

Tools for company capitalization

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Abstract - *The high level of debt that characterizes the capital structure of companies has always been one of the biggest problems of the Italian economy. Traditionally, Italian enterprises especially the small and medium sized enterprises have a weak financial structure, due to a strong imbalance of funding sources in favour of debt. The under-capitalization of firms, and therefore their dependence on borrowed capital, makes them vulnerable to risks that can arise from changes in the environment and external variables, ensuring that they have more difficulties to face periods of financial crisis, such as the recent one that we are experiencing. In addition, the subordination of Italian companies to the banking system determines a lesser degree of independence, which is reflected in putting greater constraints in choosing the best investment opportunities. Firms that are characterized by a balanced capital structure are stronger, enjoy greater operational freedom and are able to deal adequately with the difficulties arising from sudden changes in the external environment. For these reasons it is useful to investigate what are the causes at the root of underfunding and solutions that can be taken in order to encourage companies to strengthen their capital structure. The objective of this study is to identify what are the most appropriate regulatory instruments for encouraging the companies to strengthen their capital structure and in particular to demonstrate the validity of a law that establishes a 100% corporate tax exemption in case of reinvesting the operating profit in the business. This is not a new rule in the international context; in fact it is still in force in Estonia. The rule is intended to encourage companies to retain earnings and reduce the phenomenon, which often occurs in Italy, consisting in the reduction of the tax base of the company through the introduction of discretionary costs (such as directors' fees), higher than the amount due.*

Key Words: capitalization, tools, accounting

1. INTRODUCTION & AIM OF THE RESEARCH

To prove this thesis it was decided to simulate the effects of the introduction of the fiscal incentive on the financial statements and therefore on the results and financial performance of a sample of companies, by creating an empirical model that reproduced the logic and managerial choices resulting from the introduction of the measure. The empirical model was created and applied to each financial statement considering a number of basic assumptions; which have given rise to an equal number of quantitative results; can provide a measure of the effectiveness of the tax incentive.

The empirical analysis has been accompanied by a survey on the perception of entrepreneurs on the Italian tax system by means of a series of surveys.

Through this investigation it was possible to explore some issues of concern, for example: the taxation of business income, the Italian tax system as a whole and the incentives that it provides to facilitate the capitalization of companies considering the opinion of business owners.

Elaborating on the results obtained jointly by empirical research and survey on the perception of entrepreneurs, the conclusion remarks have been constructed based on a comparison of the strengths and weaknesses of the proposed law.

The operational part of the work was supplemented by an in-depth analysis of the Italian economy, with particular reference to reality and to the aspects that characterize the management of small and medium-sized enterprises, and the research aimed to identify the causes behind the under-capitalization of the Italian firms and their dependence on debt capital.

Moreover, taking into consideration some studies and researches that were conducted by other authors on the subject, it was possible to identify what are the features that a tax system should provide in order to encourage companies to strengthen their capital structure, and specifically what are the instruments, nature of tax or extra tax that allow achieving the best result in reducing the indebtedness of companies.

2. LITERATURE REVIEW

The literature on this topic identifies three main factors which over the years have led to the phenomenon of under-capitalization of the Italian companies.

The first is represented by the high degree of closure that marks the ownership structure of the Italian firms against the entry of new investors.

The classical approach of the organizational structure of the Italian enterprises refers to the family firms.

The characteristics of this approach are the following:

- the control of the company is in the hands of a small number of members (on average 1 to 3)
- the firm is controlled by an individual or by individuals linked by family relations
- low degree of separation between the ownership and the management of the company
- aversion to the entry of new shareholders in the company and therefore low intake of equity

The combination of these characteristics may in part explain the low capitalization of the Italian companies; how the financial resources of an individual or a family could be sufficient for the initial phase of the life of the company.

However, the increase in size requires a discontinuity in both the way the company is managed and the methods by which it obtains the financial resources it needs.

A growing need not only for internal resources but also for external resources to find in the market, the increase in the size calls for a more decentralized decision-making through the use of the instrument of delegation of authority, which is often associated with the acquisition of more managerial resources, and so on.

These changes in the organizational structure must necessarily be accompanied by a greater ability to raise external funds, which can reach up to the listing of the company.

In Italy, the growth of the business seems to meet a limit connected with their ability to control the entrepreneur and his family, the company grows to the point where the controlling family is able to handle it.

According to Bianchi et Al. (2005), the reluctance on the part of the Italian entrepreneurs to open governance structures of their companies and use the stock market to finance them seems to be motivated by the inadequacy of models of governance and financing of the company that can be practiced in Italy; such inadequacy in turn derives at least in part the inadequacy of legal instruments aimed at ensuring effective corporate governance.

The analysis carried out by the authors shows that the reluctance of employers to give up control of the company or to share with new players is mainly linked to the fact that they are high in Italy compared to other advanced economies, the private benefits of "expropriation" of the control are difficult to defend and appropriated those "profitable."

On one hand the entrepreneur heading a company needs more financial resources to ensure that it can grow, on the other hand does not intend to lose the benefits that derive from his exclusive control.

Conversely, a person who is willing to enter into the corporate enterprise by providing financial resources

wants a return on his investment and then is adverse to the exclusive control held by the entrepreneur. From this conflict of interest arises the closure of the Italian business ownership for the entrance of new investors and this means that the only source of financing available to fuel the growth of business activity is constituted by the third-party capital.

The second cause of the imbalance of the Italian firms in the choice of financing is represented by the high tax burden on the Italian companies, on average, higher than the main major European countries.

Considering the effect the study by the World Bank, the total tax rate on businesses is equal to 65.8%, the highest value recorded to one of the most developed countries.

Among the countries considered by the study, France has a value equal to 64.7%, in the U.S. 46.3% and the UK to 34.0%.

The third factor that has historically influenced in an important way the financing choices of the entrepreneurs, making them lean towards the debt capital, is the deductibility of interest expense.

Historically, the Italian legal system, like most of the tax systems, has provided tax treatment of interest expense and then the third-party capital, cheaper than that accorded to the cost of equity capital.

Until the 90s was in fact planned a full deductibility of the cost of debt, i.e. interest expense arising from borrowings undertaken by the company, and did not include any possibility to deduct the cost of capital.

Consequently, it has come to create a gap between the cost of financing through the debt capital (lowest) and the cost of financing through equity (the highest). This discrimination of funding sources has led to the increasing indebtedness of companies, an incentive to increase the amount of debt of the company, since the cost of financing was fully deductible.

In particular, the high tax burden combined with the ability of firms to deduct interest expense has meant that the use of debt capital appears under the tax aspect, much cheaper than the increase in equity.

Solutions adopted by the Italian Government

To solve the problem of underfunding and to limit the use of debt by firms, the Italian government has introduced over the years a series of measures.

Among these, the last in order of time were the introduction of the "mechanism ROL" and "incentive ACE."

The first, introduced in 2007, limits the deductibility of interest in order to promote the capitalization of the companies. This rule provides that the interest expense can be deducted from taxable income up to the amount of interest income and the excess is deductible to the extent of 30% of gross operating profit (ROL).

The introduction of the ROL mechanism has not, however, eliminated the difference of treatment between the two sources of funding.

In order to make the neutral taxation in respect of the financing choices was introduced in 2011, the "Allowance for Corporate Equity" (ACE), it consists of an incentive to the capitalization of the companies realized through a reduction in the tax burden on income resulting from payments venture capital, and is based on applying a notional return on equity calculated on the increase, which will make then deductible for corporation tax purposes.

It provides for the deduction from the taxable amount of any increase in equity of the company made during the year by a percentage equal to 3% in the first three years of application of the rule (2012-2014). The notional return of new equity that is determined by applying the rate of 3% to the increases of capital is compared to the existing one at the end of the year to 31 December 2010.

The introduction of this incentive has helped to reduce the gap between the cost of debt and the equity.

Incentives for business capitalization

In 2008 an important and huge study was made by the European Commission with the extent of investigating on effects of different tax systems on the capital structure of companies and their role in encouraging the entrepreneurs to increase the net assets of their business. Specifically, the project aims to identify the tax measures that have an important impact on the decisions of the entrepreneurs, particularly with respect to the owners of small and medium-sized enterprises, regarding the choice between reinvesting profits in the company and their distribution. The aim is also to highlight what are the tax obstacles to increases in equity capital currently existing in the different legal systems of European states.

The study identified three types of tax systems:

- those that take clear measures in favour of reinvestment of profits
- those that encourage more entrepreneurs to distribute profits
- neutral ones, i.e. those tax systems in which there are no rules that favour particularly the distribution or reinvestment of profits

An examination shows that a few countries promote a clear and systematic reinvestment of profits in the company and therefore the strengthening of its capital structure. Only Estonia, Ireland, Lithuania, Slovenia and Sweden in recent years have implemented specific policies in this direction.

In these countries, the set of tax rules is aimed to further promote the use of debt capital rather than equity and the use of self.

Tax systems of the remaining countries are considered neutral, and in these countries have not been adopted fiscal measures with the aim to foster in a predominantly one or the other form of financing.

Are considered neutral tax systems, even those where there are incentives to the capitalization of the companies, but at the same time, were also provided with the rules that limit the effects.

This category also includes the Italian tax system, which is considered neutral because it does not provide tax rules designed to encourage clearly one or the other form of financing.

In general it can be said that tax systems that require a lower level of taxation on business income or those that provide the possibility of deferring the payment of tax, in combination with the presence of relatively high tax rates on dividends and income of individuals, have a strong influence on the decisions of entrepreneurs, as they offer a strong incentive to invest their resources in an enterprise.

It is important to note that both the level of taxation that the differences between the tax rates have an impact on the choices made by entrepreneurs / investors.

Theoretically, in fact, a high level of taxation on corporate income, when combined with a level of very high taxation of dividends should favour the retention of earnings, but in reality, however, this combination leads to a disappointing result because it can have the 'undesirable effect of reducing the spirit of entrepreneurship in the country, as well as to promote the development of the black market and cause capital flight to tax systems more.

Measures that have proved more effective in boosting the market capitalization of the companies are as follows: Low tax rates on business income (especially if the lower rate of tax on private income).

The empirical results of the analysis say that a low level of tax rates applied to corporate income push entrepreneurs to retain earnings in the company, and this is confirmed by the entrepreneurs themselves and the analysis of capital structures of companies resident in countries that have adopted a lower level of corporate taxation.

This effect is amplified if the rate of corporation tax is lower than the burden on private income; in this case, the entrepreneur who did not need to use the net proceeds for the private expenditure has a tax incentive reinvest profits in the company.

Deferral of taxation of business income

The deferral of corporate taxation is a tax measure that is to defer the taxation of business income at the time of distribution of profits; the tax liability of the company towards the tax authority arises when an enterprise distributes profits and until that time does not apply any tax rate on income earned.

This tax system is currently in force in Estonia, which, with reference to businesses, has one of the lowest debt ratios among the 19 examined by the study.

The results of the investigations made to Estonian entrepreneurs show that they are strongly convinced that this measure will promote the reinvestment of profits in the business.

Tax Rate on dividends higher than tax rate on capital gains
A tax system that imposes a tax rate on dividends greater than the tax rate on capital gains certainly encourages business owners to retain earnings in the company in anticipation of a future capital gain related to the sale of

the shares of the company, rather than paying higher taxes on dividends received.

Ultimately, the study showed that countries whose firms are on average the lowest debt ratios are those that have adopted clear incentives to the capitalization of the companies. Among the measures adopted one that shows greater efficacy seems to be the solution adopted in Estonia, which provides a tax exemption of business income and the taxation of profits distributed only to members. The superiority of this solution lies primarily in its ease of understanding; entrepreneurs recognize the intent of the standard and its incentive effect.

3. RESEARCH HYPOTESIS

An analysis of the literature shows that a good solution to solve the problem of under-capitalization of the Italian companies would be the introduction of a rule which provides for no taxation to the reinvested earnings in the enterprise. In particular, this rule provides that the company will no longer be taxed on income earned during the year, it is expected that they are taxed only amounts that are distributed by the company to its shareholders.

Its aim is, on one hand, to encourage the entrepreneurs to reinvest the profits of the enterprise, on the other hand to reduce the phenomenon of tax evasion and avoidance which are very common in Italy.

What would be the economic effects of the introduction of this solution in the Italian context?

What are the advantages and disadvantages that it would entail?

What is the perception that the entrepreneurs have today about the Italian tax system and the incentives for their businesses, and how would welcome the introduction of a rule such as the one described above?

To answer these questions, two different researches have been carried out; on one side is a simulation was made of the economic effects of the measure on the financial statements of a sample of small and medium-sized businesses through the application of an empirical model, on the other side was carried out a survey with the entrepreneurs to understand what are the characteristics of Italian companies with particular regard to their relationship with the tax authorities and what is the opinion of the entrepreneurs about the tax system and tax incentives. It was possible to carry out the investigation with the support provided by the API (Association of Small and Medium-sized Enterprises and the Province of Turin) who submitted the questionnaire to its members.

4. SAMPLE AND PERIOD

As for the simulation of the economic effects on the financial statements of the Italian companies, the study considered a sample consisting of a total of 187 companies from different Italian regions and sectors of activities.

Only small and medium-sized companies, therefore having a workforce of less than 250, a turnover not exceeding EUR 50 million or total assets maximum of 50 million were analyzed.

Also the companies analyzed, are unlisted companies, whose financial statements are available for 2008, 2009, 2010, 2011 and 2012.

In addition, companies that make up the sample are those whose shareholder of reference are only individuals or families; thus were excluded from the research companies belonging to group structures; whose business and financial results could be affected by the logical group.

Sampling, with the exception of the conditions presented above, was done randomly in order to best represent the composition of the Italian companies.

The survey carried out among business owners has been about 111 business owners of small and medium size of the province of Turin belonging to different operating sectors.

The sample is constituted by 37% of micro enterprises, 50% of small firms and 13% for medium-sized companies¹.

5. EMPIRICAL MODEL

To simulate the economic effect of the tax incentive on the firms in our sample, we have created a theoretical model. Using the Microsoft Excel, it has been possible to apply the model to the financial statements of the companies in the sample to determine the overall effects on their financial structure and profitability. Below are exposed to the assumptions underlying the empirical model.

The tax incentive provides that:

- Operating income of the company does not bear any kind of tax, therefore, the operating profit of the company coincides with the pre-tax profit from the application of civil law
- only the amounts that will be distributed to shareholders as dividends will be subject to tax, where applicable, will apply a single rate and dividends received will not be subject to further taxation for the purposes of the tax on individuals

The introduction of the incentive results in a tax savings for the company, equal to the amount of income taxes payable in the absence of 'incentive; which is an increase in the operating result and therefore the net assets of the company.

¹ For the purposes of the study were considered:

- micro enterprises: number of employees less than 10 and turnover less than EUR 1 million or total assets less than EUR 1 million
- small business: number of employees from 11 to 50, turnover of less than EUR 5 million or total assets of less than € 5 million
- medium-sized enterprises: the number of employees between 51 and 250, turnover of less than EUR 50 million or total assets of less than EUR 50 million

The model considers that the increase in the equity of the company will lead to an increase of assets or a decrease in liabilities.

The companies that have a debt to equity ratio of less than 1 are treated as companies with a balanced capital structure, firms with a debt to equity ratio greater than 1 are considered undercapitalized.

The empirical model expects that firms with a balanced financial structure use the tax savings to increase assets. For indebted enterprises, it has been considered both the case in which the increase of equity coincides with the increase of the asset, and the case in which it coincides with the decrease of the passive (in particular of financial liabilities).

The model is also based on two additional assumptions:

- the introduction of the rule has no effect on the profitability of the company
- the operating results of the company is fully reinvested

In the event that the company uses the most efficient way of reducing debt, borrowing costs are calculated based on the interest applied to the company in the absence of the rule.

Finally, the model considers a further scene, according to which the rule may also have an effect in discouraging the entrepreneurs to avoid the corporation tax, in terms of charging the profit and loss account of the company in the amount of deductible costs higher than those actually incurred. To find out which companies are using this mechanism; a comparison was made between the return on equity for each business (considering the average value over the period 2008-12), and the profitability of risk-free assets (considering the same period): firms that have lower profitability than that of risk-free assets are those that have used policies of "tax efficiency".

With the introduction of the norm these firms would be encouraged to minimize their profit before tax, to simulate this effect on the financial statements of the companies it has been hypothesized that, compared to the first hypothesis, the costs have decreased by 1%. This percentage has been chosen in an arbitrary manner and is relatively small in order to not influence the results of the study.

6. RESULTS

The survey carried out by the entrepreneurs in the Province of Turin reveals that they believe that the current tax system is composed of a number of standards that are too high and it is in general unclear if not understandable.

This causes a significant amount of energy and resources from the companies that in most of the cases, for the management of fiscal issues making, use external consultants.

In addition, they believe that the tax system does not incentivize businesses in a particular way to reduce debt.

Despite the introduction of the incentive ACE in 2011 which had the goal of making neutral taxation in respect of the Company's financing choices to boost the capitalization of the companies, the majority of the entrepreneurs consider that, from the point of view of taxation, the use of debt capital to finance the company's activities is the most convenient recourse to equity. This means that there is a problem with the lack of clarity and complexity of the rules that must be solved.

In the questionnaire, the entrepreneurs were asked about what they thought of a rule which provides for the taxation of reinvested earnings in the company; almost all the entrepreneurs responded in a positive manner. In particular, 75% stated that they would welcome it in absolutely in favour of the introduction of the incentive because they believe that it is valid way to promote the capitalization of the companies and the use of self-financing and the use of own capital to finance enterprises.

Relevant information were also detected on the composition of the corporate enterprises and the role of the business owner in corporate management: most of the companies are controlled by a number of members between 1 and 3, in most of the cases, the members are also directors of the company and only 1% of cases; the management of the activity was exclusively entrusted to external managers. Given that the shareholders are also directors of the company, and thus intervene directly in its management, the remuneration paid to the directors may represent a form of alternative distribution to the distribution of profits. Therefore it is very likely that they can "inflate" the remuneration of directors in order to subtract a portion of the profits from the taxable amount calculated for the purposes of corporation tax.

The empirical analysis carried out shows that the effects of the introduction of the tax incentive on the capital structure of Italian companies, as well as on their ability to meet their commitments to the lenders, are very positive. Considering the results obtained on the sample, the leverage, expressed as the ratio between the debt of the company and its shareholders' equity was reduced (considering the average value from 2008 to 2012) of 68% with the introduction the tax incentive, from a mean value of 4.8 in the absence of the tax incentive, to an average value of 1.5 with the adoption of the standard.

This means that if firms have an average amount of financial liabilities that amounted to almost five times the value of the net assets of the company, with the introduction of the incentive the amount of debt would be reduced to a value that is equal to one and a half times that of equity.

This is the effect that the incentive would result in the case where the most indebted companies decide to use the financial resources arising from tax savings to repay part of their debts. In case you decide instead to use them to increase the value of its assets, leaving unchanged the value of the debt, the Debt to Equity ratio decreased on average by 52%, from a value of 4.8 to a value of 2.3

Although the effect on the return on equity is important, in the absence of the tax incentive if the average ROE is equal to 2.35%, with the introduction of the standard, it becomes equal to 14.25% in the first case and 13.30% considering the second. This is due to both the increase in net income resulting from the tax exemption of business income, and the reduction of financial expenses recorded in the income statement. The coverage of financial expenses, equal to the ratio between EBITDA and the total financial expense, grows by 260% in the first case and 7% in the second.

The results were obtained from a sample of 187 firms, which is consistent though, it may not accurately represent the effect that the rule would have on the whole total of the Italian companies, if not in terms of quality.

However, the improvements that normally produce on capital ratios and return on equity are net; all of the analyzed companies have seen a reduction in their Debt to Equity ratio.

7. CONCLUSION

The analysis has carried out that it can be stated definitely that the introduction of a rule which provides for no taxation of reinvested earnings in the enterprise has an important effect in stimulating the market capitalization of the companies.

The average debt drops significantly, while greatly increases the return on equity of companies, thanks to lower financial expenses on the profit for the year, resulting due to the decrease of debt. In particular, the effect produced by the rule on debt indebtedness is as strong as most companies use the tax savings in order to repay the debt.

The element that determines the success of this standard is mainly represented by its simplicity: in

the eyes of employers, as demonstrated by the survey carried out by other studies and, is very clear that the incentive effect of the rule, and also they are in favour of its introduction into the Italian system.

Its introduction would inevitably create a consistent effort on the part of the state's finances. Taking into consideration the tax revenue guaranteed exemption from corporate income tax and from the regional tax on productive activities, which amounted in 2011 to about 69.7 billion euro (37.7 billion for IRES and 32 billion for ' IRAP), and represents a total of 15.7% of the total tax revenue of the state currents (amounting to 4.5 percentage points of GDP) .

The empirical analysis carried out can not give a quantitative measure in terms of the overall economic benefits produced by the standard on the Italian economic system, as well as on the State Budget. However, the qualitative results obtained from the research show that the benefits related to the implementation of this standard may be higher than the costs it requires.

It should be also considered an additional effect related to the implementation of the tax incentive. It acts as a disincentive for companies to use strategies of "tax efficiency", i.e. they minimize the income before taxes for the sole purpose of reducing its tax burden. If the income is tax-free enterprise, there are no incentives by employers to declare a profit of less than "real", so the rule would bring out a part of the income that today are taken away from corporate taxation.

Using the empirical model has also tried to measure the effect on the indices of financial structure and profitability of firms. The results show a further improvement, but turns out to be particularly difficult to define to what extent can increase the level of profits reported by the companies.

Finally, we must consider that; despite of that the cost of the incentive in terms of loss of tax revenue for the treasury, is high, a portion of these resources would be recovered in the event that the shares of the company are sold and that more resources arising from the tax savings could be used by companies to increase their production capacity or to undertake projects that today cannot be achieved with the financial resources they have. Such actions would have strong positive effects on the level of employment in the country and would also involve an increase in the revenue from the indirect taxes such as consumption tax.

A further advantage would lie in the increased capacity of the Italian economy to attract foreign

investment. It is difficult to quantify the effect of the rule on these variables, but the tax exemption of business income can be seen not only as a simple tax incentive, but as a real benefit for enterprise and employment, and so it can have significant effects on the economy and growth of the Italian firms.

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