Do Taxes Motivate Corporate Managers?

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Lily Batchelder, *Accounting for Behavioral Considerations in Business Tax Reform: The Case of Expensing* (Feb. 5, 2017), available at SSRN.

Tax scholarship is interdisciplinary. To evaluate tax policy it helps to know at least a little about economics, a little about philosophy, something about budget processes, and a lot about the dizzying creativity of the marketplace in exploiting loopholes and facilitating tax-advantaged transactions. In her recent article *Accounting for Behavioral Considerations in Business Tax Reform: The Case of Expensing*, Lily Batchelder shows us that we must add financial accounting and firm (and corporate managers') behavioral considerations to the mix.

The article evaluates which of three policies, adopted on a revenue neutral basis to replace our current regime of accelerated depreciation, would cause the largest increase in new investment by the corporate sector. The three policies are: expensing of new investments combined with higher statutory corporate rates; lower statutory rates combined with more gradual and economically accurate economic depreciation; and an investment tax credit combined with economic depreciation.

The conventional wisdom is that the first of these options, allowing for current expensing of new investment, will have the biggest bang-for-the-buck. But the analysis that yields this conclusion assumes that corporate managers choose investments to maximize the after-tax net present value of the investment returns. If that were true, managers would care about the marginal rate applicable to the investment, which is zero (at least as to the normal returns) if the investment is equity financed and the cost of the investment is expensed. The key insight that Batchelder shares is that managers don't look at the marginal rate. The financial accounting literature shows that they make their decisions based on either the statutory rate or their "book" tax rate, because these are what affect income for financial reporting purposes. Neither rate reflects the value of tax deferral, so managers tend not to incorporate the benefits of tax deferral when making investment decisions. The best of the three policies is instead to eliminate accelerated depreciation and use the revenue to finance a statutory rate cut.

This paper makes two significant contributions. The first is to bring evidence on the tax variables that affect managers' decisions to a live debate about how to increase investment. Batchelder not only canvasses relevant accounting theory and empirics, but also corroborates the incentives created by financial accounting standards by talking with corporate managers. The care with which she buttresses this important premise of her argument makes her conclusions about the ineffectiveness of expensing that much more credible. The second contribution is her argument that the optimal investment policy—at least in terms of maximizing the increase in new investment—is one that minimizes the capital-weighted relevant rate on new investment.

It doesn't make sense to lower the marginal rate on new investment if the benefit is entirely inframarginal and generates no new investment. Different firms rely on different rates, and if we knew which rate each firm focused on, we might lower just that rate, for just that firm. Since that's impracticable, Batchelder's solution is to calculate the average target rate across all firms, weighted by the firms' capital, and minimize that average. Note that this average rate isn't the rate that is targeted by any one firm. To conclude that the optimal policy is the one that minimizes that average rate,

Batchelder must assume that the elasticity of investment responses to changes in this rate are constant across firms, regardless of which rate they focus on. This assumption is worthy of further investigation. Presumably there is some reason that some firms focus on the statutory rate while others focus on the marginal rate. It could well be that the same managerial preferences, incentives, or constraints that cause some firms to focus on statutory rates also influence their investment behavior. If this were true, it could imply that a mix of policies, including investment tax credit, selectively available expensing, and lower statutory rates, might be the best approach.

Moreover, if deferral generally doesn't matter to corporate managers, then we should also ask why we don't provide for even slower depreciation or perhaps delay basis recovery at disposition in exchange for lower headline rates. Batchelder rightly notes that this would mean that firms will carry a lot of assets with built-in losses that could lead to asset churning, but this worry is in tension with the premise that there are very few firms that care about the timing of tax income and losses to begin with. If that's the case, then we shouldn't expect much churning after all.

Finally, a comprehensive analysis of these policy options would require some understanding of the tax sensitivities of non-corporate entities. Since the benefits of deferral accrue directly to investors in such entities, then we might expect that they would be more attuned to, and force managers to be more responsive to, the benefits of expensing. Batchelder's data don't allow her to calibrate her estimates by including these entities, but incorporating them would make for an important extension.

Understanding how policy interventions affect taxpayer behavior requires knowing the objectives of those taxpayers and the constraints that they face. Research in behavioral economics, particularly the literature on tax salience, has revealed some of the ways that individuals may not respond rationally to taxes. However, much less work has been done on the possibility that the assumption of economic profit maximization may fail in the case of firms. This paper is an important contribution in remedying this deficit in the scholarship.

In some sense, the marriage of accounting and tax law should be a natural one. Tax lawyers are accustomed to thinking about the pernicious consequences that flow when substance and form are allowed to come apart. They are sensitive to how taxpayers respond to labels such as "debt" and "equity," or "employee" and "independent contractor" even when the underlying economic reality is the same. Accountants are engaged in a similar enterprise. It would seem that tax lawyers and accountants have a lot to talk about, and Lily Batchelder's paper is a wonderful illustration of the important insights that can be generated from that conversation.

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