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General investment neutral tax systems and real options

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Abstract:

The question of investment neutral tax systems is particularly important. For example in Croatia an investment neutral tax system was introduced by an income tax system where interest income is non-taxable and interest payments are non tax-deductible. Nevertheless, the tax system in Croatia and most other investment neutral tax systems have been theoretically derived and proved to be neutral only under the assumption of certainty.

By contrast, under uncertainty the investment neutrality of tax systems has been addressed for special cases only. The Dixit/Pindyck (1994) real option approach, as an instrument that enables an investor to model investment decisions under uncertainty independently of individual preferences, provides an attractive avenue to study investment neutrality under uncertainty.

This paper examines whether tax systems, which are investment neutral under certainty, keep this property under uncertainty and irreversibility. The authors extend the real option approach for taxes and deduce investment neutral tax systems. Finally the authors discuss, whether the results of the analysis can be transferred to the case of risk aversion.