Two opposite trends have recently affected the relationship between the taxable income that companies report to the government and the financial accounting income that they report to investors. In the United States, a “two–book” country in which the two measures are largely independent, the rise of the book–tax gap (i.e., the excess of financial accounting over taxable income), providing suggestive evidence of earnings manipulation and/or tax sheltering, has led to calls for moving towards a one–book system, in which companies generally would have to use the same measure for both purposes (Desai, 2006). Meanwhile, several previously “one–book” members of the European Union (EU), such as Germany, Austria, Belgium, and France, have moved in the two–book direction (Schon, 2005, 116).

One interpretation of these opposite trends would be that the grass is always greener on the other side of the tracks. People on each side of the Atlantic, one might surmise, have a better grasp of their own approach’s failings than of those arising under the other approach. Examined more closely, however, the opposite trends reflect complementary and intellectually consistent concerns about the tax–book relationship, rather than contradictory views of a single phenomenon.

American concern about a two–book system relates to the issue of managerial discretion to manipulate the two measures in opposite directions. Managers can more easily both overstate earnings and engage in tax sheltering if neither activity interferes with the other. Thus, proponents of a one–book system argue that “the latitude afforded managers by the dual nature of corporate profit reporting has contributed to the simultaneous degradation” of both measures (Desai, 2006, 171).

By contrast, the EU’s movement away from a one–book system reflects concern about political discretion over the definition of income. The countries that decoupled financial reporting from legislatively determined taxable income did so by adopting international financial reporting standards (IFRS), which were promoted as a means of providing investors with better information about company performance, as integrated global capital markets increasingly demand (Haller...
and Eierle, 2004, 40–41). To this end, IFRS offers two benefits: depoliticization of the process of defining income, and cross-border convergence. The latter, however, is an EU goal in tax policy as well as accounting, reflected in ongoing efforts to reach agreement on a common consolidated corporate tax base (CCCTB). Accounting convergence has gone faster because EU members are considerably more reluctant to cede national political control over the definition of income in the tax realm than the accounting realm. If the EU reaches agreement on a CCCTB, reflecting similar acceptance of income depoliticization in the tax realm, it could easily revisit the one-book versus two-book choice by determining how the CCCTB and IFRS should relate to each other.

Accordingly, the opposite U.S. and EU trends are not intellectually contradictory in substance, and in combination help to illustrate two key points. First, the proper relationship between taxable income and financial accounting income depends in large part on incentive problems at two distinct stages: rule design by the relevant political authorities, and rule application by corporate managers. Second, new multinational institutions such as the International Accounting Standards Board (IASB), established to determine IFRS, or the EU if it develops a widely accepted CCCTB, potentially can affect both the actual and the optimal relationship between the two income measures.

The rest of this paper elaborates on these two points by proceeding as follows. The next section discusses how taxable income and financial accounting income might differ in the absence of the managerial and political incentive problems that affect income measurement. The third and fourth sections discuss the implications of those two sets of problems for the relationship between the rules for measuring the two types of income. The fifth section discusses a recent proposal (from Shaviro (2009a)) for partial integration of the two U.S. measures, while the sixth explores the significance of international convergence with respect to measuring income. The final section offers a brief summary and conclusion.

SIGNIFICANCE OF THE DIFFERENT PURPOSES SERVED BY THE TWO MEASURES

In principal, income is a reasonably coherent economic concept, commonly defined (for individuals) as equaling the market value of one’s consumption plus the change in one’s net worth during the relevant accounting period (Simons, 1938, 50). One can adapt it to a legal entity, such as a corporation, by substituting distributions to owners for consumption. Use of an income measure in any given setting requires motivation, however, potentially affecting how it is best defined in that setting.

The tax and financial accounting motivations for measuring income differ markedly. Taxable income determines how tax liabilities are distributed between taxpayers, reflecting underlying distribu-

tional concepts such as earning ability or ability to pay (Shackelford, Slemrod, and Sallee, 2007, 4). While such concepts logically apply only to individuals, not legal entities, a corporate–level tax on earnings can act as a withholding device, substituting for taxing the earnings directly at the owner level. Financial accounting

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1 In Germany, the shift away from a one–book system predated adoption of IFRS and reflected broader concerns about the informational value of the income measure that was used for tax purposes. See Schon 2005, 116.


3 See Barenfeld (2007, 269), noting disadvantages to the lack of any current link between the emerging CCCTB and international accounting standards. Establishing a link may be difficult, however, until such time as a depoliticized CCCTB meets with broad acceptance.
income, by contrast, provides a discrete informational input to actual and prospective owners of corporate shares who are making ongoing investment decisions regarding whether to buy, hold, or sell such shares at any given market price. Managers and investors often appear to care about the amount reported on the income line even if the exact details of the computation arguably do not affect available information—for example, because a given expense, even if ignored in computing income, is disclosed in footnotes (Walker, 2007, 938).

The chief implications of these distinct functions include the following.

1. For taxable income but not financial accounting income, mismeasurement may not matter if it does not affect the overall taxes imposed on all of the parties to a given transaction. Thus, if corporations and their employees share the same marginal tax rate, it may make no long-term difference whether wages are (1) currently deducted by the company and included by the employee or (2) neither deducted nor included. In the financial accounting setting, by contrast, it is important to measure correctly the corporation’s income (net of employee compensation).

2. Multiple jurisdictions, such as countries, typically coordinate their income taxes in order to limit the extent to which cross-border investment, by reason of being duplicatively taxed, is disfavored relative to investment wholly within a single jurisdiction. A jurisdiction may, for example, provide exemption or deferral for foreign source income of domestic corporations, or offer credits for foreign taxes paid. In the financial accounting setting, since

3. An increasing scholarly consensus holds that consumption taxation might be superior as a distributional instrument to income taxation, since it eliminates the latter system’s inefficient discouragement of saving and can achieve similar progressivity (see Bankman and Weisbach, 2006; Shaviro, 2007). One way to make the tax base consumption, rather than income, is through expensing for all business outlays, as distinct from the typical income tax approach in which outlays that create lasting value are recovered only over time. But in financial accounting, investors would likely find an expensing rule (leading to a measure of current net cash flow rather than income) informationally inferior, since it would impede evaluating company performance. The difference reflects that investors, but not the government through its position as a claimant on corporate earnings via the tax system, must make ongoing buy–hold–sell decisions regarding particular companies’ shares. The government does not comparably need to make any such determination, as it will automatically receive higher tax payments in the future (in a well-functioning system) if current business outlays increase future earnings. Given this difference, adopting a cash flow corporate tax might be an appealing tax reform, but shifting to cash flow accounting is unlikely to be an appealing financial accounting reform, as it would

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4 Investors will, however, presumably want financial accounting reports to set forth the implications of foreign taxes paid for domestic tax liability net of foreign tax credits.
reduce the measure’s informational value to investors.5

4. Externalities may make it optimal for the government to subsidize some activities or outlays while penalizing others, and this potentially can be done through the income tax system. Financial accounting, since it merely provides information rather than distributing liabilities, has no exact equivalent. As David Walker (2007, 934) notes, if managers care about reported earnings, “instrumental accounting,” or deliberately mismeasuring financial accounting income to serve social policy goals, may similarly affect their behavior. However, the direction of deliberate error would need to be opposite, since here one would encourage a given activity by over–measuring, rather than under–measuring, the income that it yields.

5. Income taxes can be levied on either a tax–inclusive or a tax–exclusive basis—the difference being that the taxes paid are themselves deducted or excluded under the latter methodology but not the former. So long as nominal tax rates are suitably adjusted, these two systems can be equivalent and, thus, it may not matter which is adopted. In the financial accounting setting, however, investors presumably care about after–tax income, since taxes paid affect the resources available for distribution to owners. Accordingly, for financial reporting purposes, it is important to treat the taxes paid as deductible.

These considerations suggest that optimally designed taxable and financial accounting income measures might have various differences, based solely on the two measures’ distinct purposes. Still, the two measures would have a lot in common apart from requiring a set of discrete adjustments, such as in their treatment of domestic and foreign tax liabilities, and there is no implication that they would employ distinct approaches to the basic task of measuring changes in net worth (leaving aside the effects of distributions) based on observed cash flows and transactions.

The most commonly cited difference in the literature between the tax and accounting measures is that suggested by the U.S. Supreme Court in Thor Power Tool Company v. Commissioner,6 where the Court stated that financial accounting income, but not taxable income, aims towards “conservatism” and is “hospitable to estimates, probabilities, and reasonable certainties.” Rather than following from the two measures’ functions, however, this distinction appears designed to counter the incentives of corporate officers, who might be all too willing to use undue conservatism and low–ball estimates when gauging taxable (but not financial accounting) income.7 Accordingly, I next turn to the significance of managerial incentive issues for the design of rules defining the two types of income.

MANAGERIAL INCENTIVE PROBLEMS AND THE BOOK–TAX RELATIONSHIP

Since companies report on their own income to the tax and accounting authori-

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5 There also is likely to be a stronger case for selective expensing of some capital outlays in the income tax than in financial accounting, if one assumes that uniform expensing is politically unfeasible. But see Gentry and Hubbard (1997) arguing that inter–asset distortions generally are more significant economically than the intertemporal distortion that results from having an income tax rather than a consumption tax, arguably with the implication that a uniform income tax is likely to be superior to a mixed system.


7 An additional reason for mandating accounting conservatism might be to assist investors in limiting losses by informing them of bad news and potential downsides as early as possible.
ties, managers’ incentives with regard to the amounts reported inevitably must figure in the income measures’ optimal design. Absent these incentive issues, there might be no reason to require, as do both tax and financial accounting, a transactionally based income measure that relies on realization of asset value fluctuations and that stipulates the use of particular accounting conventions (such as depreciation or amortization) for specified outlays. Rather, one might simply let companies make their best guess concerning their “true” income for the year, all things considered. Relying on transactions and accounting conventions to measure income is a tradeoff, requiring disregard of potentially value–relevant information in order to emphasize that which is relatively objective and verifiable (Shaviro, 2009a, 449). This, in turn, still leaves corporate managers with at least two types of discretion that they can use to advance their income–measurement ends. The first concerns transaction choice (such as whether to realize a particular gain or loss), while the second concerns how to report income when its amount is legally ambiguous.

Concern about managerial incentives can further suggest requiring that transactions meet economic substance or business purpose requirements in order to be recognized for income measurement purposes. Moreover, it may support providing for non–recognition of technically realized gain or loss in circumstances where it is feared that companies would otherwise forego engaging in economically desirable transactions given the effects on reported income.8

While all these considerations apply analogously to taxable and financial accounting income, the direction of managerial bias is notoriously opposite in the two settings. With respect to taxable income, managers generally prefer to aid both the shareholders and themselves by under–measuring income, so that their companies will owe the government less tax. By contrast, with respect to reported earnings, managers, pursuing their own self–interest to the detriment of financial market transparency, are prone instead to over–measuring income. This alone might suggest that the two measures would optimally restrict managerial discretion differently—for example, by asymmetrically limiting loss recognition for tax purposes and gain recognition for accounting purposes. Moreover, the optimal tradeoffs of social costs against benefits in designing rules to offset managerial bias might well differ between the settings even if both treated gain and loss symmetrically (Shaviro, 2009a, 456). Accordingly, despite the common nature of the problems presented in the two settings by managerial incentives to manipulate reported income, taking these problems into account in rule design seems likely to make well–designed measures of taxable and financial accounting income look even more different than they would if only their distinct purposes supported differentiating them.

There is a major complicating consideration, however. Rather than designing and applying each measure separately, one could require that the same amount of income be reported for both purposes (subject only to specified permissible causes of divergence), precisely in order to impede managers from simultaneously manipulating reported income in both directions. Under this approach, managers would lose some of their current ability jointly to optimize achievement of their tax and financial reporting goals, because advancing either goal would set back the other.

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8 The U.S. income tax does this by providing for gain and loss nonrecognition in various circumstances. U.S. accounting rules used to contain a similarly rationalized rule concerning pooling of assets (Shaviro, 2009a, 451).
Two distinct rationales might be advanced in favor of such an approach. First, it might increase the accuracy (relative to economic income) of the amounts reported for one or both purposes. Suppose initially that managers were equally motivated to reduce taxable income on the one hand and inflate financial accounting income on the other. This might result in their having no net bias with respect to a measure that applied for both purposes. Moreover, while such a scenario seems over-optimistic, it potentially applies to some extent whenever managers have opposite preferences as to the two measures. They may manipulate reported income less (if doing so is costly) once the net payoff declines because desired and undesired effects occur simultaneously.9 Second, the offset might reduce the resources wasted by managers in transactions designed to manipulate reported income for purposes of either measure.

Two examples may help make both of these potential social payoffs more concrete. Consider corporate tax shelters, or elaborate paper-shuffling transactions designed to have as little economic substance as possible (although arranging and executing them consumes resources) and yet to generate tax losses. It is well-known in the business world that shelter transactions, in order to be marketable, generally should reduce only taxable income, not financial accounting income (Bankman, 1999, 1780–1). Establishing a stronger link between the two measures would make it impossible fully to satisfy this design constraint.

Second, consider the popularity of transactions that involve the use of tax-accounting “hybrid” financial instruments that are classified as debt for tax purposes but as equity for financial accounting purposes (Shaviro, 2009a, 481). The underlying motivation is to generate interest deductions, reducing net income, solely for tax purposes, and this apparently is considered worth the extra costs, such as from legal and accounting fees, that creating a hybrid instrument may entail. This example differs from that of purchasing a corporate tax shelter in that neither system’s treatment of the hybrid financial instrument is necessarily “correct” (unlike simply disallowing net losses generated by paper-shuffling), absent coherent and normatively persuasive grounds for distinguishing debt from equity and treating payments solely to holders of the former as tax-deductible. Having separate tax and accounting rules to define debt and equity seems likely to generate needless waste, however, even if we posit that the underlying distinction between the two categories makes no sense.

While forcing managers to use the same income measure for both purposes might both increase reporting accuracy and reduce the cost of wasteful transactions, it also would have drawbacks. Perhaps the biggest one (leaving aside political choice issues, which I discuss next) relates to heterogeneity among corporate managers with respect to their objectives. Whether due to variation in their preferences or their circumstances, some managers may care a lot more about financial accounting income, relative to taxable income, than others do. Non-publicly traded companies, for example, do not even have to issue published financial statements. And even among those subject to reporting requirements, the managers in companies that are relatively closely held may care a lot less about financial accounting income, whether because the shareholders are better-informed or because they themselves are predominant shareholders. Inducing publicly traded companies with diffuse ownership to over-report taxable income relative to other companies might inefficiently disfavor them.

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9 If managers care a lot more about one income measure than the other, however, then combining the two may reduce the accuracy with which they report the one they care about less.
The underlying problem here, potentially relating to financial accounting income as well as taxable income, is that the social value of reporting accuracy may depend as much or more on its degree of achievement relatively between companies as absolutely. Thus, suppose all companies reported as taxable income exactly half of their true economic income. One could in theory adjust for this by simply doubling the tax rate, relative to the case where income was reported accurately. By contrast, differential accuracy leads inexorably to uneven tax treatment (all else equal). Likewise, the investment choices that financial accounting income is supposed to help inform may depend as much on comparing companies as on separately evaluating them. Heterogeneity, therefore, potentially undermines the value of inducing earnings–minded managers to report income more accurately, in a manner not similarly applicable to the case for discouraging wasteful transactions by conforming the two income measures.

POLITICAL INCENTIVE PROBLEMS AND THE BOOK–TAX RELATIONSHIP

The rules for defining taxable and financial accounting income are set not by philosopher–kings, or through the scientific application of a social welfare calculus, but by designated political actors responding to their own personal and institutional incentives. Accordingly, the relevant agency costs in determining the tax–book relationship include those that would affect the likely design of the rules under different institutional arrangements. This consideration has often played a central role in debate about the book–tax relationship, but without always being framed in sufficiently general terms.

In the U.S., the rules governing both taxable income and financial accounting income are ultimately subject to legislative control by the Congress. For each, however, Congress has the option of delegating authority to informed professionals who are at least partly insulated from direct political control. As it happens, Congress has chosen to exercise substantial direct political control over the definition of taxable income, subject only to giving the Treasury Department (itself controlled by the Executive Branch) relatively limited regulatory authority. With respect to financial accounting income, by contrast, Congress has opted for a considerably broader delegation of authority. Financial accounting rules generally are set by the Financial Accounting Standards Board (FASB), a professional organization that operates under the aegis of the Financial Accounting Foundation, an independent not–for–profit entity that is controlled by accountant, managerial, and state and local government organizations. Congress occasionally either intervenes directly with respect to the financial accounting treatment of a given item or else threatens to do so, thereby reminding FASB that its authority persists purely on sufferance. In the 1990s, for example, Senator Joseph Lieberman threatened to eliminate FASB’s authority over the definition of financial accounting income if it proceeded with a proposal to require that managers’ stock options be deducted in calculating financial accounting income (Shaviro, 2009a, 468 n. 152). However, even when demanding that FASB heed political direction on a particular issue, members of Congress routinely insist that “nobody [is] more committed to the independent setting of accounting standards than I am” or that “I would like to begin by reaffirming my belief that FASB … is best suited to set accounting standards” (468).

In principle, Congress could, if it liked, similarly delegate the definition of taxable income—for example, to an independent agency akin to the Federal Reserve Board, or to tax lawyers through the bar association equivalent of FASB. Its not doing so evidently reflects politicians’ much
greater interest in controlling the tax base, which they may regard as at the core of their expected prerogatives and which gives them enormous political leverage (Shaviro, 2009a, 466). Exerting control over financial accounting income may be appealing as well, such as if constituents demand oversight in response to accounting scandals or if campaign contributors express interest in a given outcome, but evidently is considered more tangential, and also can have the political downside of inviting blame for subsequent governance scandals—as Lieberman eventually learned (see, e.g., Baker (2006)).

Neither the Congressionally controlled system for defining taxable income nor the largely FASB–run system for defining financial accounting income is entirely ideal. Congress’s stewardship over taxable income has received almost uniformly dismal reviews. “For many decades, observers ranging from tax policy experts to political scientists to politicians and ordinary voters who view the tax code as a ‘mess’ or a ‘disgrace’ have repeatedly concluded that tax politics is extremely flawed” (Shaviro, 2009a, 466). Perhaps the central problem is interest group politics, although aggressive rent–seeking by politicians and the tendency to “legislate for legislation’s sake” or use the tax code as a device for position–taking or credit–claiming may have ill effects as well (467).

FASB is not immune from interest–group influence, but studies suggest that the problem is far less bad here than with Congress (see Shaviro, 2009a, 470). Perhaps the main complaint about FASB is that, despite its nominal independence from direct control by the accounting profession, it nonetheless unduly serves accountants’ interests, such as by devising rules that “justify large fees, while requiring little work and reducing legal risk” (Mundstock, 2003, 817). Many observers would agree, however, that Congress’s track record with respect to taxable income, along with the record of its sporadic but frequently interest–group–driven interventions in the accounting realm, suggests that the rules for defining financial accounting income would likely change for the worse if Congress took a greater direct role in their determination (Hanlon, LaPlante, and Shevlin, 2005).

This view, if accepted, has important implications for proposals to move towards a one–book system in response to concern about managerial incentives. If such integration between the measures had the effect of increasing Congress’s direct control of financial accounting income, any social gain from the hoped–for improvement in managerial incentives might be offset by worsening the impact of bad political incentives. Suppose, for example, that Congress legislated that taxable income would also serve as the official financial reporting measure for public companies. A recent study suggested that this would reduce by approximately 50 percent the explanatory power of earnings (Hanlon, LaPlante, and Shevlin, 2005), reflecting the dilution of its information content through the interpolation of politically motivated “noise.”

This picture is perhaps too simple, given that responding favorably to interest–group pressures might be more complicated if the same rules had to apply in both the tax and accounting settings. For example, the executives who cheered on Senator Lieberman’s war against deducting stock options for book purposes presumably wanted them to remain deductible for tax purposes. However, Congress cannot really be forced to apply the same rules for both purposes when it is not so inclined. Thus, the advantage of preventing managers from simultaneously responding to their opposite incentives in the two realms by requiring tax–book conformity may not comparably apply to Congress, since it continually decides how much conformity there should be.
Accordingly, addressing managerial incentive problems through book–tax conformity would create a fundamental challenge: how to limit the harm that might result from inducing greater direct political control over financial accounting income. This problem has no simple answer, but I next examine two particular aspects. First, I briefly review a partial conformity proposal that I have made elsewhere. Second, I address recent trends towards the internationalization of both the tax and financial accounting measures, and consider how these trends might affect the relevant tradeoffs.

A MODEST PROPOSAL TO MOVE PARTWAY TOWARDS TAX–BOOK CONFORMITY

In Shaviro (2009a), I described a proposal to move partially towards tax–book conformity, in the hope of mitigating managerial incentive problems without greatly worsening political incentive problems. While recognizing that the proposal cannot be adequately evaluated without greater empirical knowledge about the effects that it would have in practice, as well as greater specification concerning the social costs of inaccurate income measurement in both the tax and financial accounting realms, I argued that it was sufficiently promising to merit further consideration. Here, in the hope of encouraging such consideration, I offer a brief description of how it would work and its underlying rationale.

Under the proposal, companies initially would separately determine both taxable and financial accounting income, just as they do currently. However, as a final step in the determination of taxable income, its amount as otherwise determined would be adjusted by a specified percentage, such as 50 percent, in the direction of financial accounting income. Thus, a company with “preliminary” taxable income of $100 million and financial accounting income of $140 million would adjust the preliminary amount by 50 percent of the difference between the two, and report “final” taxable income of $120 million. (As discussed below, however, certain adjustments would first be made to financial accounting income, solely for purposes of applying the rule.)

Further details included the following.

1. For consolidated corporate groups, the adjustment would be made with respect to the financial accounting income of the tax reporting group, not the financial accounting group where these differed. Since 2004, large public companies have been required to include IRS Schedule M–3 with their federal income tax returns, showing the sources of difference between taxable income and financial accounting income. This schedule generally contains the information that such companies would need to make this adjustment.

2. Financial accounting income might also be revised in various other respects, solely for purposes of the taxable income adjustment, before computing final taxable income. Many of the differences between taxable and financial accounting income reflect the two measures' distinct purposes, and may not strongly raise managerial incentive issues. Thus, applying the adjustment to such items arguably would be undesirable. Illustrative examples might include federal income tax liability and illegal bribes (both of which are deducted for book but not tax purposes), business meal and entertainment expenses (only

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10 The U.S. corporate alternative minimum tax contained a similar rule, applying solely for purposes of determining alternative minimum taxable income, from 1987 through 1989. See Shaviro (2009a, 463).
partly deductible for tax purposes), and tax rules matching the timing of stock option deductibility to that of inclusion by the employee. However, even if such items ought to be excluded from the taxable income adjustment on the ground that they reflect differences between the two measures’ underlying purposes, there is an argument for not making a long list, which could end up facilitating the inclusion of spurious items as well (Shaviro, 2009a, 476–7).

3. A further potential issue relates to deliberate income tax preferences that reduce or defer taxable income relative to financial accounting income. While scaling back the preferences via the taxable income adjustment might be a good end result, one should not assume that Congress would fail to notice that its presumably intended policies were being undermined. Lest it respond either by requiring the preferences to be used in computing financial accounting income or by making them nominally bigger (which might affect taxpayers not subject to the adjustment), one might instead encourage Congress to provide that financial accounting income is modified, solely for purposes of applying the adjustment, to allow the use of specified preferences.

4. In principle, one might like the adjustment to be symmetric, permitting taxable income to be reduced as well as increased. However, managers who lacked strong motivation to inflate reported earnings would then be able to use the adjustment to reduce their companies’ tax liabilities, by regularly reporting financial accounting income that was substantially less than preliminary taxable income. To limit this problem, one might require that reductions in taxable income through application of the adjustment be limited to the amount of prior increases that it had caused.11

5. One of the toughest dilemmas raised by the proposal concerns its application to non–publicly traded companies. Exempting them seems appropriate given that the underlying managerial incentive to overstate earnings presumably does not apply comparably to them. This, however, would lead to tax bias (all else equal) against publicly traded companies. One possible response would be to treat them more favorably in some other respect—for example, by slightly lowering their marginal rates so the proposal was revenue–neutral or burden–neutral.

Perhaps the proposal’s clearest advantage is that it would reduce public companies’ managers’ incentive to devote resources to driving a wedge between taxable and financial accounting income, such as by engaging in tax shelter transactions or constructing costly and complicated tax–accounting hybrid financial instruments. The proposal would also potentially improve the accuracy of income reports for both purposes by creating an offset between managers’ desire to inflate the one measure and reduce the other. This depends, however, on the competing incentives’ relative weight,12 and

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11 To accomplish the same objective more precisely and limit income–shifting in response to statutory tax rate changes, one might instead require that reductions in tax liability by reason of the adjustment not exceed prior increases.

12 For evidence suggesting that tax–book conformity can reduce financial accounting’s informativeness by inducing undue conservatism in reporting earnings, see Hanlon, Maydew, and Shevlin (2008).
is subject to the heterogeneity problem discussed earlier.\textsuperscript{13} The proposal also aims to minimize any effect on Congress’s interest in exerting greater control over the financial accounting rules. The provision for merely a half-way adjustment ensures that taxable and financial accounting income will still otherwise be separately determined. Where Congress cares about the effect on taxable income of a given financial accounting rule, the hope is that it would settle merely for requiring that the rule’s effect on the adjustment be negated. One problem to worry about is that members of Congress seeking backdoor tax changes might operate via the financial accounting rules. While interest groups presumably would be less grateful if the price of a tax cut were lower reported earnings, heterogeneity in managerial objectives might make this less of an obstacle in some cases than others.

**SIGNIFICANCE OF INTERNATIONAL TRENDS**

The U.S. has traditionally followed a largely independent approach to defining both taxable income and financial accounting income, rather than closely following or seeking to emulate approaches from abroad. Recently, however, global pressures in favor of convergence have started to play a role on the accounting side. Indeed, the FASB chairman recently urged U.S. adoption of IFRS within the next few years, on the ground that “[t]he world has changed and we are not the only big player anymore.”\textsuperscript{14} With respect to corporate taxable income, no such pressures appear as yet to be felt significantly in the U.S. While global tax competition has increasingly led to calls for lowering the U.S. corporate tax rate (see Shaviro, 2009b, 167), international tax base coordination has received only sporadic and ad hoc attention here—for example, through legislative and regulatory responses to taxpayer efforts at “cross-border tax arbitrage,” or tax planning that exploits small semantic differences between countries’ tax rules (see Shaviro (2002)).

Both institutionally and economically, the EU faces much stronger internal pressures for cross-national convergence in defining income than does the U.S. externally. Thus, it comes as no surprise that the EU has moved much further than the U.S. to achieve such convergence, through the adoption of IFRS and the establishment of the ongoing (if slow-moving) CCCTB project. The EU resembles the U.S., however, in finding the sacrifice of national political authority—a necessary prerequisite to internationalization—easier to countenance for accounting income than taxable income. As noted above, this disjuncture has to date led EU countries to move towards a two-book approach, but general adoption of a CCCTB could lead to renewed consideration of integrating the tax and financial accounting definitions of income.

In the U.S., where corporate tax base conformity to some accepted set of international standards appears to be far off on the horizon (if indeed one can espy it at all), it is worth considering how adoption

\textsuperscript{13} In addition, even if income reports became more accurate in some respects, they might become less accurate in others. For example, applying the proposal solely to U.S. members of a worldwide consolidated group would create an incentive to shift reported financial accounting income from U.S. to foreign group members, thereby diminishing U.S. tax liability without having any effect on the reported financial accounting income of the worldwide group.

\textsuperscript{14} Quoted in Donna Block, FASB Chief Backs Shift From U.S. Accounting Standards, The Daily Deal, October 26, 2007. FASB and IFRS, in addition to having different rules for a number of different situations (e.g., how to account for derivative financial instruments, and how to define a lease), differ conceptually in that GAAP is generally more rules-based, offering specific guidance in particular situations, while IFRS is more principles-based and offers less specific guidance. See Deloitte (2008, 6).
of IFRS would affect the issues posed by the book–tax relationship. An initial question is how such adoption would affect the location of substantive authority over the U.S. definition of financial accounting income. At one end of the spectrum, FASB might perform this role largely as it does today, and merely exercise its discretion to follow IFRS most or all of the time. At the other end of the spectrum, even if FASB continued to oversee U.S. accounting practices and to work with the IASB in developing IFRS standards over time, substantive authority over the definition might effectively have been transferred overseas. The key difference lies in the extent to which internationalization would reduce the threat of Congressional intervention in the process of defining financial accounting income.

If internationalization significantly deterred such intervention, the case for tax–book uniformity, subject only to whatever exceptions (such as for specified tax preferences) Congress chose to mandate on the tax side, would become stronger. Indeed, one key rationale for my suggesting only a 50 percent adjustment—that Congress might refuse to keep its hands off financial accounting rules that fully applied for tax purposes—might lose most of its force if such rules were sufficiently protected by the combination of IASB independence from U.S. political control and U.S. acceptance of the need to maintain accounting convergence.

Thus, while the main effect of internationalization has been to move Europe from a one–book to a two–book approach, conceivably it could point the other way over the long haul. This depends, however, on countries’ willingness to depoliticize the corporate tax base in response to the growing advantages of tax base convergence in an ever more economically integrated world.

SUMMARY AND CONCLUSION

Taxable income and financial accounting income are measures that use the same name but serve different purposes, leading to some differences in how they might ideally be defined. However, concern about managerial incentive problems may support integrating them, either to increase the accuracy of amounts reported or to reduce the resources that managers expend on reducing taxable income and increasing reported earnings. Political incentive problems, on the other hand, arguably support separating the measures, so that legislative eagerness to control the tax base need not promote politicization of accounting standards. The case for a largely one–book system may grow stronger, however, if pressures for international convergence in defining income on both the tax and accounting fronts lead to reduced politicization of both.

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15 While the U.S. Congress would in any event have the power to dictate U.S. divergence from IFRS, one could imagine a scenario in which there were strong norms or pressures against its doing this, causing the power to matter relatively little.

16 Even if the IFRS is outside U.S. political control, one would have to worry about the degree to which it is subject to interest group influence. The IASB is controlled by the European Commission without an intermediary akin to the Securities and Exchange Commission, which to a degree stands between the FASB and the U.S. Congress. A disturbing recent indication that IFRS, through the IASB, may be subject to undue political influence arose in October 2008, when the IASB, under heavy political pressure, permitted European banks to conceal heavy losses by changing in midstream their balance sheet treatment of troubled assets. See Glenn Kessler, “Accounting Standards Wilt Under Pressure,” Washington Post, December 27, 2008, page A–1, available at http://www.washingtonpost.com/wp–dyn/content/article/2008/12/26/AR2008122601715.html?hpid=topnews.
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