along this margin keeps rates down, the EU has a central role to play to prevent a race to the bottom, and it must act as a watchdog against opaque sweetheart deals negotiated between national governments and large multinational corporations or national champions. Although they reduce effective tax rates, such exceptions violate the principles of neutrality and transparency; the Union should therefore encourage member states to remove discrepancies between statutory and effective corporate income tax rates stemming from these deals.[1]

[1] Discrepancies can be due to accelerated depreciation rules, inventory valuation rules, and ad hoc country- or industry-specific tax reductions. They are usually the result of effective lobbying by vested interest; at best, they do little harm, but typically they distort the behavior of various agents in the business sector, e.g., by favoring specific industries, ownership forms, and sources of finance (King and Fullerton 1984).

Proposal 6: Eliminate discrepancies between statutory and effective corporate income tax rates.

It is imperative that these discrepancies be addressed, as it becomes more difficult to realize the behavioral effects that policymakers envision if economic actors can obtain an effective tax rate lower than the statutory one (Chetty et al. 2009). Moreover, all firms should be treated equally under corporate income tax law.

There is, however, one (transparent but decidedly non-neutral) exception to the equal treatment rule that we would consider appropriate: that start-ups be allowed to retain their profits for reinvestment. The fact that new firms create useful knowledge about new technologies and business models (even if they ultimately fail) justifies this departure from the neutrality principle. This does not mean that personal incomes earned from start-ups should be tax exempt, as this could trigger unproductive tax arbitrage and promote solo self-employment (Liebregts 2016). This reform would make it easier and more attractive to make and reinvest profits while simultaneously creating a tough selection environment for firms without creating a need to develop (transparent, democratic, and accountable) criteria for public support. In addition, this supports new ventures without siphoning off resources from successful firms and avoids the risk that direct government support is channeled to the wrong firms. The latter risk is far from negligible; it could induce entrepreneurs to spend less time and effort on catering to consumer demands, and more on developing expertise in getting such public support (Gustafsson et al. 2018). In the extreme case, entrepreneurial profits could be made fully tax exempt. However, such a policy would only be effective when statutory corporate tax rates are also effective corporate tax rates, as proposed above.

Generally, a corporate income tax is not a potent way to tax the income of firms, especially incumbents, since they respond to such measures by increasing their prices and/or lowering the returns to their production factors. Corporate income taxation may have made sense in times when collecting taxes on personal income and consumption was cumbersome and complicated, but digitalization has made these indirect methods of taxation redundant. Ultimately, they only distort incentives and give rise to fiscal arbitrage. The principle of transparency justifies making all corporate profits tax exempt (not only those of young firms) while taxing primary incomes and consumption directly.

Proposal 7: Grant full corporate income tax exemption to genuinely new, innovative start-ups through their 3rd year, with the long-term goal of abolishing corporate income taxation altogether.

Clearly, the short-term goal of this proposal violates one of the principles we hold dear: neutrality. Moreover, it may give rise to undesirable tax-induced arrangements and does not distinguish between innovation-based new ventures producing knowledge spillovers and low-tech replicative ventures. However, because it is difficult for bureaucrats to distinguish deserving from non-deserving ventures, it is probably best to refrain from fine-tuning this further. Regardless, start-ups rarely make big profits in their first years, meaning that the proposal will not be costly in terms of foregone tax revenue. Fulfilling its long-term goal could, furthermore, make it a vital step towards a tax system in line with the desired principles of transparency, neutrality, and moderation.

3.2.3 Taxation of Dividends and Capital Gains

The returns to entrepreneurship mainly accrue to investors and entrepreneurs in the form of dividends and capital gains on their firm ownership stake. A high dividend tax rate encourages entrepreneurs to rely on retained earnings to finance expansion but can also trap capital in incumbent firms, thereby obstructing the flow of capital to the most promising projects in a collaborative innovation bloc (Chetty and Saez 2005). This imbalance is probably part of the reason why owners receive most of their economic return from successful entrepreneurship in the form of increased share values. Consequently, the taxation of capital gains on stock holdings typically has a substantial effect on the financial incentives of potential high-impact entrepreneurs and their (equity) financiers (Cumming 2005; Da Rin et al. 2006).

As shown in Table 3.2, standard tax rates on dividends and capital gains differ substantially among EU countries. Moreover, there are many ways in which effective rates can and do diverge from standard rates (Grant Thornton 2016).[2] For example, the Swedish dividend and capital gains tax rates vary between 20 and 60% for physical persons; in Ireland, meanwhile, the divi-

[2] These divergences depend on factors such as the holding period, firm size, whether the firm is private or traded on a stock exchange, and whether ownership is passive or active. Other decisive factors are whether the firm and/or the investor qualifies for inclusion in a tax-favored scheme (e.g., a scheme geared towards encouraging innovative start-up activity), and the tax status of the body (a natural or a juridical person, etc.) receiving the capital income.

Table 3.2 The standard dividend and capital gains tax rates (short-term/long-term) in EU member countries and the USA, 2018

Country	Dividends	Capital gains	Country	Dividends	Capital gains
Austria	27.5	27.5	Latvia	0.0	20.0
Belgium	30.0	0.0	Lithuania	15.0	15.0
Bulgaria	5.0	41.0	Luxembourg	21.0	42.0
Croatia	12.0	12.0	Malta	0.0	35.0
Cyprus	17.0	0.0	Netherlands	25.0	n/a[a]
Czech Republic	15.0	15/0	Poland	19.0	19.0
Denmark	42.0	42.0	Portugal	28.0	28.0
Estonia	0.0	21.0	Romania	5.0	10.0
Finland	28.9	34.0	Slovakia	7.0	25/0
France	30.0	30.0	Slovenia	25.0	25/0
Germany	26.4	26.4/0	Spain	23.0	23.0
Greece	15.0	15.0	Sweden	30.0	30.0
Hungary	15.0	15.0	UK	38.1	28.0
Ireland	51.0	33.0	USA	29.2	39.6/20
Italy	26.0	26.0			

Source: OECD Statistics, Table II.4 Overall Statutory Tax Rates on Dividend Income, and the websites of the respective national tax agencies

[a]The Dutch tax rate on capital gains does not depend on the realized return. It is a flat tax of 30% on an assumed nominal rate of return

dend tax rate is 51%, whereas the capital gains tax rate can be reduced from 33% to zero under certain conditions. Levels are low, and variation is smaller in the Netherlands, Poland, and Estonia.

What most European member states have in common, however, is that their tax schemes for dividends and capital gains are complex, thereby feeding a thriving but macro-economically unproductive tax advice business. Countries should thus aim for dividend and capital gains tax rates with few exceptions and few (opaque) concessionary schemes. Here, Eastern European countries, such as Poland and Estonia, offer exemplary models: tax rates are at reasonable levels, and the effective tax rate is largely independent of any particular circumstances. Arguably, the simplicity is due to the relatively recent transition of these former communist countries to liberal market-based democracies. These economies essentially had to start from scratch in the early 1990s and were exempt from the burden of decades of lobbying and the type of political compromises obfuscating the tax system in most Western European countries.

> Proposal 8: Countries should aim for low dividend and capital gains tax rates with few exceptions and few (opaque) concessionary schemes.

Dividend taxation also creates an undesirable differential in the risk-adjusted returns on debt and equity that possibly biases the supply of financial capital away from small, uncertain, experimental entrepreneurial venturing. We would, therefore, propose dividend taxation be kept low and at a par with the fiscal treatment of interest income on debt to avoid such biases. A similar argument holds for capital gains taxation to the extent that retained profits drive capital gains. To promote a more entrepreneurial society, the tax system should not be biased against the most relevant sources of finance for entrepreneurial venturing.

3.2.4 Taxation of Private Wealth

"Triple-F" finance plays an important role in the early stages of many ventures in a collaborative innovation bloc. When entrepreneurs exhaust their own resources, friends, family, and "fools" typically step in (Mitter and Kraus 2011). The last category includes informal investors, who, perhaps contrary to the general perception, contribute resources neither blindly nor foolishly. Entrepreneurs distribute ownership rights to informal investors early in the start-up process, putting the lie to the idea that triple-F financiers act out of charity (Kotha and George 2012; Ford and Nelsen 2014). In fact, the supply of such finance typically follows demand closely, and the amounts invested are of the same order of magnitude as amounts committed by angel investors in later stages of development (Burke et al. 2014). In other words, entrepreneurs mobilize significant funds from their personal and informal networks that aid in the development of their nascent ventures. It is possible, therefore, that more private wealth would increase the supply of informal finance, ultimately enabling more entrepreneurial venturing.

> Proposal 9: Harmonize and reduce taxes on private wealth, private wealth transfers, and inheritance if productively invested.

Because the incomes used to build up private wealth have typically already been taxed, some would argue that any form of private wealth taxation is double taxation (Boadway et al. 2010). A country may choose to tax the wealth of its citizens for equity reasons, but the fact that this gives rise to unproductive tax arbitrage (Harrington 2016; Zucman 2014, 2015; Montes 2018) is probably why most European countries have lowered wealth taxation. However, as shown in Table A.1 in the Appendix, countries such as France and Spain still tax wealth at steep rates even if the exempted amounts are sizable. The real effective tax rate on wealth income can become extremely high in the current low interest regime: For instance, a wealth tax of 2% is a real tax that is levied in addition to any tax on the nominal return of the asset. Invariably, this problem forces the government to introduce distortionary safety valves (e.g., Du Rietz and Henrekson 2015).

Equity considerations, while relevant, should take a backseat to ensuring that accumulated private wealth is mobilized and productively invested (Krippner 2005; Hudson and Bezemer 2012; Piketty et al. 2013; Bezemer 2014; Bezemer and Hudson 2016). The entrepreneurial society loses out when its wealthy families become rentier dynasties, i.e., passive portfolio investors in large incumbent firms and real estate. Preferably, their accumulated wealth should be used to create opportunities for the next generation of entrepreneurs (Acs and Phillips 2002; Acs 2006; Auerswald and Acs 2009). Acs and Phillips (2002) argue that in the USA, wealthy entrepreneurs perform this function in part through philanthropy. Historically, European nations have relied more on the taxation of accumulated wealth, wealth income, and inheritance, redistributing the proceeds through publicly funded investments in, e.g., education and health.

To ensure that Europe's wealthy families reinvest their fortunes in promising ventures on their own accord, a preferential treatment of equity investments in young SMEs could be considered. Alternatively, leaving private wealth invested unproductively could carry a penalty (Shakow and Shuldiner 1999).[3] Whichever route is chosen to mobilize more private wealth for entrepreneurial venturing, a strong case can be made for a harmonization of wealth taxation at the Union level. Appropriately implemented, such a measure would prevent a legislative race to the bottom and minimize the scope for unproductive tax evasion. Such considerations would benefit the current debate on European wealth taxation, which appears to be dominated by concerns of tax revenue and equity (Astarita 2014; Krenek and Schratzenstaller 2018).

Regarding inheritance taxation, another delicate balance must be struck—this time between preventing the build-up and entrenchment of passively invested dynastic fortunes on one hand and incentivizing the accumulation of wealth through productive investment on the other hand. Table A.2 in the Appendix reveals that inheritance taxes differ widely across member states, being zero or close to zero in 14 of the 28 member states but very high in some of the larger states, such as the UK, Germany, France, and Spain, as well

[3] This need not be complicated. For example, the Dutch system for taxation of private wealth assumes a 4% return on assets (above a threshold of 30.360 euros per person) which is taxed at 30%, implying a tax on the value of wealth above the threshold of 1.2%. Since 2017 the percentage increases with the size of the wealth. By assuming the return instead of measuring it, the wealth owner has an incentive to invest her wealth with higher risk and earn a higher return.

as in Finland and Belgium. As private wealth is most often invested productively in ventures when investors are knowledgeable about local conditions, fiscally motivated movement of capital to avoid inheritance taxation is unproductive. The EU should aim for harmonization in this area to prevent such wasteful actions.

> Proposal 10: Harmonize inheritance taxes across member states and introduce a moderate flat tax rate and exempt the majority of inheritances from taxation.

Most Western European countries have reduced their inheritance taxation significantly since the 1960s. Interestingly, the tax is least popular among the lower income brackets. Following the work of Piketty (2015), however, the issue of preventing the accumulation of "dead" wealth has resurfaced in the policy debate (e.g., The Economist 2017). While there are strong arguments for taxing inheritances, the devil is, as always, in the details. The primary purpose of this tax should not be to raise revenue but to incentivize the productive investment of wealth. People should be discouraged from rolling over large fortunes into risk-free portfolios of government bonds, and the liquidation of productive ventures to avoid inheritance taxation would be especially damaging. A moderate and harmonized inheritance tax would broaden the tax base while limiting the incentives and opportunities for tax avoidance. Furthermore, in member states where family-owned businesses are engines of innovation and growth, policymakers should consider additional means to strengthen the entrepreneurial society, for example, by introducing exemptions for wealth that remains productively invested in family firms.

Reducing and simplifying the taxation of private wealth are the first steps towards freeing up more savings for productive investment in entrepreneurial ventures. Those steps are not enough, however, if the interests and skills of private wealth owners do not meet the entrepreneurial sector's needs. Here, a well-developed financial sector, to which we return below, has an important role as a matchmaker and intermediary.

3.2.5 Tax Neutral Treatment of Equity and Debt

Innovative entrepreneurs have limited access to bank credit and tradable debt obligations. They may borrow from friends, family, and fools or through crowdlending, but these types of lending are often exposed to the same risks as equity and given in anticipation of the same return profiles (with no formal governance rights). The reason is that innovative start-ups face large disadvantages in attracting more formal forms of debt finance due to high uncertainty and the lack of a robust track record and readily collateralizable assets. Therefore, tax structures that favor debt over equity investments will, often unintentionally, bias the flow of financial resources away from innovative entrepreneurial venturing and impede the workings of the collaborative innovation bloc. Moreover, the tax-deductibility of interest payments has provided large firms with ample room for artificially shifting profits to low or zero-tax locations (OECD 2017).

Currently, national tax systems in Europe favor debt finance. Debt becomes (too) cheap relative to equity because interest payments are deductible as operating costs, while dividends are subject to corporate income taxation before they can be paid out to shareholders. Moreover, strong legal creditor protection reduces risks for creditors that would otherwise justify a higher risk premium on debt finance. Together, these fiscal and institutional arrangements bias the supply of finance towards debt, and entrepreneurs are at a disadvantage when competing for debt relative to homeowners, large multinationals, and other actors. As such, debt finance channels society's available savings into the reproduction and growth of the existing capital stock, and a case can be made that only equity type investments finance innovation and progress beyond the status quo (Polzin et al. 2018a).

Neutrality between debt and equity can be achieved in two principal ways: by reducing the tax advantages of debt finance or by giving similar advantages to equity (e.g., De Mooij and Devereux 2016). The EU's efforts in this regard have mainly been to reduce interest deductibility. In 2016, the European Council (2016) adopted the Anti-Tax Avoidance Directive (ATAD), which lays down rules against tax avoidance practices that directly affect the functioning of the internal market. Article 4 in the Directive stipulates a limit to interest deductions: net interest payments cannot exceed a certain percentage of company earnings, typically defined as 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA), allowing for a minimum deductible amount independent of earnings. Table A.3 in the Appendix shows that almost all member states have instituted such rules, with most of them settling for a minimum deductible amount of EUR 3 million.

Unfortunately, the Council has prioritized its concern regarding tax base erosion over the need to even out the imbalance between debt and equity as sources of finance. It is unclear to what extent the EBITDA rules will be binding for incumbent firms, and if the rules are not binding, they will do nothing to reduce the difference in effective taxation of debt and equity.

A better route to follow to achieve neutrality would be to introduce a so-called *comprehensive business income tax*. This measure would eliminate the fiscal favoring of debt-financed investment by disallowing any deduction for interest payments while compensating the business sector with a commensurate lowering of the corporate tax rate. If implemented, this proposal would promote an entrepreneurial society by lowering the taxation of high profits, thereby incentivizing the pursuit of ventures with high risk and high expected returns. Moreover, although firms are allowed to deduct interest payments from corporate taxes, the creditors appropriate most of that benefit, as competition in debt markets is much higher on the demand side than on the supply side. Nevertheless, resistance against such a reform will likely be extensive; it is in the best interest of creditors (notably banks) to lobby against it, and many firms also (believe that they) benefit from the favorable tax treatment of debt finance. In practice, therefore, policymakers may need to opt for an *allowance for corporate equity* scheme instead. Such a scheme would replace the deductibility of actual interest payments by allowing the deduction of an amount corresponding to the normal return applied to the book value of the firm's total assets. While this scheme eliminates the bias towards debt finance, such a reform would, in fact, tax profits at a higher rate than before. It would thus reduce the bias, and also reduce firms' ability to retain funds. In the short run, however, it may be the best we can hope for.

> Proposal 11: Initiate a balanced program aiming to achieve tax neutrality between debt and equity finance.

In an entrepreneurial society, it is (primarily) equity investments that enable innovative entrepreneurial venturing and thereby generate useful knowledge about the products, services, and business models that work or fail. This knowledge constitutes a positive externality, which may even justify the preferential tax treatment of equity investments over debt.[4] At the very least, the long-term ambition should be to eliminate any fiscal advantages held by debt finance over equity.

3.2.6 Taxation of Stock Options

The fiscal treatment of stock options deserves special mention, harking back to the role played by key personnel in the collaborative innovation bloc. As a

[4] The same logic suggests that banks and other investors should be encouraged to disclose information on loan applications they accept or turn down. Of course, the traditional banking business model relies in part on exclusive access to financial information on clients, but as European banks have largely abandoned the traditional relationship-based banking model, it is difficult to justify exclusive access. Presently, alternative platform finance is exploring practical ways to collect and disseminate such information. We return to this issue in Chap. 4.

promise of a future ownership stake, employee stock options are used to encourage and reward individuals who supply key competencies to a young firm that is typically short on cash. However, their value—and effectiveness as an incentive mechanism—greatly depends on the option tax code, notably on whether employees can defer the tax liability until they sell the stocks (and whether they are taxed at a low capital gains tax rate at this point) (Gilson and Schizer 2003).

The effective tax treatment of option contracts is a major determinant of the size of the VC-funded entrepreneurial sector (Henrekson and Sanandaji 2018a). In a cross-country perspective, the tax rates on stock options vary considerably. For instance, the tax rate is as low as 7% in Ireland, while it typically exceeds 70% in Italy, and the tax rules tend to be highly complex (see Table A.4 in the Appendix). The VC sector remains small in most countries where the tax rate on stock options is high, while low-tax countries such as Hong Kong and the USA have large and highly dynamic VC sectors (Armour and Cumming 2006).

> Proposal 12: Taxes on capital gains on stock options and the underlying stock in start-ups should be low and only be taxed when exercised and/or sold, i.e., when gains are realized.

In many EU countries, the lower taxation of gains on employee stock options in the start-up sector is necessary, both as a means to lure talented people away from traditional careers in incumbent firms and to channel institutional capital into the entrepreneurial sector, which should be mediated by a professional VC sector. A tax break that targets human capital in this segment would promote innovative entrepreneurship without the high fiscal cost of broad capital gains tax cuts (Henrekson and Sanandaji 2018c).

3.3 Summary

Taxation is essential to any government's ability to finance essential public infrastructure and collective goods. Therefore, where we argue in favor of moderation, healthy government finances are assumed. Inevitably, this implies that countries in the Union will end up with different tax levels and rates. However, given the aggregate level of tax income required to ensure a long-term stable government budget, we maintain that *moderate*, *neutral*, and *transparent* taxation are key to boosting entrepreneurial venturing across Europe. Adhering to these three principles requires an ongoing effort to keep

Table 3.3 Summary of proposals regarding taxation, specifying the level in the governance hierarchy where the necessary decisions should be made

No.	Principle(s)	Policy area	Proposal	Policy level[a]
5	Neutrality and transparency	Labor taxation	Reduce high tax burdens on labor instead of making subsidies, pension rights, and social benefits more conditional on employment status.	MS
6	Transparency	Corporate income taxation	Eliminate discrepancies between statutory and effective corporate income tax rates.	EU, MS
7	Moderation and transparency	Corporate income taxation	Grant full corporate income tax exemption to genuinely new, innovative start-ups through their third year, with the long-term goal of abolishing corporate income taxation altogether.	EU, MS
8	Moderation and transparency	Dividend and capital gains taxation	Countries should aim for low dividend and capital gains tax rates with few exceptions and few (opaque) concessionary schemes.	EU, MS
9	Moderation and neutrality	Wealth taxation	Harmonize and reduce taxes on private wealth, private wealth transfers, and inheritance if productively invested.	MS
10	Moderation and neutrality	Inheritance taxation	Harmonize inheritance taxes across member states and introduce a moderate flat tax rate and exempt the majority of inheritances from taxation.	EU, MS
11	Neutrality	Debt and equity taxation	Initiate a balanced program aiming to achieve tax neutrality between debt and equity finance.	EU, MS
12	Moderation	Stock options taxation	Taxes on capital gains on stock options and the underlying stock in start-ups should be low and only be taxed when exercised and/or sold, i.e., when gains are realized.	EU, MS

[a] *EU* federal level, *MS* member state level

the tax system simple, clear, and effective in the face of interest groups lobbying for exemptions and exceptions. The alternative is less transparency, impaired neutrality, and increased complexity, which will distort behavior.

Table 3.3 provides a summary of our proposals regarding taxation and the level(s) of the governance hierarchy at which political action should take place to make them a reality. In contrast to the previous chapter, the proposals in this chapter require little policy coordination across policymaking levels: the legislative powers in tax policy are almost exclusively reserved for the member states. However, as Suse and Hachez (2017) note, the EU can and should use a number of nonbinding instruments and approaches to influence the tax policies of its member states.