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Taxation and the optimal constraint on corporate debt finance: why a comprehensive business income tax is suboptimal

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5% of corporate tax revenue. The welfare gain would arise mainly from a fall in the social risks associated with corporate investment, but also from the cut in the corporate tax rate made possible by a broader corporate tax base.

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bonds from 1995 to 2003 was 146.27 basis points. For AAA-rated corporate bonds, the yield spread was 82.44 basis points, and for A-rated bonds, it was 177.68 basis points.

- 6. To derive the optimal constraint on debt finance from formula (21) and the resulting welfare gain from formula (30), I use an iterative solution algorithm implemented in an Excel spreadsheet available on request.

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A second-order Taylor approximation of this expression around \(\beta =\bar{\beta \}\) yields

```
$$\begin{aligned} p\left( \beta \right) \approx p\left( \bar{{\beta }} \right)
+\frac{\hbox {d}p\left( \bar{{\beta }} \right) } {\hbox {d}\beta }\left( {\beta -
\bar{\beta }} \right) +\frac{1}{2}\frac{d^{2}p\left( \bar{{\beta }} \right) }
{\left( {\hbox {d}\beta } \right) ^{2}}\left( {\beta -\bar{\beta }} \right) ^{2},
\end{aligned}$$

(33)
```

where

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In the absence of tax (\(\tau = 0)\), private and social risk premiums would coincide, and firms would minimize their cost of finance by minimizing the expression in (36), implying the first-order condition

```
\left( {\beta } \right) \Rightarrow \equiv 0 \quad \Rightarrow \nonumber \&p_\mathrm{d} \left( \beta } \right) - p_\mathrm{e} \left( \beta } \right) + \left( \1 - \beta } \right) - p_\mathrm{e} \left( \her{\beta } \right) + \left( \1 - \beta } \right) - p_\mathrm{e}^{{\phi}} \left( \her{\beta } \right) + \left( \her{\beta } \right) + \left( \her{\beta } \right) - \left( \
```

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as stated in ($\underline{6}$) in Sect. $\underline{2}$. Further, by using ($\underline{37}$), we can write the second-order Taylor approximation to the social risk premium ($\underline{36}$) around \(\beta = \bar{\beta}\) as

```
\left( \left\{ \left( \right) \right\} \right) + \left\{ \left( \left( \right) \right) \right\} \left( \left( \left( \right) \right) \right) + \left\{ \left( \left( \right) \right) \right\} \left( \left( \left( \right) \right) \right) \right\} \left( \left( \left( \left( \right) \right) \right) \right)
```

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```
\label{left} $$\left(a \right) p_\mathrm{d} \left(b \right) \approx \left(k\{2}\right) $$ (44) $$ (44) $$ (43) and (44), we may therefore write (41) as $$\left(a \right) p_\mathrm{d} \left(b \right) \approx p_\mathrm{d} \left(b \right) $$ \left(b \right) \left(b \right) +\frac{b }{2}\left(b \right) \approx p_\mathrm{d} \left(b \right) $$ (45) $$
```

In Sect. <u>5.1</u>, we introduced the second-order approximation

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