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ABSTRACT. This article reconsiders the role of dividend taxation and its effect on the cost of capital of small firms. Using a simple portfolio model for small open economies, we show that a decrease in dividend taxes on large companies unambiguously increases the required rate of return for small companies. A dividend tax cut for both, large and small companies, may however lead to the counter-intuitive result of increasing cost of capital for small firms. For different small open economies, we further provide statistics on the correlation between the return of large and small firms that drives the counter-intuitive result. Our results suggest that mitigating payout taxes in small open economies can have ambiguous effects on the cost of capital of small, domestically owned firms. This is particularly relevant when tax reforms are designed to stimulate investments by small firms scarce in internal funds.
1. Introduction

Under a classical corporate tax system corporate profits are taxed twice: A first time at the company level by the corporate income tax and then a second time in the hands of the shareholders when profits are paid as dividends. This double taxation of corporate source income is often seen as detrimental to real investment and as promoting excessive borrowing, by raising the costs of equity funds. Looking back, the Nordic countries Finland, Norway and Sweden have taken different policy stands on this issue. Following the major tax reforms in the beginning of the 1990’s, Finland and Norway introduced imputation systems, which effectively exempted dividends from taxation in the hands of the shareholders. Sweden instead retained the so-called Annell-deduction, allowing companies – within certain limits – to deduct dividends on newly issued shares. Compared to the situation in Finland and Norway, mitigation of double taxation of corporate profits has been a controversial issue in Sweden. In 1994, the Annell-deduction was interrupted by the then non-socialist government and replaced by a new shareholder relief system which directly exempted dividends from tax at the shareholder level. This new regime was of brief duration, however, and as the Social Democrats returned to power in late 1994, a full classical double taxation was soon adopted. This regime is still in effect.

By the end of the century, a large number of countries outside the Nordic scene had chosen to mitigate double taxation at the shareholder level, through imputation systems or shareholder relief systems of various designs. Though this picture remained throughout the 1990’s, the last decade has witnessed a clear reversal in policy. Imputation systems have been abandoned in favour of the classical system or shareholder relief systems which tax dividends from both domestic and international sources at preferential rates.¹ A likely impetus behind this policy change within the EU area was the ruling of the Court of Justice of the European Union in the so called Manninen case (C-319/02). The Court declared that by denying imputation credits to Finnish tax payers on foreign source dividends, the Finnish tax code hindered the free movement of capital within the Union. A modification of the imputation system was hence required. However, rather than extending imputation credits to dividends from abroad as a response to the Court ruling, the Finnish government chose to reintroduce double taxation from 2005, albeit at a preferential rate compared to the standard personal tax rate on income.

¹ See Jacob and Jacob (2011) and Becker et al. (2011) for a comprehensive account of recent global developments in shareholder taxation.
from capital.² Still, outside the EU some countries such as Australia or New Zealand have full imputation systems.

Because of its membership of the European Economic Area, the EU Court ruling against the imputation system was a matter of concern also for Norway. When Norway abandoned its imputation system from 2006, however, the focus was rather on the mounting problems of taxing closely held corporations. Since the Norwegian imputation system exempted dividends from tax at the personal level, there was a strong incentive to report highly taxed earned income as leniently taxed income from capital. As the Norwegian income-splitting system to an ever increasing extent failed to prevent such income shifting, the chosen solution was to abandon the imputation system (see Alstadsæter and Fjærli, 2009). The new approach, which included the taxation on shares from both closely and widely held firms, was to exempt dividends corresponding to a normal rate of return and to levy a full tax – equal to the personal tax rate on income from capital - on any excess returns.

The economic consequences of dividend taxation have been the subject of a continuing debate among public finance researchers for a very long time. Much of this discussion has been concerned with whether the “new” or “old” view of dividend taxation best describes its effects.³ Under the new view, the dividend tax has no impact on investment incentives, as the tax reduces the opportunity cost to the shareholders of an additional unit of profits retained for investment in the same proportion as it reduces future dividends. Under the old view, the firm is unable to cut dividends to finance new investment projects, and with new share issues as the marginal source of equity funds, the dividend tax falls also on marginal investment projects.⁴

Though this controversy is still unsettled, it may yet be of little relevance to the Nordic countries. In small open economies, stock market prices, and hence rate of return requirements on corporate equity (before personal taxes), are likely to be determined by international investors on world capital markets, rather than by domestic household investors.

² See Kari and Laitila (2010) and Ylä-Liedenpohja (2007) for a detailed discussion. Ylä-Liedenpohja claims that the EU Court decision was only the formal reason for abandoning the imputation system, other more important factors being a desire to promote competitiveness through more efficient tax instruments and concerns about income distribution effects of exempting dividends from tax.

³ The new view of equity was developed by Auerbach (1979), Bradford (1981) and King (1977). For a survey of the debate, see Auerbach (2002) and Auerbach and Hassett (2002, 2005).

⁴ Becker et al. (2011) show that payout taxes drive a wedge between internal and external equity. The taxation of dividends and share repurchases affects the allocation of investment and high tax rates lock-in capital in profitable firms.
As implied by earlier research by Boadway and Bruce (1992), Devereux and Freeman (1995) and others, the level of domestic investment will then be independent of the tax treatment afforded domestic investors.

In the Nordic countries it is widely recognized that the openness of the economy limits the effectiveness of various policy instruments. Even proponents of mitigating corporate double taxation at the shareholder level admit that such tax breaks may have little impact on the cost of capital of the large companies listed on national stock exchanges. Shareholder relief is rather motivated by its alleged importance to small companies which have limited access to international markets for raising new equity. Therefore, these firms rely on domestic savings to finance their investments in real assets. A segmentation of the market for equity finance is thus a key assumption of the proponents of shareholder relief.5

However, whether shareholder relief will promote real investment in small firms is not just a matter of financing opportunities on domestic or international markets but will also depend on the determinants of the investors’ rate of return requirements. To what extent will the required rate of return before tax of small companies depend on the rates of return earned on international markets for equity, and what is the role of the shareholder relief?

In a theoretical contribution, Apel and Södersten (1999) address these questions. They set up a simple portfolio model, where the representative investor may hold three assets: Risk free bonds, shares in small companies which are traded only domestically and shares in large internationally traded companies. A striking result of their analysis is that an increase in the personal tax on equity returns may have a negative effect on the rate of return requirement – and hence the cost of capital – of small companies. A sufficient condition for this counter-intuitive finding is that the “beta” (measuring the degree of covariance) between the returns on small company shares and large company shares is above unity – a condition that cannot be ruled out on theoretical grounds.

The purpose of this short article is to shed some additional light on the problem of mitigating corporate double taxation at the shareholder level by providing information on the “beta”-factor for a number of small open economies. As a background to this, we first present a simplified version of the Apel-Södersten model where we include different tax rates on the

returns on small and large company shares. Two conclusions stand out: (i) We find for all countries included in our estimates, that the “beta”-factor is positive. By the theoretical model, this suggests that a cut in the tax on the returns to large company shares will unambiguously increase the expected return on small company shares (cf. equation (10)). This effect is stronger, the higher is “beta”. If beta exceeds unity, then a simultaneous cut in taxes on large and small firms, will raise the expected return on small companies (cf. equation (11)). (ii) Our estimates of “beta” fall in the range 0.64 to 1.20, which indicates a substantial impact of the return on shares in internationally dominated large firms on the rate of return requirement for small company shares. A tentative policy conclusion based on our findings is that a tax reform which aims at promoting real investment in small companies in small open economies should combine a high tax on large company shares with a low tax on small company shares.

2. The model

To focus on the key mechanisms, we analyze a highly simplified tax system, where interest income is taxed at the rate $\tau_i$, income from shares in large companies is taxed at the rate $\tau_L$ and income from small company shares is subject to the tax rate $\tau_S$. We follow Apel-Södersten (1999) and assume that the risk-free interest rate, $R_f$, and the expected return on large company shares, $R_L$, are exogenously determined. The expected return on small company shares is $R_S$. Small company shares are domestically owned (by the representative investor), and amount to a constant proportion $\alpha_S$ of the investor’s initial wealth. The portfolio problem is then to determine $R_S$ and how much to invest in large company shares $\alpha_L$ and in risk-free bonds (with portfolio share $1- \alpha_L-\alpha_S$).

We next set up a simple portfolio model, which covers two periods. In period 1, the representative investor is assumed to maximize his expected utility of wealth in period 2

$$\max_{[\alpha_f, \alpha_L, \alpha_S]} E\left\{U[W(1+r)]\right\} \approx \tilde{r} - \frac{c}{2}\sigma^2, \quad (1)$$

subject to

i) $\tilde{r} = \alpha_f R_f (1-\tau_i) + \alpha_L R_L (1-\tau_L) + \alpha_S (1-\tau_S)$,

ii) $\alpha_f + \alpha_L + \alpha_S = 1$. 
In (2), \( W \) is initial wealth, \( c \) is Arrow-Pratt’s measure of relative risk aversion, and \( r \) the after-tax expected return on the investor’s portfolio. \( \alpha_j \) is the initial portfolio share of asset \( j \) (\( j = f, S, L \); where \( f \) represents bonds, \( S \) shares in small domestically owned firms, and \( L \) shares in large firms), \( R_f \) is the risk-free return on bonds, and \( R_j \) is the expected pre-tax return on asset \( j = S, L \). The tax rates are defined above. The portfolio variance in equation (1) equals

\[
\sigma^2 = \alpha_f^2 (1 - \tau_f)^2 \sigma_f + \alpha_S^2 (1 - \tau_S)^2 \sigma_S^2 + 2 \alpha_f \alpha_S (1 - \tau_f)(1 - \tau_S)\sigma_{SL},
\]

(2)

where \( \sigma_{jh} \) is the covariance between the pre-tax returns on asset \( j \) and \( h \). The first-order conditions for the portfolio allocation problem from equation (1) give the expected after-tax returns on small company shares

\[
R_S (1 - \tau_S) = R_f (1 - \tau_f) + c \left[ \alpha_S \sigma_S^2 (1 - \tau_S)^2 + \alpha_L \sigma_{SL} (1 - \tau_S)(1 - \tau_L) \right],
\]

(3)

where the first term on the right-hand side is the risk-free return on bonds taxed at the capital income tax rate \( \tau_f \), and the second term is the risk-premium. The size of this risk-premium depends on the investor’s risk tolerance, measured by \( c \), multiplied by the amount of risk that the small company shares add to the investor’s portfolio. This amount is expressed as a weighted average of the variance of the return on the small company shares, \( \sigma_S^2 (1 - \tau_S)^2 \), and the covariance between the returns on small company shares and large company shares, \( \sigma_{SL} (1 - \tau_S)(1 - \tau_L) \). The weights are the portfolio shares, \( \alpha_S \) and \( \alpha_L \). The expected before-tax rate of return (the cost of capital) on small shares is hence

\[
R_S = R_f \left( \frac{1 - \tau_f}{1 - \tau_s} \right) + c \left[ \alpha_S \sigma_S^2 (1 - \tau_S)^2 + \alpha_L \sigma_{SL} (1 - \tau_S)(1 - \tau_L) \right]
\]

(4)

The expected before-tax return on large company shares amounts to

\[
R_L = R_f \left( \frac{1 - \tau_f}{1 - \tau_L} \right) + c \left[ \alpha_L \sigma_L^2 (1 - \tau_L)^2 + \alpha_S \sigma_{SL} (1 - \tau_S) \right]
\]

(5)

As explained, we treat \( R_L \) and \( \alpha_S \) as exogenous. The investor’s remaining problem is hence to determine the amount to be invested in large company shares \( \alpha_L \).

We derive from equation (5) that
The intuitively clear answer given by the model is that the portfolio share for large companies \( \alpha_L \) (the share of risk-free bonds) is larger (smaller) the higher is the expected return on large company shares. A high variance \( \sigma_L^2 \) for the return on large company shares and a large covariance \( \sigma_{SL} \) between the returns on large and small company shares has the opposite effect. In case the covariance is negative \( \sigma_{SL} < 0 \), more investments in large company shares reduces risk. With a positive covariance, \( \alpha_L \) is larger the higher is the tax rate on small companies \( \tau_S \). With \( \alpha_S \) exogenously given, we may conclude in this case that an increase in the small company tax induces the investor to hold a larger share of risky assets \( \alpha_L + \alpha_S \) in his portfolio.

Using equation (6), we eliminate \( \alpha_L \) from equation (4), to give

\[
R_S = R_f \left( \frac{1-\tau_S}{1-\tau_L} \right) - R_f \left( \frac{1-\tau_S}{1-\tau_L} \right) \frac{\sigma_{SL}}{\sigma_L^2} \sigma_{SL}^2 + \frac{\sigma_{SL}^2}{\sigma_L^2} \sigma_L^2 + c\alpha_s \sigma_S^2 (1-\tau_S) \left[ 1 - \left( \frac{\sigma_{SL}}{\sigma_S \sigma_L} \right)^2 \right]
\]

(7)

where \( \frac{\sigma_{SL}}{\sigma_L^2} \equiv \beta \) has an interesting interpretation as the “Beta” between the returns on small and large company shares and \( \frac{\sigma_{SL}}{\sigma_S \sigma_L} \equiv \rho \) is the coefficient of correlation between the returns.

Hence

\[
R_S = R_f \left( \frac{1-\tau_S}{1-\tau_L} \right) - R_f \left( \frac{1-\tau_S}{1-\tau_L} \right) \beta + R_L \beta + c\alpha_s \sigma_S^2 (1-\tau_S) \left[ 1 - \rho^2 \right]
\]

(8)

where \( \rho^2 \leq 1 \), since \(-1 \leq \rho \leq 1 \).

It is now straight-forward to determine the impact of shareholder taxation on the expected return on small company shares. First, we assume an isolated change in tax on small firms. From equation (8), we derive:
This implies that the normal required return increases in the tax rate $\tau_s$ (first term of equation (9)) but decreases in the investors’ risk premium (second term). As a result of this, the impact of a tax change on the expected return is ambiguous.

With an isolated change in the tax on the return to large companies, we get

$$\frac{\partial R_s}{\partial \tau_L} = \frac{R_f (1-\tau_L)}{(1-\tau_L)^2} \beta$$  

(10)

and in case of a positive covariance between the returns – implying that $\beta > 0$ – the tax on returns on large company shares will reduce the expected return on small company shares.

Finally, we consider the case where there is a uniform tax on equity returns, $\tau_s = \tau_L = \tau_E$. This is a realistic assumption for most of the economies where small and large firms face similar tax rates. From equation (8), we then derive

$$\frac{\partial R_s}{\partial \tau_E} = \frac{R_f (1-\tau_E)}{(1-\tau_E)^2} (1-\beta) - c\alpha \sigma^2_s \left[1 - \rho^2\right]$$  

(11)

Again, the impact of the (uniform) tax on equity returns is ambiguous. However, since the last term of (11) is non-negative, a sufficient (but not necessary) condition for the tax to have a counter-intuitive negative impact on the expected return of small firms is that $\beta \geq 1$. That is, a tax increase reduces the cost of capital for small firms due to the high correlation between large and small firms. Moreover, and as apparent from a comparison between (11) and (9), the possibility for the tax to have a positive effect, i.e. raise the required rate of return, is greater when any tax change is targeted on the returns to small company shares.

3. Data and the empirical evidence

In this section we compute beta-values for eight OECD countries to illustrate the impact of changes in shareholder taxation in different small open economies. We compare the Scandinavian countries with two EU countries (Ireland and Belgium) as well as with South Korea and Australia. We follow the approach in Södersten and Lindhe (2011) and proxy the
beta between small and large companies by monthly returns between the stock market index for large companies and an index for small caps in the respective country. The beta is defined as \( \beta = \frac{\text{cov}(r_L, r_s)}{\text{var}(r_L)} \) where \( r_L \) is the log return on the index for large stocks and \( r_s \) is the log return for the respective small cap index. We use monthly stock market data provided by Euronext, Korea Exchange, and Yahoo Finance. Table 2 in the Appendix summarizes the countries in our sample, stock market indices, and the sample period.

For our eight countries, we further collect aggregated data on foreign share ownership.\(^6\) Data on gross domestic product is obtained from the World Development Indicators. Table 1 presents the results for the beta-factors for the 2000-2010 and the 2008-2010 period\(^7\), GDP in 2007 and the foreign ownership in equity in 2007. The GDP for 2007 of our selected countries ranges from USD 246 bn to USD 1,049 bn. This translates into a size of the economies in our sample of 1.75% (Finland) to 7.49% (Korea) relative to the GDP of the United States.

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>857</td>
<td>5.97%</td>
<td>29.0%</td>
<td>1.07</td>
<td>1.20</td>
</tr>
<tr>
<td>Belgium</td>
<td>458</td>
<td>3.34%</td>
<td>19.3%</td>
<td>0.64</td>
<td>0.64</td>
</tr>
<tr>
<td>Denmark</td>
<td>311</td>
<td>2.26%</td>
<td>30.2%</td>
<td>-</td>
<td>0.74</td>
</tr>
<tr>
<td>Finland</td>
<td>246</td>
<td>1.79%</td>
<td>51.6%</td>
<td>-</td>
<td>0.90</td>
</tr>
<tr>
<td>Ireland</td>
<td>260</td>
<td>1.90%</td>
<td>60.0%</td>
<td>0.71</td>
<td>0.92</td>
</tr>
<tr>
<td>Norway</td>
<td>388</td>
<td>2.83%</td>
<td>40.8%</td>
<td>-</td>
<td>0.83</td>
</tr>
<tr>
<td>Korea</td>
<td>1,049</td>
<td>7.64%</td>
<td>37.3%</td>
<td>0.76</td>
<td>0.95</td>
</tr>
<tr>
<td>Sweden</td>
<td>463</td>
<td>3.30%</td>
<td>38.0%</td>
<td>-</td>
<td>0.77</td>
</tr>
</tbody>
</table>

Notes: Beta-values for Denmark, Finland, Norway, and Sweden are taken from Södersten and Lindhe (2011) and are based on monthly data for the 2007-2010 period. Foreign ownership in companies for Ireland is from 2004 and for Korea from 2006.

As all \( \beta > 0 \), our model predicts that a reform that only increases taxes on large companies will reduce the expected return on small company shares in all our countries. We can further observe \( \beta \)-factors greater than 1 for one country (Australia) in our sample. For the 2008-2010 period, the remaining six countries have beta-factors within a range of 0.64 (Belgium) and 0.95 (Korea).

\(^6\) Foreign share ownership is defined as the percentage of listed firms’ equity held by foreign investors. We obtain data from the Australian Bureau of Statistics, Danmarks Nationalbank (http://www.statbank.dk), Statistics Sweden, the Norwegian Registry of Securities, the Korean Stock Exchange, Finfacts Ireland, BelgoStat Online, the Finnish Foundation for Share Promotion, and the Deutsches Aktieninstitut’s factbook.

\(^7\) For Belgium we report beta-values for the 2005-2010 period.
With the help of Table 1, we are able to predict how a dividend tax increase on both, small and large corporations in small open economies such as Australia, Finland or Ireland will affect the required rate of return on small company equity. Especially Finland and Ireland are characterized by a significant share of foreign ownership. More specifically, we observe this predominantly among the largest companies, such as Nokia in the case of Finland. In Ireland, more than 75% of the building material group CRH, which accounts for about one fifth of the Irish Stock Exchange market capitalization, is held by foreign shareholders.8

Both countries have certain characteristics in common. The beta-values predict a similar impact on the cost of capital following a dividend tax increase on large as well as small companies. With a beta value close to unity for the last years, a dividend tax increase could even reduce the required rate of return for smaller, domestically owned companies in both countries. The same phenomenon results for Australia, where the beta-factor exceeds unity. Our model suggests that these countries could reduce the required rate of return by simultaneously increasing payout taxes for large and small companies.

However, there are major differences in shareholder taxation between Finland, Ireland, and Australia. Ireland has a classical shareholder tax system. Australia in one of the few remaining countries with a full imputation system as it was implemented in Finland until 2004. With the current state of tax law in Ireland and top marginal tax rates on dividends of 41%, an increase in shareholder taxes seems to be very unlikely. Should the Irish tax authority instead decide to reduce shareholder taxes in an attempt to stimulate domestic investments, the required rate of return of small companies might actually increase since the beta-value is close to unity. In contrast, in the case of Australia, it is more likely that the full imputation system is suspended and any form of classical shareholder taxation is installed. At first glance, one might expect a trade-off from implementing a classical tax system and increasing payout taxes: On the one hand, introducing classical shareholder taxation would put an end to the earlier discrimination of foreign investors who are not entitled the imputation credits.9 On the other hand, the tax increase for domestic shareholders may be seen to increase the cost of capital for small companies. However, this trade-off may not exist for Australia. According to our model for small open economies, higher payout taxes reduce the cost of capital for

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8 Cf. CRH Annual Report 2009, p. 121.
9 See Footnote 2.
smaller companies when the “beta” between small, domestically owned and large, internationally dominated companies is above unity.

4. Conclusion

This paper shows that mitigating payout taxes in small open economies can have ambiguous effects on the cost of capital of small, domestically owned firms. This is particularly relevant when tax reforms are designed to stimulate investments by small firms scarce in internal funds. The Finnish economy is one example where a tax increase could lead to the counter-intuitive effect of lower cost of capital for small firms. The reason for this possible outcome is the high correlation between returns of domestically owned small firms and the return of large firms that are predominately owned by foreigners who are not affected by a domestic dividend tax cut.

References


## Appendix

### Table 2: Description of Stock Market Indices

<table>
<thead>
<tr>
<th>Country/Index</th>
<th>Description</th>
<th>Time Period</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Australia</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ASX 20</td>
<td>20 largest companies by market capitalization.</td>
<td>04/2000-05/2010</td>
</tr>
<tr>
<td>ASX Small</td>
<td>300 largest firms excluding firms in the ASX</td>
<td>04/2000-05/2010</td>
</tr>
<tr>
<td>Ordinaries Index</td>
<td>100 (100 largest firms).</td>
<td></td>
</tr>
<tr>
<td><strong>Belgium</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BEL 20</td>
<td>20 largest companies traded at the Brussels Stock Exchange.</td>
<td>03/2005-05/2010</td>
</tr>
<tr>
<td>BEL Small Index</td>
<td>The BEL Small index consists of stocks not included in the BEL20 index. Market capitalization is between the level of the BEL 20 index multiplied by EUR 5,000 and the level of the BEL 20 index multiplied by EUR 50,000.</td>
<td>03/2005-05/2010</td>
</tr>
<tr>
<td><strong>Ireland</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ISEQ 20</td>
<td>20 companies with the highest trading volume and market capitalization.</td>
<td>05/2000-05/2010</td>
</tr>
<tr>
<td>ISEQ Small</td>
<td>The index consists of companies not included in the ISEQ 20. Further, the market capitalization must be below a certain threshold (e.g. € 400 million in 1999).</td>
<td>05/2000-05/2010</td>
</tr>
<tr>
<td><strong>Korea</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>KOSPI 50</td>
<td>50 largest companies by market capitalization.</td>
<td>01/2000-05/2010</td>
</tr>
<tr>
<td>KOSPI SmallCap</td>
<td>The KOSPI SmallCap consists of all listed companies smaller than the 300th company by market capitalization.</td>
<td>01/2000-05/2010</td>
</tr>
</tbody>
</table>

Sources: [www.ise.ie](http://www.ise.ie), [www.euronext.com](http://www.euronext.com), [www.asx.com.au](http://www.asx.com.au), and [eng.krx.co.kr](http://eng.krx.co.kr).
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