Tax reforms to influence corporate financial policy: the case of the Italian business tax reform of 1997-98

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Abstract

In this paper company-level panel data are used to explore the role of tax changes on corporate financial policy. A panel model for the years 1993-98 is estimated confirming the explanatory power of the tax variable. The estimation also shows that firms reduced leverage in the last three years (1996-98) as a reaction to important tax changes; the reduction in 1996 was the effect of the temporary investment tax credit of the previous year, while the one in 1997-98 was the result of the business tax reform started in 1997. The reform, by modifying the system for taxing profits, termed Dual income Tax (DIT), and introducing a new regional tax on business activity (IRAP), reduced the bias against equity finance that was present in the previous tax system. Focusing on the reform, a Logit model is estimated to highlight the characteristics of firms that used the DIT tax system in the first two years. The probability of using the DIT increases with profitability, productivity and investment. The significance of the latter variable suggests that the DIT system was used by firms to reduce the cost of financing new investments after the temporary investment tax credit of 1995.

Suggested Citation

Alessandra Staderini, 2001. "Tax reforms to influence corporate financial policy: the case of the Italian business tax reform of 1997-98," Temi di discussione (Economic working papers) 423, Bank of Italy, Economic Research and International Relations Area.

Handle: *RePEc:bdi:wptemi:td_423_01*