Empirical Analysis of Corporate Tax Reforms: What is the Null and Where Did It Come From?*

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Abstract

Absent theoretical guidance, empiricists have been forced to rely upon numerical comparative statics from constant tax rate models in formulating testable implications of tradeoff theory in the context of natural experiments. We fill the theoretical void by solving in closed-form a dynamic tradeoff theoretic model in which corporate taxes follow a multiple-state Markov process with exogenous rate changes. We simulate ideal difference-in-differences estimations, finding that constant tax rate models offer poor guidance regarding testable implications. While constant rate models predict large symmetric responses to rate changes, our model with stochastic tax rates predicts small, asymmetric, and often statistically insignificant responses. Under plausible parameterizations with decade-long regimes, the true underlying theory – that taxes matter – is incorrectly rejected in about *half* the simulated natural experiments. Moreover, tax response coefficients are actually smaller in simulated economies with larger tax-induced welfare losses.

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