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A Legal Perspective on Unanswered Questions in Tax Research

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INTRODUCTION

The goal of this paper is to provide an interdisciplinary perspective on some of the important topics that accounting researchers might take on. In one sense, we need to be very careful in advising non-legal entry academics on questions of interest to lawyers and economists. The most important advice might be to first succeed within the traditional boundaries of your field (e.g., finish your Ph.D., obtain an academic position, and earn tenure) before worrying about branching out. On the other hand, an interdisciplinary focus might help young academics find questions that are new to a field and apply new ways of thinking to help answer them.

Before getting to the questions, we should start with a few caveats. First, researchers in any field should always think in terms of comparative advantage: "What skill do I bring to the table that others may not have that can help answer a question?" The three fields most central to taxation—economics, accounting, and law—each have unique comparative advantages.

Economists bring a mathematically based theoretical foundation to their work. This foundation has several advantages. First, a rigorous mathematical foundation often helps to illustrate aspects of the problem that would not otherwise be noticed. An example of this approach in action is the optimal tax literature: while intuition suggests that the proper tax rate schedule must balance redistribution and disincentives to work, the optimal tax literature illustrates how subtle this balance is. Second, a mathematical foundation also forces basic assumptions to be stated explicitly (although often less explicitly than one might hope because assumptions are often embedded in utility functions, production functions, and the like). Finally, a rigorous mathematical approach helps to generate well-defined testable hypotheses, facilitated by a set of statistical tools used in empirical work.

Lawyers possess a detailed knowledge about how the tax law actually works. Lawyers often know about interactions and imperfections that are not captured in economics models, or that cannot be easily stated in mathematical terms. Indeed, it is standard among tax lawyers to think that the economists' models are hopelessly simplistic, notwithstanding the pages of detailed (and often impenetrable) math. Lawyers often use their institutional knowledge to write articles about how best to design the "plumbing" of the tax system—how best (within the legal framework) to fit the various pieces together, and how to get the various rules to properly interact. Such work is extremely important, but it rarely focuses on the big issues. At other times, however, lawyers' understanding of broad legal principles

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is crucial to address design issues in the tax system—after all, the tax system is fundamentally a legal document, based on legislative language and the interpretation of the law by the courts.

Accountants, in some sense, sit in the middle. Increasingly, academic accountants are trained in many of the same theoretical and statistical methods of economists, and couple that knowledge with a greater sensitivity to transactional details, complementing the legal literature. In general, however, the accountant's expertise is less transactional than lawyers, focusing instead on the role of and incentives caused by institutional aspects of the financial reporting system, such as reported earnings, the influence of debt covenants, managerial compensation, and earnings patterns—items that have generally not attracted very much attention from lawyers.¹ Lawyers are also often focused on individual tax issues, such as taxation of the family, or on various types of gains and losses that individuals can have (casualty losses, tort awards, imputed income, found property, and so on). Accountants tend to focus almost exclusively on business issues.²

To illustrate how the three approaches complement each other, imagine analyzing tax reform that imposes a broad-based business-level income tax, such as the Comprehensive Business Income Tax.³ Expertise from each of the three professions would be needed to understand its effects. An economist might estimate the reduction in deadweight loss as a result of imposing a more level tax rate on different sectors of the economy. An accountant might examine how businesses would deal with the compliance burdens, given that the tax system would no longer resemble financial accounting and identify behavioral and/or reporting responses. A lawyer would think about possible loopholes and responses, designing the detailed tax rules that would apply.

The above example illustrates the second caveat for research ideas: researchers rarely try to address the entirety of a problem. Instead, the usual approach is to isolate important pieces, attempting to capture a core aspect of the problem while ignoring other features (and hoping that they can be held constant). It is important to keep in mind that a list of major unanswered question is not a list of actual research topics. Instead, it is a list of areas in which research needs to be done.

The third caveat for new researchers is that when we focus on a discrete aspect of a problem, it is important to keep in mind how it fits into the "big picture." A good example is the recent discussion of tax shelters. It is standard to distinguish avoidance from evasion, as evasion is illegal, often criminal, and avoidance is legal. Discussion often assumes that the line between these two is fixed and proceeds to analyze tax shelters given this line. An analysis of shelters, however, has to proceed with a goal to figure out which shelters to allow and which ones to disallow. For example, the tax system allows individuals to reduce their taxes by choosing to work (and earn) less, but not to engage in a complicated maneuver that results in a similar reduction in liability (there may even be a greater loss to society from the decrease in the labor supply). Assuming there is a clear distinction between avoidance and evasion assumes away the central question and ignores the important point that the line between avoidance and evasion is an artificial one; it is a policy choice. If the researcher can remember the big picture—what assumptions are being made and how they fit into the question being asked—then he or she can avoid this type of pitfall.

¹ There are exceptions, such as the recent debate on the extent to which financial statement measures of income should be used in the tax system; see Johnson (1999) and Whitaker (2005).

² See Shackelford and Shevlin (2001) for a survey of accounting research.

³ See U.S. Treasury (1992a, 1992b).

Finally, researchers must understand what tax questions can safely be classified as having been *answered*. From a theoretical perspective, there is agreement on some general principles—lower rates and a broader base are generally preferable—but from an empirical view, the extent of behavioral effects and the efficiency gains from various tax alternatives remain very much unanswered. Estimates of even basic parameters, such as labor supply elasticity, or the elasticity of taxable income, remain disputed.

Shackelford and Shevlin (2001), in their survey of accounting research, highlight three areas that have attracted the most attention from accountants: tax and nontax trade-offs, taxes and asset prices, and multijurisdictional issues. Our list of the most important tax topics, in a sense, is orthogonal to these areas. For example, our first topic is tax reform. Within tax reform, an understanding of each of these three areas is important: how the tax system will interact with nontax factors, how it will affect asset prices, and how it will work in a multijurisdictional world. The same holds for our second topic, compliance.

Our list of important unanswered questions is quite general. In thinking about comparative advantage, it is evident that not all of the problems on the list are best addressed by accountants. We put these items on the list in the spirit of this paper—an interdisciplinary look at the important issues—in the hope that there might be some cross-fertilization.⁴

TAX REFORM

It seems trite to say that tax reform is one of the big unanswered questions, but there is very little academic research being done on the design of basic reform plans. The current tax and expenditure system raises significant long-run issues that suggest that the current path is fiscally unsustainable. Absent significant spending changes (and even with them) there will be increasing pressure to change the tax system to meet budgetary needs. Complicating any prospective tax changes is the increased mobility of capital and the corresponding ease with which it can be moved outside the U.S. tax system. As a result, tax reform of some sort seems inevitable, either through a reform of the current system or the addition of a second.⁵

To be more specific, consider the possible replacement of our current system with a consumption tax. To properly consider and construct a consumption tax (1) requires a better understanding of how to design one that is sufficiently progressive, (2) solves international issues (such as border refundability and treaty requirements), (3) properly addresses financial intermediation, and, finally, (4) can be transitioned into from the current system. The major economies of the world tend to rely on both income and consumption taxes, so if the U.S. were to rely solely on a consumption tax many questions would need to be addressed. Such a fundamental change in the tax structure would also have to address both our “negative tax” system—the welfare system, which currently relies on an income and asset base, rather than a consumption base—and the positive tax system (e.g., the Earned Income Tax Credit).

The recent President’s Advisory Panel on Federal Tax Reform highlights the importance of these issues. Although consumption taxes have long histories in other countries and have been examined in the context of U.S. tax reform, the Panel felt that it did not have an

⁴ Plesko (2006) discusses the need for better integration of accounting, economics, and legal issues in business tax research and highlights the survey results of Graham et al. (2005) to show that many basic economic assumptions are not found to be true in practice.

⁵ Recent administration and congressional hearings seem to bear this out. See, for example, President’s Advisory Panel on Federal Tax Reform (2005) and U.S. Senate (2006a, 2006b).

adequate template for a stand-alone progressive consumption tax. The Panel started considering the X-tax or Flat Tax,⁶ but these general systems left out numerous details, many of which significantly affect the workings of the system.⁷ Moreover, the Panel ended up recommending a mixed, imperfect system⁸ and it is not clear whether this was simply the result of the constraints under which the committee operated, or whether such a compromise is inherent in the design of a consumption tax.

While this issue may seem difficult to address, even on a conceptual level, and tax reform does not appear to be an immediate policy concern, its importance should not be downplayed. Fundamental tax reform will likely appear on the national agenda as a surprise: there will not be five years of notice to prepare a plan. Research initiated at the time tax reform is being debated will be too late to have a significant effect on the deliberations or the design of the proposals. The time to start researching these questions is now.

The economics literature, to the extent it focuses on tax reform, uses a very broad brush, focusing, for example, on the macroeconomic effects. Economists tend not to care about the details of the system, the very details that make it work (or not). Leading economists used to have tax reform plans on their agendas: Shoup and the VAT,⁹ Bradford (1996) and the X-tax, and Pechman (1977) and the comprehensive income tax. But, with few exceptions, economists seem to have moved on to other issues.

In looking at possible scenarios for tax reform, accounting researchers have a number of potential avenues for contribution. Businesses will inevitably play a large role in a reformed tax system, since they are like the customs collectors in the modern economy—most of our economy flows through businesses, making them an ideal point for taxation. Accountants can help illuminate the role that businesses could or should play in a reformed tax system by informing the discussion on how business reporting and behavior would be affected, whether the tax motivations for earnings management would be the same, and whether the opportunities for tax-motivated behavior would be more or less constrained.

Finally, accountants have a particularly advantageous viewpoint. The models that economists use to analyze tax changes often ignore the timing of tax flows: if two tax systems generate the same present value of revenue, but one is more efficient than the other, then the more efficient one is preferred. However, the timing of tax receipts matters both to governments and taxpayers, and accounting research often focuses on cash flow effects. Thus, accounting researchers may well provide better insight in understanding many aspects of firms' responses to tax changes.

COMPLIANCE

Current estimates put the tax gap, the amount of uncollected but otherwise legally owed federal taxes, at \$345 billion, with additional billions potentially lost to tax shelters. The U.S. government spends an estimated \$100 billion a year ensuring compliance with the tax system. These numbers are so large that anything that might reduce them seems worth studying. In an important sense, tax compliance and administration are the biggest and most important unanswered sets of issues—the questions regarding the major tax bases, income, consumption, or wealth may very well pale in comparison to the problems of tax collection.

⁶ See Bradford (1996) for a discussion of the X-tax, and Hall and Rabushka (1995) for a flat-tax proposal.

⁷ See Weisbach (2002) for a discussion of the difficulty of administering mixed systems.

⁸ President's Advisory Panel on Federal Tax Reform (2005, Chapter 5) provides an overview of the proposal.

⁹ The "Shoup Mission" is often referred to for the design of the post-WWII Japanese tax system. A general overview of value-added taxation can be found in Schenk and Oldman (2007).

Mark Everson, Commissioner of the IRS, suggested that a significant portion of the tax gap could be collected with only minimal changes to current law and with little additional burden: "At some point you will be more intrusive, but you can clearly reduce [the tax gap] by \$50 or \$100 billion without changing the way the government interacts with its citizens."¹⁰ While political barriers, such as worries about an intrusive IRS, play a large role in limiting some approaches aimed at reducing the tax gap, that so much additional revenue might be collected within the current system suggests that better quantification of the effects of various enforcement actions can help inform decisions related to increasing compliance. The same holds for compliance costs. Some states, such as California, are experimenting with government-prepared tax returns. Quantifying the costs and savings of such systems would be extremely useful.

There is no shortage of ideas, nor is there a shortage of examples from other governments using alternative tax administrative options such as the PAYE in Great Britain, the VAT (both the widely used credit-invoice method and also the subtraction method) in other countries, and state-level experience with formulary apportionment. How does operating in an underground economy affect a small business's ability to keep accurate books? What about the use of government-issued cash registers for small businesses? Can this be done without being too intrusive? China uses carrots as well as sticks to encourage compliance—sales tax receipts in China function as "free" lottery tickets. A similar system here might select ten tax returns to win \$1 million each on April 16, provided that they are determined to be within a reasonable range of being fully compliant.

Closely related to compliance is the role of technology in taxation. The ability to track individual activity has grown exponentially in the last few decades. The government, if it wanted to, could gather enormous amounts of information about each of us, information that could be used to optimize and automate the tax system. For example, traffic tickets are now issued electronically through camera and radar in many places. Britain is experimenting with cameras on all of its major roads, allowing the country to assess road usage taxes that are keyed to place and time of day. Global positioning systems could function similarly. Stockholm is experimenting with peak load pricing for tolls into the city. Smart cards could potentially allow sales taxes to be tailored to individual circumstances. Governments may choose not to take advantage of these technologies because they seem too intrusive, but to make informed decisions about technology usage, researchers need to quantify the gains in compliance costs. Most individuals, for example, are happy to allow websites to track their use and share data about them in exchange for conveniences such as automatic recognition and personalized service. The stakes are enormous, and most of the ideas unexplored.

FINANCIAL INNOVATION

Financial innovation has long been recognized as an important area of tax research. Notwithstanding, we still understand very little about its effects. This area may be perfect for accountants to study since it involves difficult empirical questions closely related to finance. Subtle interactions of the rules create opportunities and loopholes that economists are likely to miss. An analysis of financial instruments also requires a detailed knowledge of both the tax and financial reporting rules, and although lawyers may have a mastery of these rules they are unlikely to be equipped to handle these empirics. Accountants, sitting in the middle, might be best equipped to tackle these issues.

¹⁰ *Tax Notes* (2006).

Consider a few examples. One of the most studied areas of finance is corporate capital structure, and the choice of debt and equity levels. Various theories—trade-off, pecking order, and so forth—have been put forward to explain the use of debt or equity, but none has been satisfactory. Financial innovation changes the nature of the analysis. Firms have long been able to take features of debt or of equity and combine them to create new instruments, to the point where there is no longer such thing as a single debt-to-equity ratio. Instead, firms issue securities along a continuum that operates along several dimensions. For example, issuing additional debt may not increase the risk of bankruptcy, at least very much, if the debt has significant equity features, such as the ability to defer interest payments, or if the firm can force the holders to receive equity as repayment. Firms can also issue combinations of securities that together look different from each of the pieces. Some of the pieces may be readily observable and others may not, which means that standard observations of debt ratios may be faulty.

Credit default swaps are one of the fastest growing categories of financial instruments. It was recently reported that standard practice, even for very large transactions, is *not* to document the transactions. At first blush, this is astounding. A possible explanation for this practice is tax uncertainty: qualifying the instruments as swaps for tax purposes turns out to be very important if one of the parties to the transaction is foreign. Once the transaction is documented, however, firms are stuck with a particular characterization. Taxes, therefore, might be significantly affecting the operation of the large market.

SUMMARY

No one field has a monopoly, natural or otherwise, on contributions to research in taxation. By its very nature, the factors that influence the design of tax policy will come from multiple fields and be further complicated by political considerations. Ideas that are perfectly clear from an economic perspective may fail when administration and enforcement considerations are included. Each field—accounting, economics, and law—is an important element in any debate of any element of tax policy.

Modern tax research is increasingly aware of the comparative advantages of each field, as well as the benefits of integrated research. The publication of Scholes and Wolfson's (1992) text, and subsequent editions, along with the research it helped to motivate, contributed to the trend. While professionals from the various fields have long collaborated in the development of tax policy inside the Treasury Department and on Capitol Hill, the past two decades have seen an enormous and exciting expansion in the breadth of knowledge brought to bear in analyzing tax issues, as well as greater discussion among scholars from various fields.¹¹

Written law is subject to interpretation by those affected by it and, eventually, by the courts. Thus, tax policy must be clearly enunciated in the tax code. The accounting discipline, by having firm footing in both the institutional complexities of the tax law and in the foundations of economics, is in a particularly strong position to contribute to tax policy discussions by merging knowledge from all three disciplines. Future research, and future tax policy, will be the better for it.

¹¹ See Slemrod (2003) for a perspective on multidisciplinary tax research. More recently, the May conference of the National Tax Association devoted a session to the key factors multiple fields found important in analyzing a recent tax policy change. For summaries, see the papers by McClelland (2006), Mills (2006), and Plesko (2006) and the presentation by Potter (2006).

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