The Tax Elasticity of Financial Statement Income: Implications for Current Reform Proposals

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Introduction

- Early-to-mid 2000’s: concern about book-tax divergence, tax avoidance and earnings management
  - Desai (2005); Desai and Dharmapala (2009)
  - Hanlon and Shevlin (2005)

- Recent proposals for reforming MNC taxation
  - OECD/G-20 GloBE (Pillar Two) proposal (OECD, 2019)
  - “Real Corporate Profits” Tax (Saez and Zucman, 2019)

- Aim: to bridge accounting and economics/policy perspectives by interpreting the evidence in terms of potential efficiency costs
GloBE Proposal: Global Minimum Tax

But on what tax base should the minimum tax be imposed?

\[ Y^T = Y_A^{TLA} + Y_B^{TLB} \]  
\[ Y^T = Y_A^{TLA} + Y_{B}^{TLA} \]  
\[ Y^T = Y^F \]

\( Y^T \): tax base
\( Y^{TL} \): taxable income defined by tax law
\( Y^F \): consolidated financial statement income

But, country B might create a narrow tax base
But, compliance costs would be high
How should we conceptualize the efficiency costs and benefits?
Elasticity of Taxable Income (ETI)

Approximately: $$\% \Delta \text{ in } Y^T \over \% \Delta \text{ in } (1-t)$$

- Feldstein (1999): ETI is a sufficient statistic for the deadweight loss under fairly general conditions
  - Regardless of whether $\Delta$ in $Y^T$ is due to real responses or tax avoidance, as taxpayers equate the marginal costs
  - Exceptions – e.g. when costs of tax avoidance are not social costs (e.g. Chetty, 2009)
  - But, if ETI is a sufficient statistic for the deadweight loss from profit shifting, we would also expect this to be true for tax-motivated earnings management
## ETI for Corporate Income

<table>
<thead>
<tr>
<th>Tax Base</th>
<th>Study</th>
<th>Sample</th>
<th>Reported ETI</th>
</tr>
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<tbody>
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Preferences and deductions that are allowed under regular tax law but disallowed under the AMT

50% of \((Y^F - (Y^N + P))\)

BIA or “Business Untaxed Reported Profit” (BURP) adjustment:
\[
\text{AMT} = 20\% \times (Y^N + P + 0.5(Y^F - (Y^N + P)))
\]
→ 10% tax rate on \(Y^F\) for firms subject to the AMT in 1987-1989
ETI for Financial Statement Income

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<td>Manzoni (1992)</td>
<td>US firms subject to the AMT (hand-collected)</td>
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<td>1.4 to 1.9</td>
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Studies of US firms’ responses to the BIA/BURP adjustment – do not discuss magnitudes (but these can be inferred using some assumptions)
Caveats

Consistent with downward earnings management of $Y^F$ (v. that of $Y^T$) being relatively unconstrained; but:

- Various potential problems with these studies?
  - Choi, Gramlich and Thomas (2001); Shackelford and Shevlin (2001)

- Short-run v. long-run responses?

- However, a number of biases $\rightarrow$ underestimation of effect
  - TRA86: ↓ in corporate tax rate
  - AMT credits

- No “precise zero” estimates in the literature
Conclusion

- The available evidence on the ETI of $Y^F$ is limited, but suggests quite large deadweight losses from taxing $Y^F$
  - Potentially mitigated by adjusting $Y^F \rightarrow Y^{NL}$, but this seems to undermine the rationale for taxing $Y^F$

- OECD (2019): why pursue GloBE proposal?
  - Profit shifting
  - Tax competition
  - Putative danger of countries unilaterally imposing digital services taxes (DSTs)

- But, should also bear in mind the potential costs of GloBE and similar proposals