IDENTIFYING EXCESS PROFITS [WHAT IS A NORMAL RETURN]?

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Views are mine alone

Excess profit, rents, residual profit and all that

Defining Terms

- Several themes converging around taxation of

'Excess profit' = Rents
≡ PV of (pre-tax profits
– minimum required pre-tax earnings)

with

Minimum required return = 'normal' return (r_i)
= safe rate + risk adjustment,

the risk adjustment depending on asset pricing model

- Most experience of rent taxation is in natural resources

Do we need to know r_i to tax rents?

No, in theory:

- Take e.g. cash flow tax:
  - With full immediate offset, no knowledge of r_i needed for neutrality
  - Without such offset, if future relief is certain, neutrality assured by carrying losses forward at safe rate (Fane, 1987; Bond and Devereux, 1995)
    - Value additivity means that this relief then discounted at safe rate
- Same is true for all of the infinity of schemes giving deduction for some proportion α of cumulated costs (Boadway and Bruce, 1984)

But in practice?

- In schemes above, sovereign risk (and maybe changing rates) bring in a role for required return
  - Too high an 'uplift' e.g. leads to gold plating
- Neutrality results presume costs of entrepreneurial inputs fully deductible
- Danger of focusing on quasi-rents
- Outside resources, schemes aimed at taxing excess profit typically aim to do so directly, imputing some r_i on assets
  - Bringing valuation of intangibles to the fore

Excess Profits Taxes in history

- Earliest was in confederate Georgia
- All major belligerents adopted in First World War
  - UK started by comparing with pre-war profits
  - Then moved to taxing above a certain return on assets: looking much like an ACC

  And in Second too
- Recent resurgence of interest in ACE/C and RPA, GILTI, Amount A of Pillar 1 proposals—amplified now by COVID-19

Rents vs. Residual

Residual profit = Profit – routine profit

where routine return = profit a third party would expect to earn for performing a particular set of functions and activities on an outsourcing basis—such as developing a drug

This will reflect risk to contractor, not MNE—which reflects risk of drug being a commercial success

So in general Residual profit ≠ Rents

Auerbach et al, (2019)

Some empirics

(from Beer et al. (2020)

Data

At various points use both:

- ‘Micro’: Consolidated data on 8.854 largest MNE groups in S &P Capital IQ database for 2011-17
- ‘Macro’: Capital stocks, revenue for 114 countries

NB: No unconsolidated micro data

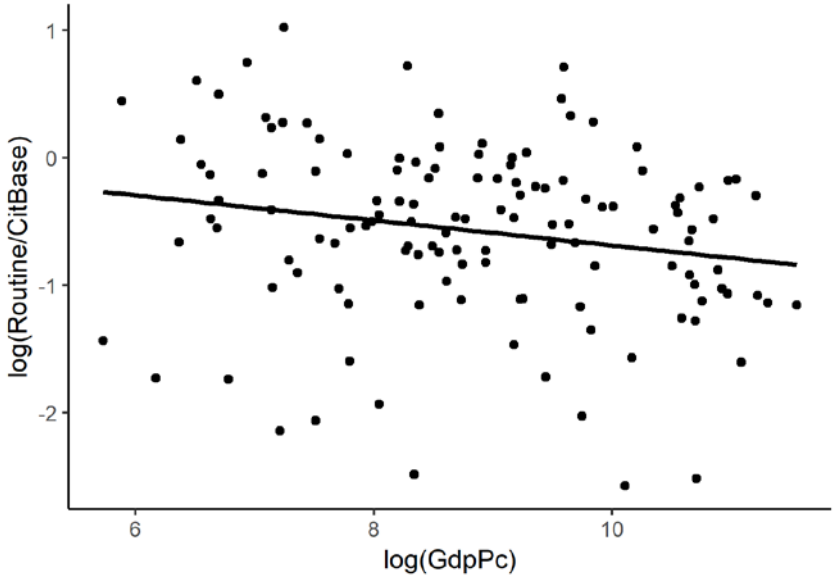
Routine profit

Infer as a markup on either COGS or capital

At return on tangibles of 10 percent and on COGS of 5 percent:

- About 40-50 percent of total profits
- For MNE with positive residual, abut 30 percent of total profits

Exceeds CIT base in many countries



Residual profit is…:

Often negative:

At return on tangibles of 10 percent and on COGS of 5 percent:

- 19 and [13] percent of MNEs have negative residual

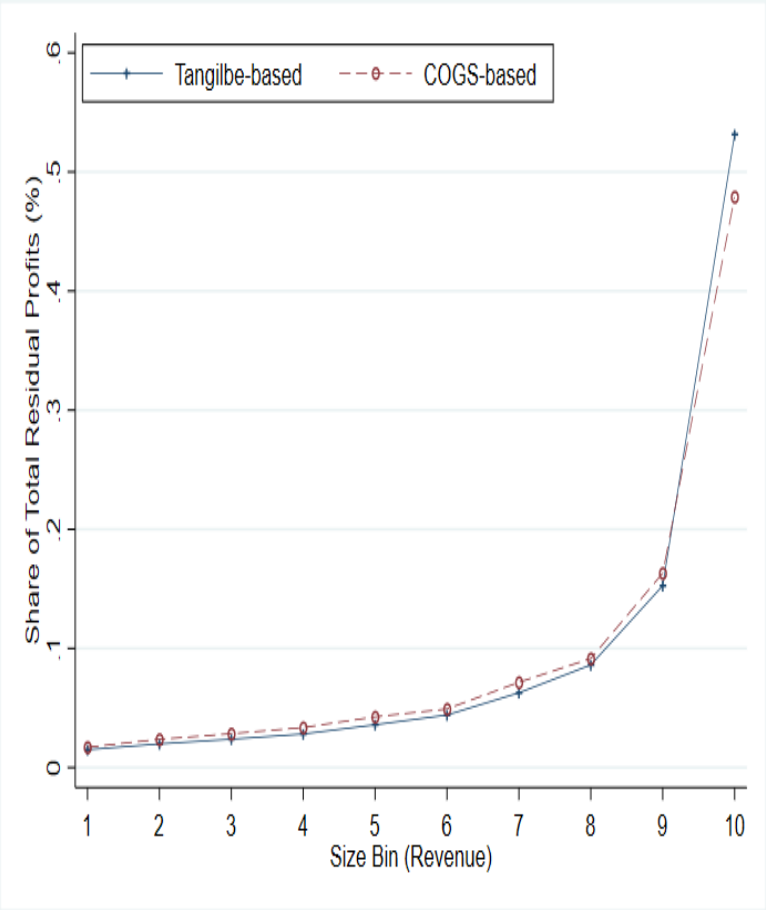
Highly persistent:

(By quintile, in percent)

Year t	Year t+1				
	1	*2*	*3*	*4*	*5*
1	72	17	6	3	2
2	15	62	20	3	0.5
3	5	15	61	18	1
4	3	2	13	69	13
5	2	0.4	1.3	8	88

…and is highly concentrated

Among a few MNEs



Among a few countries of HQ

	Tangible, 10%	COGS, 3.75%
U.S.	38	33
China	8	12
Japan	7	7
U.K.	7	6
Rest	42	42

Concluding

In concluding, to note:

- Do not need to know r_i exactly: setting benchmark rate too high need not interfere with neutrality

- Tax on rents not neutral when shared across jurisdictions by some weights, so that total liability is

$$\left(\sum_i \omega_i(s)\tau_i\right)\mathrm{V}(s),$$

since distortion arises though impact on the weights

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