FRANCISCO PÉREZ-GONZÁLEZ Professor at Stanford
Winner of the Jaime Fernández de Araoz Award, the Mexican economist explains Belgium’s formula to reduce excessive leverage, something Spain suffers, in a controlled manner

“The tax system pays us to get into debt”

PABLO R. SUANZES / Madrid
Francisco Pérez-González, Mexican and Professor at Stanford University, has just been recognised in Madrid together with his colleagues Frédéric Panier and Pablo Villanueva, with the Jaime Fernández de Araoz Award, sponsored by Deutsche Bank, for an innovative paper on the difficult balance between debt and capital in corporations and the effects of the tax systems.

Question: What is your research about?
Answer: Our work focuses on indebtedness. In the current economic situation it is important to be aware of the factors that promote indebtedness, which has had a key role in the crises we have seen. And if there is over-indebtedness, as apparently is the case, propose alternative to deter it.

Q: How do you approach this?
A: Corporations can be financed in two ways. Using debt, such as bank loans, or through shareholder resources. If one wants to undertake an investment project, money coming from a bank is as good as that coming from shareholders. But that is where parity ends, because taxes come into play. There are deductions for debt. If you try to do the same thing with capital, you will not get them. It’s strange, but the tax system pays us to get into debt.

Q: Except in Belgium.
A: In 2006, Belgium set up an innovative tax reform. There was a drastic change in tax incentives by introducing parity in financing allowing tax savings if entrepreneurs use shareholders’ equity. But without doing away with debt deductions. They just made them level.

Q: And how well has it worked?
A: After the reform there was a clear decrease in aggregate leverage in the economy, which is a reflection of the reduction of corporate debt. And we analysed them as a whole, not only the publicly listed ones. Deductions for interest on debt favour companies with the greatest capacity for indebtedness, which are the large ones, the ones consolidated and with significant fixed assets. Because banks want assets to back up their loans.

New companies, or those without a lot of assets, are at a disadvantage. There was a generalised effect. With the reform, the proportion of capital over assets increased. Data show at least 15%. And an even greater impact for companies with assets of over €100 million, of up to 25%.

Q: Was there an effect on the country’s public policy?
A: Over-indebtedness occurs because we generate it. Companies react to the incentives they are given and they get into debt. Therefore we should be asking
ourselves whether they should be maintained. Economic logic tells us they are neither necessary nor efficient.

Q: Should we get rid of them altogether?

P: What is the rationale behind subsidising debt and not capital? It is not at all clear there is one and it is entirely arbitrary. There are two pathways. Eliminating tax savings on debt or a reform such as the Belgian one. And both have advantages and consequences. In the USA, the discussion to withdraw deductions has been going on for 30 years, but it is a political issue, since companies heavily in debt put on a lot of pressure.

Q: What if capital leaves?

A: In a context of economic weakness, eliminating a subsidy is equal to increasing taxes. Our paper does not evaluate. With what I know already, clearly it is worth at least to try for parity.

Q: The figures are astounding.

A: Dramatic. According to figures from the U.S. Department of the Treasury, the marginal rate applied to equity investments is 37% vs -60% for debt. In Spain it is 36% vs -22%, respectively. We can complain about reality, but if you have a system that encourages this behaviour and we don’t reconsider it, we will not get different results. You can pray for debt to go away by itself gradually, but...