Identifying tax losses entitled to full loss offsets in a business profits tax under the Domar-Musgrave risk model

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IT'S ESSENTIAL

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Abstract

An influential article by Evsey Domar and Richard Musgrave, published in 1944, argued that an efficient income tax ought to provide full loss offsets for losses suffered by investors subject to that tax. The basic argument was that by allowing full loss offsets, a tax system not only eliminated a bias against risky investments but also reduced the risk to private investors, making it more likely that they would make socially useful investments in risky ventures. In this context, a "loss offset" is an adjustment to a taxpayer's income equal to the amount of the loss multiplied by the tax rate. For example, if the tax rate is 30% and the loss is $1,000, the proper loss offset is $300.

The focus of the Domar–Musgrave model is on risk. One basic contention is that an income tax without full loss offsets provides an inefficient penalty to risky investments and a concomitant bias in favor of safe investments. It follows that loss offsets, for purposes of the Domar–Musgrave model, ought to be limited to losses resulting from risky investments gone sour. Domar–Musgrave defines "risk" as the probability of the actual yield on an investment being less than zero – that is, as the probability of a loss. By this definition, all losses are due to risks gone sour.

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In this paper, I argue that many categories of losses do not merit a loss offset under Domar–Musgrave, properly understood. One of the categories of losses that does not warrant loss offsets is the set of losses resulting from improper tax accounting. Flawed tax account rules may themselves be inefficient by treating taxpayers able to take advantage of the flawed rules more favorably than other taxpayers with equivalent real income. Allowing full loss offsets may exacerbate the inefficiency. Losses resulting from improper tax accounting rules probably account for a substantial percentage of all corporate losses, although I have not tried to compute the percentage.

I.   Introduction

An influential article by Evsey Domar and Richard Musgrave, published in 1944, argued that an efficient income tax ought to provide full loss offsets for losses suffered by investors subject to that tax.[1] The basic argument was that by allowing full loss offsets, a tax system not only eliminated a bias against risky investments but also reduced the risk to private investors, making it more likely that they would make socially useful investments in risky ventures.[2] In this context, a "loss offset" is an adjustment to a taxpayer's income equal to the amount of the loss multiplied by the tax rate. For example, if the tax rate is 30 per cent and the loss is $1,000, the proper loss offset is $300.

The taxpayer may obtain a loss offset by being allowed to deduct the amount of its loss from income otherwise subject to tax or by being allowed to "carry back" the loss to a prior taxable period, thereby becoming entitled to a refund of taxes previously paid. If the taxpayer does not have sufficient current or prior income to generate the full loss offset, then it would be entitled to a cash payment from the government in the amount of the otherwise uncompensated loss offset. Many tax systems allow taxpayers to deduct losses incurred in the current taxable year against income earned in a subsequent year. Such "loss carry forwards" would constitute only a partial loss offset in the Domar-Musgrave risk model because a deduction of a loss in the future is less valuable than a current deduction for that loss.

The focus of the Domar-Musgrave model is on risk. One basic contention is that an income tax without full loss offsets provides an inefficient penalty to risky investments and a concomitant bias in favor of safe investments. It follows that losses, for purposes of the Domar-Musgrave model, ought to be limited to losses resulting from risky investments gone sour. Domar-Musgrave defines "risk" as the probability

1   E D Domar and R A Musgrave, "Proportional Income Taxation and Risk-Taking", (1944) 58 *Quarterly Journal of Economics* 388.

2   The authors made clear that risk was not eliminated by the allowance of loss offsets but instead was shifted to the government: E D Domar and R A Musgrave, above n 1 at 410. That shift presumably is efficient because governments generally are better able to manage risk than individual investors.

of the actual yield on an investment being less than zero – that is, as the probability of a loss.[3] By this definition, all losses are due to risks gone sour.

The Domar-Musgrave article focused on investments in financial instruments.[4] In this paper, I address the loss issue with respect to a tax on business profits. In my view, losses on real investments, such as those typically undertaken by corporations, have many causes, only one of which is a risk gone sour.[5] I sidestep any discussion of the proper definition of losses on financial investments. My limited goal here is to distinguish losses that ought to qualify under Domar-Musgrave for offset treatment in a corporate income tax from losses that may not merit that treatment.

The basic rationale for loss offset can be illustrated with the following example. Assume that ACo, a corporate tax taxpayer, is contemplating two investments, a safe one and a risky one. The safe option offers a guaranteed rate of return of 4 per cent.[6] The risky option offers a rate of return of 10 per cent, but with 10 per cent risk of losing one-half of the investment. If ACo invests 1,000 ten times in the safe option, it will make total profits of 400. Assuming average luck, it will make the same amount if it invests 1,000 ten times in the risky option, making 900 on the nine winning investments and losing 500 on the failed investment.

In the absence of full loss offsets, the equivalence of the safe and risky options in the above example changes. Assume that ACo is subject to a corporate income tax of 50 per cent. On the safe investment, it now would earn 200 net of tax. The yield on the risky investment, however, would be negative 50 (450 – 500) without any loss offset. That is, it would receive 450 after-tax from the nine good investments and suffer a loss of 500 (50 per cent of 1,000) on the failed investment. If a full loss offset is provided, however, the safe and risky investments again have the same yield. The offset would

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3   E D Domar and R A Musgrave, above n 1 at 396.

4   E D Domar and R A Musgrave, above n 1 at 393.

5   As an aside, I note my deep scepticism that positive yields on real investments are merely compensation for risks incurred.

6   By a "safe" investment, I do not necessarily mean an investment with a guaranteed return. I simply mean an investment that is relatively safe. Domar and Musgrave assume that the return on an entirely riskless investment is "quite small or zero": E D Domar and R A Musgrave, above n 1 at 396-397, note 8. There is empirical support for this contention. See T R Chorvat, "Apologia for the Double Taxation of Corporate Income", (2003) 38 Wake Forest Law Review 239, (citing Ibbotson Associates, Stocks Bonds Bills and Inflation 1997 Yearbook 88 (1997) for the proposition that "the inflation adjusted risk-free rate of return from 1926–1996 was 0.6 per cent"). Domar and Musgrave ignore inflation adjustments in their analysis: E D Domar and R A Musgrave, above n 1 at 400 ("Losses or gains in the real value of cash, due to price changes, are excluded likewise, because the entire analysis is in terms of cash"). Thus, they treat cash holdings as riskless investments. I note without discussion my deep scepticism that business enterprises almost always have a yield approaching zero on their riskless investments, properly defined. I also note that a showing that the yield on fixed-rate bonds approaches zero after adjustment for inflation does not provide strong evidence that the risk-free return on those bonds approaches zero. Inflation adjustments are made after the fact, whereas the degree of risk is computed before the fact. The actual rate of inflation is not knowable when an investor purchases a bond, and actual inflation may not be a good proxy for estimated inflation.

give ACo a benefit of 250 (500 × 50 per cent), resulting in a net yield of 200 (250 loss offset – 50 loss). This example is summarised in the table below.

Illustration of neutrality between safe and risky investments resulting from loss offsets						
10 Investments (1,000 each)	No Tax, No Loss Offsets		Tax, No Loss Offsets		Tax, Loss Offsets	
	Safe (4%)	Risky (10%)	Safe (4%)	Risky (10%)	Safe (4%)	Risky (10%)
Yield, per good investment	40	100	20	50	20	50
Total yield on good investments	400	900	200	450	200	450
Yield on failed investment	NA	-500	NA	-500	NA	-250
Total yield on 10 investments	400	400	200	-50	200	200

NA   Not Applicable. The example assumes that 10 investments of 1,000 each are made in a safe venture and also in a risky venture, with the risky venture failing one time for a loss of half the investment (500). The safe venture has a yield of 4 per cent, and the risky venture has a gross yield of 10 per cent with a 10 per cent risk of a loss of one-half the value of the investment. The example assumes that the investment went sour in one of the 10 cases – that the probability of loss equaled the actual loss in the sample of 10 investments.

The example above illustrates the efficiency case for loss offsets in the Domar-Musgrave model. The argument is that without loss offsets, risky investments become less attractive than otherwise equivalent safe investments, resulting in an inefficient bias in favour of safe investments. In the real world, there may be no completely safe investments, so the substantive argument is that an income tax without loss offsets favours more risky investments over otherwise equivalent less risky investments. In the above simplified example, ACo simply would choose the less risky investment. Presumably, the market would adjust to the absence of loss offsets by providing for a higher pre-tax rate of return on risky investments. Thus, risky investments would continue to be made. The claim is made, nevertheless, that, all else equal, some risky investments that would have been made in a world without taxes would not be made.

The Domar-Musgrave model should not be understood as calling for offsets for all losses, although the authors of that model do not offer any exceptions to their call for full loss offsets. For example, if a company suffers a loss because the chief executive officer converted company assets to his own use, it can hardly be said to be inefficient for the government to decline to share in that loss. A critical initial step in making an efficiency case for loss offsets is to have a workable definition of losses that are entitled to an offset. In Part 2, below, I discuss which losses ought to qualify for loss offsets

under Domar-Musgrave, as applied to real investments made by corporations. In brief, I argue that only losses resulting from risks gone sour deserve full loss offsets.

Domar and Musgrave do not argue for loss offsets on fairness grounds. Their focus is entirely on efficiency grounds. They do suggest, nevertheless, that the government, by imposing a tax on profits, has implicitly made itself a partner in the businesses of its taxpayers. One might argue from this partnership analogy that a government acting fairly ought to share in the losses of a business venture if it is sharing in the gains by imposing a tax on business profits. This partnership analogy, however, is at best incomplete. Drawing on the discussion of losses provided in Part 2, I suggest in Part 3 that any fairness argument for full loss offsets based on the partnership analogy has quite limited force.

Commentators have frequently argued, based on the Domar-Musgrave model, that a government imposing a corporate income tax ought to offer full loss offsets. I argue in Parts 2 and 3 that the model can justify full offsets only for losses resulting from risks gone sour. I discuss briefly in Part 4 some policy implications of my position.

II.   Defining an allowable loss

As suggested in the introduction, a loss resulting from theft or other misbehaviour by the person suffering the loss should not be eligible for a loss offset on efficiency grounds. If the lack of a loss offset causes corporate managers to reduce their bad behaviour, so much the better. I give this example simply to make the point that the Domar-Musgrave model cannot be understood as applying to all losses. Only some subset of losses should be eligible for offsets. I do not suggest that a major percentage of corporate losses are due to misfeasance of the company managers. That some corporate losses are due to this cause, however, seems to me to be undeniable.

If it is agreed that some losses on real investments are due to causes other than risks gone sour, then full loss offsets for all corporate losses cannot be justified. The question then becomes: which losses should qualify for offsets? In addition to losses caused by misbehaviour by corporate managers, I suggest that there are at least two additional categories of losses that do not deserve offsets, both of which are discussed below. This list is intended to be illustrative rather than exhaustive.[7]

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7   I suspect that there is a category of losses that results primarily from the lack of harmony between the interests of corporate managers and the interests of the corporate owners. For example, managers might take a totally unwarranted bet with the funds of a corporation in the hope that they would benefit if the bet paid off. The huge losses incurred by US savings and loan banks in the 1980s have been explained in this way. Obviously, those losses resulted from a risk gone sour. A loss offset for such losses seems inappropriate, nevertheless, because the losses were the result of irresponsible actions of those managing the banks and were not the result of the inherent riskiness of the banking business.

A.   Artificial tax accounting losses

One of the categories of losses that does not warrant loss offsets is the set of losses resulting from improper tax accounting. Flawed tax account rules may themselves be inefficient by treating taxpayers able to take advantage of the flawed rules more favourably than other taxpayers with equivalent real income. Allowing full loss offsets may exacerbate the inefficiency. I am not addressing here, however, the possible efficiency costs of flawed tax accounting rules. My point is simply that a loss offset for a loss resulting from such rules cannot be justified under Domar-Musgrave because that loss did not result from a risk gone sour.

Losses resulting from improper tax accounting rules probably account for a substantial percentage of all corporate losses, although I have not tried to compute the percentage.[8] I offer three familiar examples to illustrate their importance.

The first example of an improper tax accounting rule often leading to a loss on the books of a taxpayer is accelerated depreciation. Accelerated depreciation may be defined as depreciation in excess of economic depreciation. It is available in many countries, and the tax savings resulting from it are very large. The tax savings – that is, the artificial losses – are often easy to predict. Tax shelter promoters do it all the time, guaranteeing certain artificial tax losses as part of their sales pitch.

The second reason for tax-accounting losses is improper capitalisation rules. Most tax systems do not require capitalisation of a lot of capital expenditures, especially the capital expenditures of new ventures. As a result, most new ventures tend to show tax losses even if the business is actually building value. For example, a new restaurant can be expected to show a cash-flow loss when starting up because it has not acquired the reputation needed for financial success. But the cash-flow losses are generally investments in the future, not money down the rat hole. Investments in the future, under proper tax accounting, should be capitalised.

A new venture, of course, may be risky, and losses from such a venture may properly be offset under the Domar-Musgrave model if they are the result of a risk gone sour. But the losses need to be measured properly before they merit an offset. A loss on the tax books is not a loss from a risk gone sour when the only reason for the loss is improper capitalisation rules.

A third reason for tax accounting losses is the improper allocation of expenses and gross income items between taxable domestic income and untaxed foreign income. Two of the expenses most commonly allocated improperly are interest payments and costs of research and development. The misallocation of these expenses is likely to be

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8   Some sense of the extent of losses resulting from improper tax accounting rules can be inferred from a study of 275 US multinational companies. According to that study, 82 companies – almost a third of the total – paid zero or less in federal income taxes in at least one year from 2001 to 2003 while earning $102 billion in pretax US profits according to their financial accounts: R S McIntyre and T D Coo Nguyen, Corporate Income Taxes in the Bush Years (Washington, DC: Citizens for Tax Justice and Institute on Taxation and Economic Policy, 2004) at 3.

a major reason that profitable multinational companies may show a tax loss. A related cause of artificial losses is the manipulation of transfer prices.

B.   Losses from incompetence

A second important category of business losses that do not deserve offsets under the Domar-Musgrave model are losses caused by the incompetence, stupidity, or gross carelessness of the taxpayer. Such losses are not related to the inherent riskiness of a venture but rather to the poor performance of the person suffering the loss. Allowing a loss offset would seem to reward incompetence; providing such a reward may not promote efficiency under the Domar-Musgrave model.

Although we may conclude that losses caused by the incompetence of the taxpayer are not the result of risks gone sour, we may have difficulty identifying such losses. Certainly some losses due to incompetence are Domar-Musgrave losses. Others are not. Sorting one from the other is not a trivial task.

For example, assume that a taxpayer seeks to build a toll bridge. The management hires engineers who have a solid reputation for competence and otherwise manages the project in accordance with industry standards. Yet, the engineers turn out to be incompetent, the bridge collapses, and the taxpayer suffers a loss. It seems to me that such a loss may be due to the inherent riskiness of selecting a competent engineering firm and is not necessarily due to the incompetence of the managers.

As a counter example, assume that management picks as its chief engineer for its bridge venture the brother-in-law of the CEO. That individual has little experience in bridge building and is disinclined to take good advice from others. He fails to do the normal engineering required for a safe bridge, and the bridge collapses. Is this a loss due to the inherent riskiness of building a bridge? I am inclined to say it is not – that it is a loss that should be borne by the taxpayer and not shared with the government. The loss does not come about because of the inherent riskiness of building a bridge but because of the incompetence, stupidity, or gross carelessness of the managers of the company.

Still, one might argue that the loss in the above example arose because the company managers were incompetent in hiring the chief engineer. Under that approach, one might argue that having incompetent managers is just one of the risks that a company faces in attempting to turn a profit. I think this latter argument is unpersuasive.

If two companies attempt to build a bridge and one succeeds and the other fails because the CEO knowingly hired an incompetent chief engineer, I think it strains the language to explain the failure as due to bad luck. Of course, if we define "risk" as "the probability of failure", we could include the probability of incompetence by the CEO as part of the calculation. At some point, however, I think it necessary to distinguish inherent risks from risks resulting from the possibility that the taxpayer, through its alter ego, the CEO, would act improperly.

The question then comes: How do we identify losses resulting from the inherent riskiness of a venture? One way to think about the matter would be to consider

how an insurance company would deal with particular risks. Would an insurance company insure a company against the loss suffered from the collapse of a bridge? If the possibility of loss were due to the inherent riskiness of the venture, I would expect that insurance would be available. I would not expect a CEO to be able to get insurance against the risk that he would hire his incompetent brother-in-law as chief engineer. More generally, I think insurance companies would be reluctant to write an insurance policy that would protect a company from the gross mismanagement or gross incompetence of the CEO.

I am not offering any bright-line test for separating Domar-Musgrave losses from incompetency losses. My insurance analogy is just a suggested way of thinking about the problem. My only firm point is that some real losses arising from the operation of a business are not due to the inherent riskiness of virtually all business ventures. If I am correct, then losses in this category do not merit an offset under the Domar-Musgrave model.

III. The government as business partner

In their classic article on risk, Domar and Musgrave repeatedly invoke the analogy of the government as a partner to the investor. They state:

> In other words, full loss offset means that whenever the investor suffers a loss, the Treasury reimburses him for a fraction of the loss equal to the tax rate. The Treasury thus becomes a partner who shares equally in both losses and gains.[9]

For Domar and Musgrave, the analogy is descriptive rather than normative. They are using the analogy to explain the effect of their proposal for full loss offsets. Informal discussions to the Domar-Musgrave model, however, seem to suggest a normative quality to the analogy. The idea seems to be that it is fair for the government to grant loss offsets because the government has made itself a partner in the business of the taxpayer and ought to be willing to take the good with the bad.

I suggest that a case for loss offsets cannot be made based on the analogy of the government as partner. The analogy is fine for the limited purposes used by Domar and Musgrave. But that analogy cannot be pushed very far, for it is inherently flawed. In no real sense can the government be viewed as a partner to its taxpayers. Moreover, even if it were treated as a partner, it would not be required under partnership principles to give full loss offsets.

That the government is not an ordinary business partner of its business taxpayers is obvious. Real partners in a business have shared control of the business. Each of them can enter contracts that bind the other, and each can force dissolution of the business and a sharing of its assets. A government, by imposing a tax on business profits, does not thereby gain operating control of the businesses subject to the tax. The government has no ability to prevent the operators of a business from making bad decisions. If those bad decisions result in losses to the business, it seems odd to

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9   See, eg E D Domar and R A Musgrave, above n 1 at 409.

suggest that the government has an obligation to share in those losses. The Domar-Musgrave model offers an efficiency argument for the government sharing in the business losses of its taxpayers, but that argument is not based on their description of the government-business relationship as a partnership.

Instead of viewing the government as a general partner in a business, it might be more realistic to view it as a limited or silent partner. A limited partner typically puts up some capital for the business but has no management control of the business under normal circumstances. This analogy is somewhat less forced than the analogy of the government as general partner because it implicitly acknowledges that the government has no management control of the business. Still, the analogy has little force, for the differences between a real limited partnership and the relationship between the government and a business taxpayer are substantial.

One example of a difference between a real limited partnership and the government's relationship with a taxpayer is that the government is not an investor in the business of the taxpayer. Another difference is that the government has no partnership rights to the assets of the taxpayer, aside from any rights arising from a failure to pay taxes due. In addition, if the business pays foreign taxes, those taxes reduce the government's share of the business profits, although a real limited partner would never agree to such a result.

Even if the limited-partnership analogy were more robust, it would not provide any ground for allowing loss offsets – that is, for the government to share in the losses of the business. A distinctive characteristic of a limited partnership is that the limited partner is not subject to the losses of the business in excess of its investment in the business. The government, however, does not make an investment in a business when it imposes tax on that business; the limitation on its potential losses would be zero under partnership principles. As a result, the government would not be liable for any net losses if the analogy to a limited partnership were taken seriously.

As an alternative to the partnership analogy, I have offered a competing analogy in which the government is viewed as an entrepreneur offering businesses the use of an infrastructure controlled by the government and a marketplace that it regulates. Under this model, a profits tax is a payment by businesses for use of the infrastructure and market owned by the people and operated for them by their agent, the government. The government, as entrepreneur, has no obligation to provide loss offsets. If it chooses to do so, it would be for the type of efficiency gains suggested in the Domar-Musgrave model, not because allowing such offsets is required under a fairness standard.

The fairgrounds analogy. An entrepreneur obtains land and constructs a fairgrounds, with booths for corporations wishing to sell goods to the people attending the fair. It invests $100,000 to prepare the fairgrounds and to present the entertainment necessary to attract visitors. It spends an additional $50,000 preparing 20 booths, which it makes available to corporations for a fee. The fee is a percentage of the profits earned by the corporations at the fairgrounds.[10]

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10   For an elaboration of this example, see M J McIntyre, "Thoughts on the Future of the State Corporate Income Tax" (2002) 25 State Tax Notes 931 at 933-934 (23 September 2002).

In this example, our entrepreneur probably would not be expected to offer loss offsets for companies that suffered losses at the fairgrounds. Even if it decided, for competitive reasons, to offer some loss offsets, it seems highly likely that it would not offer offsets for artificial tax accounting losses or for losses traceable to incompetent or grossly negligence behaviour of the fee-payers. Nor would it offer loss offsets resulting from the theft or misfeasance of employees of the fee-payers. At the most, the entrepreneur might act as an insurer for its fee-payers, offering to share some portion of losses due to pure risk, such as the risk of a major storm. It might do so because it would be better situated to take out insurance or otherwise bear the risk of loss than the individual fee-payers.

The above analogy is just that – an analogy. It is a far more robust analogy, however, than the government as partnership analogy because the players in the "fairgrounds" analogy play roles that have some functional relationship to the roles played by a government imposing a profits tax on businesses. The analogy suggests that loss offsets are not required in a market economy in which economic players are required to compensate the government for the resources put at their disposal. It also suggests that loss offsets offered to reduce the risks to taxpayers should include the types of limitations suggested in Part 2, above.

IV.   Some policy implications

The Domar-Musgrave model received justifiable praise for increasing our understanding of the impact of an income tax with full loss offsets on shifting risk from taxpayers to the government. Subsequent authors have clarified, refined, extended, and even caricatured that model. Some authors have suggested that the model is relevant in choosing between an income tax and a consumption tax.[11] One commentator has made a convincing argument that the model explains why a classical corporate income tax is more efficient that most alternative revenue sources available to a government, despite the widespread attacks on that tax from many quarters on efficiency grounds.[12]

Most discussions of the Domar-Musgrave model have taken as an implicit or explicit assumption that the model would justify loss offsets in a corporate income tax for just about any loss suffered by a corporation. The discussion in this paper is intended to cast some doubt on that assumption.

Unfortunately, there is no easy way to separate losses that ought to qualify for offsets under the analysis provided above from those losses that should not qualify. Model builders may feel comfortable simply assuming that artificial losses generated by improper tax accounting rules have been eliminated through reform of those

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11   See, eg J Bankman and T Griffith, "Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter?" (1992) 47 Tax Law Review 377. See also A C Warren, Jr, "How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax?" (1996) 52 Tax Law Review 1.

12   See T R Chorvat, above n 5.

rules. Those responsible for designing a practical tax system do not have that option. Artificial tax losses probably account for a majority of losses reported on corporate tax returns in many countries. Losses arising from the malfeasance or incompetence of the taxpayer are probably less common, but they are common enough to require caution in recommending full loss offsets.

Obviously, the best way to deal with losses resulting from flawed tax accounting rules is to reduce those losses by reforming the tax accounting rules. Such reform, unfortunately, is a challenge because of the political popularity of those rules. A second-best approach might be to allow taxpayers to employ the flawed rules generally but to require them to segregate the tax benefits resulting from those rules in a separate account and to deny loss offsets for losses resulting from those tax benefits. This approach presents significant complexity for taxpayers and the government.

Denying loss offsets for losses resulting from the incompetence or malfeasance of the taxpayer cannot be done, at least directly, without some mechanism for identifying those losses. I see no easy way to identify such losses absent detailed audits of every taxpayer claiming a loss. Even detailed audits are not enough to solve the problem. In many cases, losses resulting from incompetence or malfeasance are likely to be mixed together with losses resulting from risky ventures turned sour – the category of losses for which loss offsets are justified under the Domar-Musgrave model. Taxpayers, if they chose to do it, should be able to comminute losses into those resulting from pure risks and those resulting from taxpayer malfeasance or incompetence. They have little incentive to do so accurately, however, and the ability of the government to police abuses in this area is fairly limited.

If a government cannot effectively sort out losses that warrant full loss offsets from those that do not, it should not provide full loss offsets. In no event should the government offer cash awards for undifferentiated losses, since the possibility of taxpayer fraud in such circumstances would be large. Nor should it allow loss carrybacks or carryforwards for an extended period. Allowing taxpayers a long carryback period (more than two years) when some of the losses potentially do not deserve loss-offset treatment would give an unwarranted advantage to established firms. In addition, a company that needs a long carryforward period (more than 10 years) to utilize its losses is more likely than not to have losses generated by improper tax accounting rules. Companies obviously can experience real losses, but a company that records losses year after year is unlikely to be suffering from losses that have resulted from being unlucky. Any particular company could have a long string of bad luck, to be sure. But such cases are likely to be in a decided minority.

The underlying intuition justifying the loss offset limitations proposed above is that a company that experiences losses year after year is likely to be a company that is incompetent or is enjoying paper losses generated by improper tax accounting rules. Of course, the intuition may be wrong and is certainly not fully supported. Still, it does seem to me to be the way to bet. If the intuition is right, then a government would be well advised to be cautious in allowing full loss offsets. If it can develop techniques for separating "deserving" losses from "undeserving" loss, all to the good.

A blanket allowance of full loss offsets, as advocated by many commentators, strikes me as unsupportable under a proper application of the Domar-Musgrave model.