Corporate Taxation and Carbon Emissions[†]

Luigi Iovino Thorsten Martin Julien Sauvagnat

April 20, 2022

Abstract

We study the relationship between corporate taxation and carbon emissions in the U.S. We find that dirty firms pay lower profit taxes – the opposite of what optimal taxation of negative externalities prescribes. This relationship is driven by dirty firms benefiting disproportionately more from the tax shield of debt due to their higher leverage. In turn, we show that the higher leverage of dirty firms is explained by their higher asset tangibility. We embed our estimates into a general equilibrium framework and show that eliminating the tax-advantage of debt reduces carbon emissions by about 3.9%, while aggregate output falls by roughly 2.2%.

Keywords: Corporate Taxes, Carbon Emissions.
JEL Codes: H32, Q58.

[†]All authors are at Bocconi University. Contacts: luigi.iovino@unibocconi.it, thorsten.martin@unibocconi.it, julien.sauvagnat@unibocconi.it. We thank conference participants at the DNB Annual Research Conference 2021, EEA 2021 Congress, and European Winter Meetings of the Econometric Society 2021, as well as seminar participants at HEC Paris, UC Irvine, and Paris School of Economics. We thank Fondation Banque de France for funding, and Gabriele Confalonieri for excellent RA work.

1 Introduction

Carbon dioxide (CO_2) emissions represent the quintessential negative externality. A central tenet of economic theory is that individual decisions tend to be inefficient in the presence of externalities: left free to pollute, households and firms are likely to cause environmental damage and welfare loss. The classical response to restore efficiency is to impose a Pigouvian tax on carbon emissions or an equivalent quantity-capping mechanism, such as a cap-and-trade market. A well-designed policy re-aligns the price of carbon emissions with their social cost.

In practice, currently only 20% of global carbon emissions are covered by some form of climate-change regulation (World Bank, 2018), and even in the regions where regulation exists carbon prices are typically well below the estimated social cost. To make things worse, researchers and policymakers typically argue that optimal regulation requires a global coordination. A local intervention, the argument goes, would only reduce the competitiveness of domestic energy-intensive industries, pushing firms to relocate to less regulated regions, without any sizable reduction in global emissions.

Carbon bias of corporate taxation. In the absence of an explicit tax on carbon emissions, tax codes may still discourage pollution by taxing it indirectly. For example, if polluting firms are capital intensive, then a tax on capital will also be an implicit tax on pollution. In this paper, we document that this is not the case. In fact, we find the opposite: Dirty firms pay, on average, *lower* taxes. Thus, our analysis shows that corporate taxes *subsidize* pollution.

To reach this conclusion, we relate profit taxes to carbon intensity. Our analysis focuses on the U.S., from 2004 to 2019. We obtain firms' direct (scope 1) carbon emissions from Trucost and link it to accounting data from Standard & Poor's Compustat. In our baseline specification, we regress taxes (scaled by sales) on carbon emissions (also scaled by sales) in the cross-section of firms. We find that 1 tonne of carbon is associated with around 5 USD lower taxes.

The mechanism. Having documented a negative relationship between corporate taxes and carbon emissions, we turn to its determinants. We show that it is almost entirely attributable to the tax shield from debt financing. More specifically, many corporate tax systems—including the U.S.

one—allow firms to deduce interest expenses from profit taxes. A measure of the tax shield that a firm enjoys is thus given by the firm's interest expenses multiplied by the statutory corporate tax rate faced by the firm depending on the (domestic and international) location of its activities. We provide evidence that the tax shield of debt benefits dirty firms disproportionately. What is more, there is no significant relationship between carbon intensity and the hypothetical taxes that firms would pay in the absence of the tax shield.[1]

Why is it that dirty firms can take more advantage of the tax shield of debt? Dirty firms, our analysis shows, tend to have a higher leverage (i.e. debt over sales). At the same time, they do not pay a higher cost for borrowing, nor locate their activities in countries or U.S. states with lower tax rates. Since the tax shield of debt equals the product of interest expenses and statutory tax rates, it follows that dirty firms' higher tax shield—and the negative relationship between taxes and carbon emissions—is fully accounted by the higher leverage of these firms. Thus, dirty firms borrow more, deduct higher interest expenses and pay lower taxes.

We are left to study why dirty firms can sustain a higher leverage. Our analysis shows that asset tangibility is the key driver of differences in borrowing across firms. The fact that firms with more tangible assets can sustain a higher leverage is consistent with a large body of work in corporate finance studying the determinants of leverage across firms, industries and countries (see, e.g., Titman and Wessels (1988) and Rajan and Zingales (1995)). The novelty of our analysis is to uncover the strong positive correlation between asset tangibility and carbon emissions: Dirty firms own more tangible assets on average. In fact, once we control for the asset tangibility of dirty firms, both the positive correlation between carbon intensity and leverage, and the positive correlation between carbon intensity and the tax shield vanish.

Our estimates are economically large. To appreciate their economic significance we compute the implicit carbon subsidies associated to the existing U.S. corporate taxation scheme. We find them to range around 30 billion USD—an amount of similar magnitude to the carbon-pricing revenues raised by governments worldwide in a given year. Our analysis, therefore, uncovers a quantitatively important channel through which corporate taxation impacts carbon emissions—a channel that has been so far overlooked both in the academic literature and by policymakers.

[1] Hypothetical taxes are obtained by adding our measure of the tax shield to the actual taxes paid by firms.

The model. To properly quantify the effects of corporate taxes on emissions as well as to study the implications, for emissions and macroeconomic variables, of alternative tax systems, we build a general-equilibrium model where production generates carbon emissions. To be consistent with our empirical findings, the model incorporate three key features. First, firms belong to different industries, which differ along two dimensions: tangible-capital intensity and carbon intensity. Second, firms are subject to a financial friction linking tangible capital to leverage. This reduced-form assumption is consistent with (and implied by) many theories of financial frictions that assume asymmetric information between borrowers and lenders (e.g. Tirole (2010)). By impairing firms' ability to pledge future income, such frictions give rise to borrowing constraints; in this context, collateral (e.g. tangible capital) allows firms to ameliorate the asymmetric information problem and relax borrowing constraints. Finally, the model must consider general-equilibrium forces: taking into account the endogenous response of prices in all markets is crucial for assessing the total effects of taxes on output and emissions.

In addition to the aforementioned features, we allow for a rich input/output network structure into the model. The motivation for this assumption is that the most carbon-intensive sectors (e.g. energy production) are used both as a final good and as an intermediate good by other sectors. Abstracting from input/output linkages may thus hide important general-equilibrium forces of taxation, leading to incorrect conclusions. More specifically, we consider two types of input/output networks. First, firms in any given sector can use production from all other sectors as an intermediate input—this is the standard intermediate-goods network. Second, capital goods are produced by combining goods from all sectors—this is the investment network studied in Lehn and Winberry (2020). In fact, we consider three types of capital (i.e. structures, equipment and intangibles); there will be, therefore, an investment network for each type of capital.

Policy counterfactuals. We use the model to simulate a counterfactual economy in which firms cannot deduct interest expenses from their tax base. The policy reform raises firms' user cost of capital. As a result, firms optimally scale down their production capacity, reducing output and emissions. The model provides an estimate of both aggregate and sector-level effects of the tax reform. In particular, aggregate output and consumption in the counterfactual economy are, respectively, 2.18% and 1.82% lower. The reduction in aggregate output is accompanied by a decrease in total emissions of 3.91%.

To understand why the fall in emissions is much larger than the fall in output, we need to consider the sector-level impact of the tax reform. Consistent with our empirical analysis, in the model the tax shield of debt favors more polluting sectors, whose production technology requires more tangible capital. Following the proposed reform, therefore, firms in dirty industries experience a relatively higher increase in the user cost of (tangible) capital and, as result, scale down production by a larger extent. There is thus a positive correlation between an industry's emission intensity and the reduction in its output once the tax shield is removed. This correlation is responsible for the substantial decrease in total emissions.

Related Literature. To the best of our knowledge, this paper is the first to document an association between corporate taxation and firms' carbon emissions, and the first that quantifies the environmental consequences of counterfactual corporate taxation systems. To that end, we combine insights from the theoretical literature on environmental economics (Bovenberg and Goulder, 1996; Acemoglu, Aghion, Bursztyn, and Hémous, 2012; Golosov, Hassler, Krusell, and Tsyvinski, 2014) with the production network literature (Liu, 2019; Baqaee and Farhi, 2020; Bigio and La'O, 2020). King, Tarbush, and Teytelboym (2019); Baylis, Fullerton, and Karney (2013, 2014) study the implications of carbon pricing in multi-sector economies. King, Tarbush, and Teytelboym (2019) show that raising carbon taxes on central sectors allows to obtain larger reductions in aggregate carbon emissions.

Our findings contribute to a large body of empirical work on the environmental consequences of taxation, such as carbon taxes (see e.g. Bruvoll and Larsen, 2004; Andersson, 2019; Metcalf and Stock, 2020), energy taxes (Parry and Small, 2005) and import tariffs (Shapiro, 2020), and to the literature on the incidence of corporate taxation. While earlier work has focused on the effect of corporate taxes on shareholders (Harberger, 1962; Auerbach, 2006, for a review), more recent studies have estimated the impacts on workers (Fuest, Peichl, and Siegloch, 2018; Suárez Serrato and Zidar, 2016), business reallocation (Giroud and Rauh, 2019), and consumer prices (Baker, Sun, and Yannelis, 2019). We are to the best of our knowledge the first paper to focus on the consequences of corporate taxation for firms' carbon emissions.

We also add to a fast growing literature in climate finance (see e.g. Giglio, Kelly, and Stroebel, 2021, for a review). A series of recent work in asset pricing studies the role of financial markets in affecting the cost of capital of clean versus dirty firms. In that vein, Bolton and Kacperczyk (2021b), Bolton and Kacperczyk (2021c) and Hsu, Li, and Tsou (2020) estimate the risk premium on stocks associated to firms' carbon and toxic emissions whereas Baker, Bergstresser, Serafeim, and Wurgler (2022) and Zerbib (2019) focus on the pricing of green bonds. Piazessi, Papoutsi, and Schneider (2021) shows that ECB bond purchases favor firms with more tangible capital and carbon emissions. Bolton and Kacperczyk (2021a) find that carbon emissions disclosure lowers firms' cost of capital. Chava (2014) document that firms with poor environmental policies have higher cost of capital. Other work in corporate finance sheds light on a series of determinants of firms' pollution, such as limited liability (Akey and Appel, 2020), mandatory carbon disclosure (Jouvenot and Krueger, 2021), countries' financial development (De Haas and Popov, 2020), financial constraints (Kim and Xu, 2021; Bartram, Hou, and Kim, 2022), ownership structure (Shive and Forster, 2020), institutional ownership (Dyck, Lins, Roth, and Wagner, 2019), and investors' activism (Akey and Appel, 2021). Compared to these papers, our contribution is to study the consequences of the tax advantage of debt for carbon emissions.

Our work has important policy implications. While a Pigouvian tax on all carbon emissions would be an efficient solution to address climate change, its implementation is facing significant political constraints.[2] In a world with or without carbon tax, our results indicate that corporate taxation acts today indirectly as an important subsidy on firms' carbon emissions, and as such matters for climate change. Previous work have discussed the distortions driven by the differential tax treatment of debt versus equity (e.g King, 1974; Stiglitz, 1973; Boadway and Bruce, 1984; Devereux and Freeman, 1991).[3] In that vein, we are the first paper to show that the current tax advantage of debt financing over equity financing is implicitly subsidizing pollution, and to quantify

[2]See for instance Klenert, Mattauch, Combet, Edenhofer, Hepburn, Rafaty, and Stern (2018) for a review of the political obstacles to environmental policies, and Douenne and Fabre (Forthcoming) for survey evidence on individuals' negative attitudes towards carbon pricing in France.

[3]The tax deductibility of interest payments exists in corporate taxation schemes in virtually all countries. Some countries introduced an Allowance for Corporate Equity (such as Croatia (1994), Brazil (1996), Italy (1997), Austria (2000), Belgium (2006) and Portugal (2010)), which consists in granting to equity a similar tax deductibility than to debt.

the environmental consequences of harmonizing the tax treatment of debt and equity in a general equilibrium model. In that respect, our work suggests that the design of corporate taxation might be a relevant policy instrument for affecting global carbon emissions, and is informative about the consequences of recent tax reforms.[4]

2 Empirical Evidence

2.1 Data

We combine five main sources of data: firms' financial information from Compustat Northamerica Fundamentals, firms' carbon emissions from Trucost, the location of firms' heaquarters and establishments within the U.S. from Infogroup, the location of U.S. multinationals' activities across countries from Factset, and statutory corporate tax rates across U.S. states and across countries from the Tax Foundation. We present them in turn.

2.1.1 Firm-level Financial Information

We obtain balance sheet and income statement data for all firms headquartered in the U.S. from Compustat Northamerica Fundamentals Annual for the years 2004-2019. For our purposes, we retrieve information on firms' sales (Compustat item SALE), taxes paid on their profits (Compustat item TXPD), interest payments (Compustat item XINT), operating income (Compustat item EBITDA), debt (the sum of short-term and long-term debt, Compustat item DLC+DLTT), and property, plant, and equipment (Compustat item PPENT). We measure firm age as the difference between the current year and the year founded, using information from Jay Ritter's website. If the year founded is missing, the first year in Compustat is taken instead.

[4]The passage of the 2017 Tax Cuts and Jobs Act in the U.S. was associated with a large reduction in corporate tax rates. See also the G7 current discussions about corporate taxation of multinationals, which represent a large fraction of carbon emissions worldwide.

2.1.2 Firm-level Carbon Emissions

We merge the accounting data to firm-level direct (scope 1) carbon emissions from Trucost using the CUSIP identifier.[5] In our baseline sample we focus on firms with non-missing emissions data in Trucost in a given year. As shown in Figure A.1, coverage in Trucost has increased over time. In 2018, we observe carbon emissions for around 65% of Compustat firms, which represent more than 80% of total assets of publicly listed firms. Aggregate emissions in Trucost for Compustat firms equal around 2 gigatonnes of carbon dioxide equivalent in 2018, that is around 40% of total emissions generated by the private sector in the United States. Our main variable of interest is carbon intensity, defined as the ratio of firms' carbon emissions over their sales (expressed in 2019 USD). Due to the different reporting standards for financial institutions, we exclude financial firms (with 2-digit SIC codes 60 to 69). We further restrict the baseline sample to firms with at least 10 mn USD sales.[6]

2.1.3 Location of Firms' Operations and Firm-level Tax Rates

Infogroup. We exploit information gathered by Infogroup to identify firms' headquarter state location as well as the employment and sales for each of their domestic establishments. In our sample, 45% of firms' U.S. employees are located in different states than firms' headquarters. Infogroup contacts establishments by phone and collects data, among other things, on sales and the number of full-time equivalent employees.[7]

Factset. We use Factset to obtain the distribution of U.S. multinationals' foreign sales across countries. This is another important source of information for our purposes given that firms in our sample realize around 25% of their sales abroad. Together with information on the domestic

[5] Firm-level carbon emissions data are assembled by various data providers. All these providers follow the Greenhouse Gas Protocol that sets the standards for measuring corporate emissions. Trucost is the data provider with the broadest coverage, covering more than 15,000 firms and 95% of market capitalization globally (Trucost, 2019). Correlations across data providers are on average 0.99 and 0.98 for reported scope 1 and scope 2 emissions respectively, but considerably lower for estimated data and scope 3 emissions (Busch, Johnson, and Pioch, 2018). In untabulated tests we confirm that our baseline results hold when using data from Thomson & Reuters instead.

[6] Including firms with sales below 10 million (less than 2% of firms with available data on carbon emissions) would introduce extreme values in the distribution of firms' carbon intensity. Our results are not sensitive to the choice of the cutoff.

[7] In contrast, Compustat records only the current and not the historical location of each firm's headquarter, and does not provide information on the location of a firm's establishments.

location of firms' activities from Infogroup, this allows us to measure properly the average statutory tax rate that each firm faces depending on the location of its operations both across States within the U.S. and across foreign countries for U.S. firms with activities abroad.

U.S. States and international corporate tax data. For state-level corporate tax records, we take the data shared by Giroud and Rauh (2019) and Baker, Sun, and Yannelis (2019). They construct the dataset using information mainly from the Tax Foundation; we extend their data until 2019. Firms are taxed in every state in which they have a physical presence. Most states tax corporate activities through profits. The exceptions, as of 2021, are Nevada, Ohio, Texas, and Washington, which levy a gross receipts tax based upon firms' revenues rather than income; importantly for our purposes, in these states interest expenses are not tax-deductible. We complement the data with similar corporate tax records for each foreign country.[8] The data covers the same sample period and is also obtained from the Tax Foundation.

Firm-level exposure to corporate tax rates and the value of the tax shield. To construct a precise measure of corporate tax rates at the firm level, we first exploit information from Infogroup on employment counts (denoted Emp below), sales and state location of firms' establishments within the U.S. Formally, let us define the domestic weight of U.S. state s in year t for firm f:

$$\omega_{s,t}^{f,US} = \frac{1}{2} \cdot \frac{Emp_{s,t}^{f,US}}{\sum_{s \in US} Emp_{s,t}^{f,US}} + \frac{1}{2} \cdot \frac{Sales_{s,t}^{f,US}}{\sum_{s \in US} Sales_{s,t}^{f,US}}, \tag{1}$$

with $\sum_{s \in US} \omega_{s,t}^{f,US} = 1$.

Similarly, we use information from Factset on sales by country of U.S. multinationals, if any. Formally, for firms with positive foreign sales, let us define the weight of country c in the foreign

[8] Almost all countries allow firms to deduct interest payments against taxable earnings, though a series of countries have recently implemented caps on the amount of the debt tax shield firms can benefit from. For instance, in the United States from 2018, Section 163(j) limits interest expense to 30 percent of a group's earnings before interest, taxes, depreciation and amortization (EBITDA). See https://www.oecd.org/tax/beps/corporate-tax-statistics-database.htm for data on interest limitations rules across countries.

sales of firm f in year t:

$$\omega_{c,t}^{f,Foreign} = \frac{Sales_{c,t}^{f,Foreign}}{\sum_{c \notin US} Sales_{c,t}^{f,Foreign}}, \tag{2}$$

with $\sum_{c \notin US} \omega_{c,t}^{f,Foreign} = 1$.

We then compute the weighted-average statutory tax rate that U.S. firms face in each year using the following formula:

$$\tau_{f,t} = \omega_{US,t}^{f}(\tau_{fed,t} + \sum_{s} \omega_{s,t}^{f} \cdot \tau_{s,t}) + (1 - \omega_{US,t}^{f})(\sum_{c} \omega_{c,t}^{f,Foreign} \cdot \tau_{c,t}), \tag{3}$$

where $\tau_{f,t}$ is the corporate tax rate faced by firm f in year t, $\omega_{US,t}^{f}$ is the share of firm f's domestic sales[9], $\tau_{fed,t}$ is the U.S. federal tax rate in year t, $\tau_{s,t}$ is the corporate tax rate of U.S. state s in year t, and $\tau_{c,t}$ is the tax rate of foreign country c in year t. We set $\tau_{s,t}$ to 0 for states with a gross receipts tax.

Finally, we use $\tau_{f,t}$ to compute the value of the tax shield, i.e. the amount of taxes that firms can save by deducting interest payments to debtholders. Using the formula above, we have:

$$Tax\ Shield_{f,t} = Interest\ Payments_{f,t} \cdot \tau_{f,t}. \tag{4}$$

2.2 Descriptive Statistics

Table 1 shows summary statistics for our sample, which consists of 13,675 Compustat firm-year observations between 2004 and 2019 for which we observe both carbon emissions and financial information. We measure carbon intensity as the ratio of firms' carbon emissions over sales. The average firm in our sample emits 0.23 tonnes of carbon per 1 thousand USD sales. The distribution of carbon intensity across firms is skewed, with a median of 0.02 tonnes of carbon and a 99th percentile of 4.7 tonnes of carbon per 1 thousand USD sales.

Consider now the corporate taxes faced by U.S. publicly listed corporations. Firms in our sample paid on average 2.4% of their sales in taxes over the period 2004-2019. When we compute

[9] Formally using the same notations as above, $\omega_{US,t}^{f} = \frac{\sum_{s \in US} Sales_{s,t}^{f,US}}{\sum_{s \in US} Sales_{s,t}^{f,US} + \sum_{c \notin US} Sales_{c,t}^{f,Foreign}}$.

the statutory tax rate faced by firms in our sample using the formula (3), we find an average of around 35%. When we compute the tax shield of debt financing using the formula (4), we find that firms enjoyed a tax shield of around 1% of their sales—a sizable amount when compared to the profit taxes that they paid.

Finally, as shown in the lower panel of Table 1, the average firm in our sample is large, with sales of around 11 bn USD.[10] The average firm is 47 years old, generates around 25% of its sales abroad, has an operating profit margin of around 15%, an average stock of debt (respectively, property, plant and equipment) equivalent to 53% (respectively, 56%) of their sales, and pays an interest rate of around 6.7% on its debt (measured by dividing interest expenses by beginning-of-period debt).

[INSERT TABLE 1]

2.3 Corporate Taxes and Carbon Emissions

We now turn to the relationship between corporate taxes and carbon intensity. In our baseline specification, we estimate the following OLS regression at the firm-year level from 2004 to 2019:[11]

$$Taxes/Sales_{i,t} = \beta \times Carbon/Sales_{i,t} + \gamma_t + \gamma_{s,t} + \epsilon_{i,t}, \tag{5}$$

where $Taxes/Sales_{i,t}$ is the firm-level ratio of taxes over sales, $Carbon/Sales_{i,t}$ is the ratio of carbon emissions over sales of firm i in year t, and γ_t are year fixed effects.[12] We further include basic controls for firm size, firm age, the share of foreign sales, and more importantly firm profitability in augmented specifications, in order to estimate the correlation between carbon emissions and taxes paid for firms with the same level of profits. Finally, we also include headquarter state-year fixed effects $\gamma_{s,t}$ in some specifications, in which case the correlation between taxes paid by

[10]The average firm in our sample is larger than the average firm in Compustat. This is due to the fact that information on carbon emissions are more likely to be available for the largest firms in the economy.

[11]In equation 5, we use taxes as the dependent variable and carbon intensity as the independent variable. As shown below, this allows us to obtain from the coefficient β the dollar subsidy on carbon emissions implied by corporate taxation. Alternatively, one could consider a specification in which carbon intensity is regressed on the profit taxes paid by U.S. corporations. In that vein, note that we will study the implications of changes in corporate taxation policies on aggregate carbon emissions through a general equilibrium model in Section 3.

[12]In robustness tests presented in the Online Appendix, we use the log of the carbon/sales ratio as independent variable to address the concern that the distribution of carbon intensity across firms is right-skewed. We find similar, if anything larger, magnitudes for the estimates.

corporations and their carbon emissions is estimated within groups of firms subject to the same statutory corporate tax rate in the state of their headquarter.[13] We cluster errors at the 2-digit SIC industry level to account for serial correlation in $\epsilon_{i,t}$ across firms of the same widely-defined industry.[14]

Note that one can interpret the estimated coefficient β in equation (5) as the implicit carbon tax implied by corporate taxation (or carbon subsidy when $\beta < 0$), expressed in dollars per tonnes of carbon. To clarify this point further, consider the following example. Take two firms; firm A operates in an emission-intensive industry (say, manufacturing) and emits 1,000 kilo tonnes of carbon to produce goods and generate sales of 1 billion USD; firm B operates in an emission-free industry (say, business services) and generates sales for the same amount. Suppose we were to estimate $\beta = 10$ in equation (5). We would then conclude that firm A in the emission-intensive industry pays more corporate taxes than firm B, that is, the corporate taxation system contains an implicit tax of 10 dollars for each tonne of carbon emitted. Our analysis will not only document the difference in taxes paid by firm A and firm B; in Section 2.4, we will also isolate empirically the firm characteristics that explain the difference in taxes paid between the two firms.

[INSERT TABLE 2]

Table 2 presents the results for the relationship between carbon emissions and corporate taxes. Columns (1) to (3) show the relationship in unweighted regressions, whereas columns (4) to (6) present the estimates in regressions weighted by firm size. In columns (2), (3), (5), and (6), we add controls for firm size, age, the share of foreign sales and profitability. Finally, we include state-year fixed effects as a first pass to control for state-level variation in statutory tax rates across firms in columns (3) and (6). The point estimate for β is similar across specifications, ranging between -4.4 and -6.6, and is always statistically significant at the 1%-level. If anything, the magnitude is larger in weighted specifications. Note also that the point estimate is similar when we add controls for firm size, age, the share of foreign sales, and more importantly for firm profitability, which is unsurprisingly a significant determinant for profit taxes. Overall, our results indicate that the

[13] For studies looking at the effect of corporate tax rates on firms' outcomes, see e.g. Heider and Ljungqvist (2015); Ivanov, Pettit, and Whited (2020); Titman and Wessels (1988); Graham (1996); Faccio and Xu (2015).

[14] By clustering standard errors at the industry level, we obtain more conservative t-statistics compared to specifications in which the error term is clustered at the firm level.

negative relationship we uncover in Table 2 is not driven by differences in profits between clean and dirty firms.[15] What is more, the estimates imply that 1 tonne of carbon emissions is associated with around 5 USD of lower taxes in the cross section of U.S. firms.[16]

We assess the robustness of our baseline estimates by considering specifications in which the independent variable is the logarithm of firms' carbon intensity. Panel A of Figure 1 presents a visual representation of the negative relationship between taxes (over sales) and the logarithm of carbon intensity. We report estimates in Online Appendix Table A.1. We estimate the coefficient on Log(Carbon/Sales) to be about -1.8, which is consistent with a subsidy of around 8 USD per each tonne of carbon emissions. Thus, log specifications imply a value for the tax subsidy in the same order of magnitude, but slightly larger than the one implied by the estimates in Table 2.[17]

[INSERT FIGURE 1]

Before turning to the mechanism behind this tax subsidy, let us emphasize that we do *not* interpret the estimated coefficient $\hat{\beta}$ in equation (5) as the causal impact of carbon emissions on profit taxes. We do not claim, for instance, that firms could save on taxes by using a dirty technology. Instead, we use equation (5) as a descriptive regression that estimates the relationship between carbon intensity and profit taxes paid by U.S. corporations in the cross-section, and use it to recover the dollar value of the carbon subsidy embedded in the current U.S. corporate taxation scheme. In the following section, we investigate the reason for which carbon-intensive firms can pay lower taxes. We show that the negative relationship between carbon intensity and profit taxes is largely explained by differences in the tax shield of debt across U.S. firms.

[15] In our sample, firms with high carbon intensity have slightly higher profit margins. This is why the point estimate for β becomes slightly larger in absolute value once we control for differences in firms' profitability.

[16] To the extent that reported carbon emissions are noisy measures of the true emissions of U.S. corporations, this leads to a standard downward bias in our specifications, and thus these estimates are lower bounds on the true subsidy on carbon emissions implied by corporate taxation.

[17] An estimate of -1.8 on Log(Carbon/Sales) in Online Appendix Table A.1 indicates that an increase in carbon intensity by 10% is associated with a decrease in taxes by 0.18 USD per thousand of sales. Starting from the average carbon intensity of 0.23 (tonnes per thousand of sales, see Table 1), a 10% increase corresponds to an increase of 0.023 tonnes per 1 thousand of sales. Thus, a 1 tonne increase of carbon emissions is associated with a decrease in taxes of around 8 USD.

2.4 The Mechanism

In this section, we shed light on the mechanism which leads dirty firms to pay lower taxes. We conjecture that firms with substantial emissions—such as energy firms—operate in industries in which the nature of the assets used in production allows them to sustain a higher level of debt and, thus, save on taxes by taking advantage of the tax treatment of debt. We verify this conjecture in Section 2.4.1, where we show that the tax shield is indeed a key driver of the differences in taxes paid by firms with different carbon intensity. In Section 2.4.4, we take one step further and relate the differential gain from the tax shield to differences in debt levels—and ultimately in asset tangibility—across firms in clean versus dirty industries.

2.4.1 Tax Shield

To explore the mechanism which leads dirty firms to pay lower taxes, we study both the tax shield generated by debt financing and the hypothetical taxes that firms would pay in the absence of the tax shield. We measure the tax shield as in equation (4), i.e. as interest expenses times $\tau_{f,t}$, the corporate tax rate faced by firm f in year t.

As the U.S. tax code allows firms to deduct interest payments from their earnings, one can rewrite the total corporate taxes paid by a given levered U.S. firm as the difference between the hypothetical taxes that the firm would have paid were it entirely equity-financed (which are given by current taxes plus interest expenses $\times$ $\tau_{f,t}$) minus the value of the tax shield (i.e. interest expenses $\times$ $\tau_{f,t}$). According to this decomposition, differences in taxes paid by clean versus dirty firms can come either from differences in firms' profitability, or from differences in the structure of their liabilities.[18] To establish which of the two components drives the correlation with carbon emissions, we estimate our baseline equation (5) separately for each component and present the results in Table 3.

[INSERT TABLE 3]

[18] As noted before, it might also be that dirty firms are more likely to locate their activities in states with lower tax rates. However, we fail to find any robust correlation between carbon intensity and the weighted average state corporate tax rates at the firm level using data from Infogroup and Factset on firms' business activity across U.S. states and across countries.

Columns (1) to (3) of Table 3 show that dirty firms benefit from a larger tax shield of debt, even after controlling for firm size, age, the share of foreign sales, and profitability in column (2), and for firms' headquarters state $\times$ year fixed effects in column (3). Estimates range between 4.5 and 4.8, and are statistically significant at the 1%-level. Note also that the estimates have the opposite sign and have virtually the same magnitude as the coefficients in Table 2. This indicates that the negative relationship between taxes and emissions presented in Table 2 is explained by a higher tax shields of debt for dirty firms.

To further clarify the role played by the tax shield for the negative relationship between taxes and emissions in Table 2, in Columns (4) to (6) of Table 3 we regress the hypothetical taxes that firms would pay if they were financed only with equity on their carbon intensity. The estimated coefficient is small and not statistically significant at conventional levels, which indicates that there is no robust residual relationship between taxes and carbon emissions, beyond the robust relationship that we uncovered in Columns (1) to (3). To sum up, the relationship between taxes and emissions appears to be largely explained by the fact that dirty firms enjoy a higher tax shield of debt. Panel B of Figure 1 provides a graphical illustration of the relationship between the tax shield and (the logarithm of) firms' carbon intensity.

2.4.2 Robustness

In this subsection, we conduct a series of empirical checks to test the robustness of our baseline findings. Specifically, we present below leave-one-out-industry and yearly estimates, a replication of our results using private firms, sub-sample specifications restricted to domestic versus multinationals, and self-reported versus estimated emissions, as well as specifications in which we consider larger sets of firms' emissions, including in turn scope 2 and scope 3 emissions.

Leave-one-out industry and yearly estimates. We conduct robustness tests to assess whether the relationship between carbon emissions and corporate taxes is driven by a specific time period or a specific sector. Figure A.2 reports yearly estimates of cross-sectional regressions of, respectively, corporate taxes over sales (Panel A) and tax shield over sales (Panel B) on firms' carbon intensity. While the yearly estimates on corporate taxes show some variation over time, the estimates for the tax shield are very stable over time and highly statistically significant. These results are, once again, consistent with the idea that dirty firms benefit from a larger tax shield from debt financing and, thus, pay lower taxes. Figure A.3 displays estimates of regressions of, respectively, corporate taxes over sales (Panel A) and tax shield over sales (Panel B) on firms' carbon intensity, over the sample period 2004-2019, in a leave-one-out specification where we exclude firms in each Bureau of Economic Analysis (BEA) sector. Our results are again robust: the coefficient on carbon emissions remains virtually the same in all leave-one-out specifications, indicating that the implicit subsidy to dirty firms is not driven by a specific sector.

Private firms. One limitation of our main sample is that it only includes publicly listed firms. One concern is that the implicit tax subsidy on carbon emissions might be different in the universe of privately held firms. For this, we can exploit the fact that Trucost also provides information on carbon emissions for a set of privately-held firms. We then merge this data with financial information from Refinitiv and replicate our main specifications in the sample of private firms observed in both Trucost and Refinitiv. We end up with 2,633 observations over the same sample period. As shown in column 1 of Panel A and B of robustness Table A.2, the coefficient on carbon emissions is very similar to the one we obtained in our sample of publicly listed firms. Even though we cannot directly test it, this additional analysis suggests that our estimates are likely to be representative for the universe of U.S. private firms.

Domestic versus multinationals. One might be concerned that our results are driven by the fact that multinationals firms emit more carbon emissions and at the same time locate their activities in low-tax countries. Although we show below that there is no relationship between firms' carbon emissions and the weighted-average profit tax rates faced by firms, we can run our baseline specifications separately for domestic versus firms with foreign activities in order to test this further. As shown in columns 2 and 3 of Panels A and B of robustness Table A.2, our baseline coefficients on both taxes paid and tax shield are virtually the same for domestic and multinationals.

Measurement of carbon emissions. Another concern is that the estimates are biased by the way carbon emissions are reported by firms. If for instance, firms paying more taxes are systematically more likely to under-report their carbon emissions, our specifications would overestimate the true indirect subsidy associated to tax deductibility of debt. While there is no obvious reason for why this should be the case, we run our baseline specifications separately for firms reporting their emissions, and for firms for which carbon emissions are estimated by Trucost, the data provider. As shown in columns 4 and 5 of Panels A and B of robustness Table A.2, our baseline coefficients on both taxes paid and tax shield are virtually the same in both subgroups, which strongly mitigates the concern that the measurement of carbon emissions could bias our findings.

Relatedly, we test whether our baseline results go through when one considers broader measures of firms' carbon emissions, including also indirect emissions from consumption of purchased electricity, heat, or steam (scope 2), and other indirect emissions from the production of purchased materials, product use, waste disposal, and outsourced activities (scope 3). As shown in columns 6 and 7 of Panels A and B of robustness Table A.2, our baseline coefficients on both taxes paid and tax shield are similar when we consider the sum of scope 1 and scope 2 emissions, or the sum of scope 1, scope 2, and scope 3 emissions.[19]

Taken together, these specifications indicate that there is a robust negative relationship between firms' carbon emissions and the taxes they pay on their profits, and that this relationship is driven by the tax shield of debt.

2.4.3 Decomposition of the Tax Shield.

The findings in Table 3 demonstrate that the tax shield of debt explains the negative relationship between taxes and carbon intensity. From its definition in (4), the higher tax shield enjoyed by carbon-intensive firms could be driven by differences in leverage, cost of debt, or tax rates. In Table 4, we thus estimate the relationship between carbon intensity and each of the components of the tax shield separately, i.e. firms' debt-to-sales ratio, firms' interest rate paid on debt (measured as interest expenses over beginning-of-period debt), and firm-level tax rates (computed using equation (3)).

[INSERT TABLE 4]

[19] We prefer using scope 1 emission data in our baseline specifications, since it is the most consistent across data providers (Busch, Johnson, and Pioch, 2018), and keep track of linkages across industries using rich network structures in the model part.

We find robust evidence that the fiscal advantage of carbon-intensive firms is mostly explained by the higher leverage of such firms. As shown in column (2), there is a robust and strongly statistically significant relationship between carbon intensity and firms' debt-to-sales ratio. In terms of magnitude, 1 tonne of carbon emissions is associated with around 220 USD of higher debt. Multiplying the latter amount by the average cost of debt, 6.7%, and by the average corporate tax rate, 35% (see Table 1), yields a subsidy of 5.1 USD ($220 \times 0.067 \times 0.35$) of lower taxes per tonne of carbon—a subsidy of the same magnitude than the estimates presented in Tables 2 and 3. Panel A of Figure 2 visualizes the relationship between firms' debt-to-sales ratio and the logarithm of their carbon intensity. Finally, in columns (2) and (3), we fail to find any robust relationship between firms' carbon intensity and, respectively, the cost of debt and firm-level statutory tax rates. We conclude, therefore, that the tax advantage of carbon-intensive firms is due to their higher levels of debt. We are left with the question of what explains the higher leverage of such firms, an issue we explore in the next section.

[INSERT FIGURE 2]

2.4.4 Firms' Carbon Emissions and Asset Tangibility

We conjecture that differences in debt levels across firms with different carbon-intensity may be driven by differences in asset tangibility. As shown in Panel B of Figure 2, there is a robust relationship between the ratio of property, plant, and equipment over sales and the logarithm of firms' carbon intensity.

We confirm this positive relationship in column (1) of Table 5, which is robust to the introduction of state $\times$ year fixed effects, and controls for firm size, age, share of foreign sales, and profitability. We then test directly whether tangibility can alone explain the relationships between carbon intensity, firms' leverage, and tax shield that we documented in the previous sections. More specifically, we run the same specifications presented in respectively Columns (2) and (3) of, respectively, Table 4 and Table 3, adding the ratio of property, plant, and equipment (PPE) over sales as an additional control. Strikingly, the coefficient on carbon intensity becomes small and statistically insignificant once PPE over sales is added as an additional control, both in the specification with debt as a dependent variable (Column (3) versus (2) of Table 5) and in the one with the tax shield as a dependent variable (Column (5) versus (4) of Table 5). At the same time, the coefficient on PPE over sales is positive and strongly statistically significant.

Alternative explanations. Differences in the structure of firms' assets are not the only potential explanation for why carbon-intensive firms have higher leverage and benefit from a higher debt tax shield. While we have already shown in Table 5 that the tangibility of firms' assets fully accounts for the relationship between carbon emissions and firm leverage, we can still directly test whether firms' carbon intensity is related to other determinants of firm leverage. In Appendix Table A.3, we augment the specifications presented in Table 5 with the following variables widely used in the literature on the determinants of firm leverage (see e.g. Faulkender and Smith (2016) for a recent study): growth opportunities as measured by the ratio of research and development expenses to sales, advertising to sales, the market-to-book ratio, the depreciation-to-assets ratio to capture depreciation tax shields, and whether the firm has a bond rating any month during the fiscal year (in addition to the control variables used in the rest of our paper, namely firm size, firm age, profitability, and the fraction of foreign sales). As shown in column (2) of Appendix Table A.3, adding these variables raises significantly the explanatory power of the econometric model (the R-squared increases from 0.14 to 0.25 compared to the specification without controls presented in column (1)). Still, the coefficient on firms' carbon emissions remains large and highly statistically significant indicating that this set of variables does not explain the relationship between carbon emissions and leverage that we documented above. Instead, when we further add PPE over sales as an additional control in column (3), the coefficient on firms' carbon emissions becomes small and statistically insignificant confirming that differences in asset tangibility is the reason for why carbon-intensitve firms have larger leverage. The same patterns emerge in similar specifications with tax shield as the dependent variable, as shown in columns (4) to (6).

Taken together, these findings indicate that differences in asset tangibility across firms with different carbon intensity account for the positive relationship between carbon intensity and leverage, and ultimately for the tax advantage of dirty firms.

Industry effects One natural question is whether the relationship between tangibility, tax shields, taxes and carbon intensity is driven by variation across or within industries. To shed light on this question, we decompose firms' carbon intensity into an industry and a firm-specific component. One challenge in this exercise is that large firms often operate in multiple industries. To overcome this challenge, we utilize information on firms' sales across industries from Compustat Segments data. We first compute the average carbon intensity by SIC4 industry and year across pure play firms operating in only one industry.[20] We then compute for each firm the sales weighted carbon intensity across the different industries it reports in the segments data, *Implied Industry Carbon Intensity*.[21] Finally, we regress the actual firm-level carbon intensity on the carbon intensity implied by the segment data and predict the residuals, *Firm Residual Carbon Intensity*.

Table A.4 shows that both the implied industry carbon intensity as well as the firm residual carbon intensity are associated with higher tangibility, leverage and tax shields and consequently lower taxes, all statistically significant at the 1%-level. As such the effect operates both across and within industries. However, considering the magnitude of the coefficients, the largest part of the overall effect appears to stem from differences across industries. Therefore, our model features heterogeneity in carbon intensity across industries, and for the sake of simplicity abstracts from within-industry variation. One concern in this setting is that clean energy production is also capital intensive. If clean energy producers rely more on tangible assets than dirty energy producers, we would miss an important force in our model pushing in the opposite direction. To address this concern, we rerun our tests within the subsample of energy producers.[22] Table A.5 shows that dirtier energy producers (as captured by their carbon intensity) rely more on tangible assets, have higher leverage, enjoy higher tax shields of debt and as a result pay lower taxes.

2.5 Economic Significance of the Results

Before moving to the general-equilibrium model and the policy counterfactuals, let us comment on the economic significance of our results by providing a back-of-the-envelope total value of the aggregate subsidy on carbon emissions associated to the U.S. corporate tax system. We use the

[20] We obtain similar results when we compute implied industry carbon intensity at the SIC2-level instead.

[21] We set the implied carbon intensity to the average carbon intensity of the firm's industry in Compustat in case a firm does not appear in the segments data.

[22] We use the Compustat Segments data to identify firms with at least 80% of their sales in power generation (SIC codes 4911, 4931, 4939). If a firm does not appear in the segment data, we assume it has 100% of its sales in its Compustat industry. We cluster standard errors at the firm level in these specifications, since all firms in this subsample are in the same SIC2 industry (49).

estimated coefficient $\hat{\beta}$ in Table 2 on the 2018 (last available year) total carbon emissions of the U.S. corporate sector. We find that the U.S. corporate tax system provided an implicit subsidy to carbon emissions of around 30 USD billion in the year 2018.[23] This amount is of similar magnitude to the USD 33 billion of carbon pricing revenues raised by governments worldwide in 2017 (World Bank, 2018).[24] Our empirical analysis suggests that the corporate tax system can have large quantitative effects on aggregate carbon emissions. In the next section, we present a general-equilibrium model, which we then use to study the impact on production, prices, and carbon emissions of alternative tax policies.

3 The Model

We present a general-equilibrium model which will enable us to study several policy counterfactuals.

Time is discrete and infinite. There is a representative household who consumes, supplies labor elastically, and makes portfolio decisions. The economy features different sectors, indexed by $i \in \mathcal{N}$. In each sector, there is a unit measure of firms selling a differentiated good. Goods are sold to final consumers and to other firms, which use them both as intermediate inputs and as investment goods for the production of capital.

Household.

The representative household purchases goods from firm f at price $p_{f,t}$, and pays consumption tax τ_c. We let $i = \mathcal{I}(f)$ be the sector of firm f. The household supplies labor for a wage w_t, which is taxed at rate τ_h. The household can save through risk-free government bonds $B_{g,t+1}$, risky corporate bonds $B_{f,t+1}$, and equity shares $s_{f,t+1}$. Risk-free bonds pay interest rate r_t. Corporate bonds pay interest rate $r^b_{f,t}$, unless the issuing firm is liquidated. Finally, equity trades at price $Q_{f,t}$ and entitles the owner to dividends $d_{f,t}$, unless default occurs. We describe liquidation and default

[23] 5 USD lower taxes, or higher tax shield, per tonne of carbon implied by our estimates in Tables 2 and 3 times 6 giga tonnes of carbon equivalent emitted by the U.S. corporate sector in 2018.

[24] Carbon pricing programs cover around 11 giga tonnes of carbon dioxide equivalent or about 20 percent of global GHG emissions. The total value of Emission Trading Schemes (ETS) and carbon taxes reached USD 82 billion in 2018. In the U.S., twelve states that account for around a third of U.S. GDP have active carbon-pricing programs. Those states are California and the eleven Northeast states — Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, Vermont, and Virginia — that make up the Regional Greenhouse Gas Initiative (RGGI).

below, for now we let $\mathcal{L}_{f,t}$ and $\mathcal{D}_{f,t}$ denote the indicator functions of, respectively, the events of liquidation and default for firm f at time t. We assume that interest income is taxed as regular labor income, dividends and capital gains are, instead, taxed at rate τ_d. Finally, the representative household receives lump-sum transfers T_t. All variables are real, the consumption bundle is the numeraire.

Formally, the household problem is

$$\mathbb{E}\sum_{t=0}^{\infty}\beta^t\left(U(C_t)-V(L_t)\right),$$

subject to the budget constraint

$$\begin{aligned}(1+\tau_c)\sum_{i\in\mathcal{N}}\int_{\mathcal{I}(f)=i}p_{f,t}c_{f,t}df &= (1-\tau_h)w_tL_t+T_t+(1+(1-\tau_h)r_{t-1})B_{g,t}-B_{g,t+1}\\ &+\sum_{i\in\mathcal{N}}\int_{\mathcal{I}(f)=i}\left\{[1+(1-\tau_h)((1-\mathcal{L}_{f,t})r^b_{i,t}-\mathcal{L}_{f,t})]B_{f,t}-B_{f,t+1}\right\}df\\ &+\sum_{i\in\mathcal{N}}\int_{\mathcal{I}(f)=i}\left\{[(1-\mathcal{D}_{f,t})(1-\tau_d)(d_{f,t}+Q_{f,t})+\tau_dQ_{f,t-1}]s_{f,t}-Q_{f,t}s_{f,t+1}\right\}df,\end{aligned}$$

and a no-Ponzi condition requiring bond holdings to be non-negative in the limit as $t\to\infty$. We assume a nested Dixit-Stiglitz structure:

$$C_t\equiv\prod_{i\in\mathcal{N}}c_{i,t}^{\theta_i}\quad\text{with}\quad c_{i,t}\equiv\left(\int_{\mathcal{I}(f)=i}c_{f,t}^{\frac{\sigma_i-1}{\sigma_i}}df\right)^{\frac{\sigma_i}{\sigma_i-1}},$$

and $\sum_i\theta_i=1$. The parameter σ_i identifies the elasticity of substitution within goods in sector i; we assume $\sigma_i>1$ for all i.

Firms.

Firms within sectors are perfectly symmetric. We will thus solve the problem of the representative firm in each sector and simplify notation by replacing the firm identifier with the sector identifier. We will refer to the representative firm in sector i as "firm i".

In every period, firms choose labor, intermediate inputs, investment, leverage, final-good price, and production so as to maximize the discounted value of dividends

$$\mathbb{E}\sum_{t=0}^{\infty}\varphi_t d_{i,t},$$

where φ_t is the economy's stochastic discount factor and expectation is over the event of default, which we describe below.

Capital can be of different types. We index each type with s and let $\mathcal{S}$ denote the set of types. We let $\mathcal{T}$ and $\mathcal{I}$ denote the subsets of tangible (e.g. structures, equipment) and intangible (e.g. intellectual property) capital types, respectively.

Finally, output $y_{i,t}$ is produced through the constant-returns-to-scale production function

$$y_{i,t} = \mathcal{F}_i\left(z_i, \{x_{i,j,t}\}_j, \ell_{i,t}, \{k^s_{i,t}\}_s\right), \tag{6}$$

where $x_{i,j,t}$ is intermediate input from sector j, $\ell_{i,t}$ is labor, $k^s_{i,t}$ is the amount of type-s capital owned by the firm, and z_i is sector-specific productivity (which, for simplicity, is assumed to be constant).

Investment. Type-s capital owned by firm i depreciates at rate $\bar{\delta}^s_i \in (0,1]$. Firms can vary the amount of capital through investment, by combining inputs from different sectors. We allow the combination of inputs to be sector specific. Formally, capital of type s in sector i follows the law of motion:

$$k^s_{i,t+1} = (1-\bar{\delta}^s_i)k^s_{i,t} + I^s_{i,t},$$

where investment $I^s_{i,t}$ is a composite of different inputs $I^s_{i,t} \equiv \prod_j (i^s_{ij,t})^{\omega^s_{ij}}$, $\omega^s_{ij} \in [0,1]$, $\sum_j \omega_{ij} = 1$. We let $q^s_{i,t}$ denote the price of capital of type s, in sector i, at time t. Firms can also trade capital in a secondary market, which we describe below.

Default. Each firm is subject to an idiosyncratic default shock. We assume a tractable process for default, which nonetheless delivers a rich set of implications for interest rates, equity returns and leverage. More specifically, this process will ensure that, in equilibrium both the interest rate on corporate debt and leverage will be sector specific and a function of the amount of tangible capital. The relationship between leverage and asset tangibility is consistent with the empirical evidence. At the same time, the assumption that default and liquidation shocks are exogenous implies that the probabilities of restructuring and liquidation are independent of firm's quantity of debt—a property that will simplify firms' leverage decision substantially.

More specifically, at the beginning of every period, before production takes place, a firm can be hit by an idiosyncratic default shock with probability $(\rho_i+\lambda_i)$, with ρ_i, $\lambda_i > 0$ and $\rho_i+\lambda_i < 1$. When default occurs, firms' equity becomes worthless. There are two types of default: restructuring and liquidation. Conditional on default, with probability $\rho_i/(\lambda_i + \rho_i)$ the firm must be restructured to continue production. A firm that undergoes restructuring keeps a sector-specific and capital-specific share $\psi_{i,s}$ of its assets; the remaining capital is seized and transferred lump-sum to households. The assets retained by the firm are sold in the secondary market to repay bondholders. A restructured firm can issue new debt and equity and restart production.

All firms in default that cannot be restructured must be liquidated. Thus, with probability $\lambda_i/(\lambda_i+\rho_i)$ a firm in default is liquidated. Liquidated firms lose all their assets (which are transferred lump-sum to households) and exit the economy permanently. To keep the total mass of firms unchanged, we assume that liquidated firms are immediately replaced with new firms with the same technology.

Finally, we assume the existence of a secondary market where restructured firms and newly-born ones can purchase the assets that were transferred to households.

Leverage. The default process we have assumed implies that firms can only issue risky corporate debt. More specifically, lenders can recover up to a fraction $\psi_{i,s}$ of type-s assets from firm i, unless the firm is liquidated. Debt is thus risky and will command a credit premium in equilibrium, i.e. $r^b_{i,t+1} > r_t$. Finally, note that any borrowing in addition to the risky debt just described will not be repaid if the firm defaults. We treat this additional borrowing as equity and assume that it does not enjoy a tax shield.

Formally, we require debt $b_{i,t+1}$ to be such that

$$b_{i,t+1} \leq \frac{1}{1 + r^b_{i,t+1}} \sum_{s\in\mathcal{S}} \psi_{i,s} q^s_{i,t+1} k^s_{i,t+1}. \tag{7}$$

In equilibrium, the interest rates on risk-free and risky debt as well as the equity return will be a function of taxes and default probabilities. As discussed above, our default process implies that the probabilities of restructuring and liquidation are independent of the quantity of debt. When combined with the assumptions on model parameters we make below—which ensure that equity is more expensive than debt, consistent with empirical evidence—this property simplifies firms' leverage decision as it implies that it is always optimal to issue as much as debt as possible. Formally, condition (7) will hold with equality. As a result, firms with more tangible capital will tend to have a higher leverage, consistent with the empirical literature (see, e.g., Rajan and Zingales (1995)) and the evidence in Table 5.

Remark. While the default process we consider allows a firm to increase the amount of borrowing by investing in tangible assets, corporate rates are independent of firm's tangible capital. It is straightforward, however, to extend the default process so that, by investing in tangible capital, firms can both increase the amount of borrowing and lower the cost of debt. It is sufficient to assume that lenders recover a fraction of tangible capital even if the firm is liquidated.

Dividends. Before distributing dividends, firms pay profit taxes. The U.S. tax code allows firms to deduct expenditures on intermediate inputs, labor compensation, capital depreciation and interest. Firms can also deduct R&D expenses; we consider such expenses as investment in intangible capital. Finally, firms must pay a property tax on existing capital. Dividends are therefore equal to

$$\begin{aligned} d_{i,t} =& (1-\tau_p)\Big(p_{i,t}y_{i,t} - \sum_{j\in\mathcal{N}} p_{j,t}x_{ij,t} - w_t\ell_{i,t} - \sum_{s\in\mathcal{I}} q^s_{i,t}I^s_{i,t} - \sum_{s\in\mathcal{S}} \tau^s_k q^s_{i,t}k^s_{i,t} - r^b_{i,t}b_{i,t}\Big) \\ &+ \tau_p \sum_{s\in\mathcal{T}} \delta^s_i q^s_{i,t}k^s_{i,t} - \sum_{s\in\mathcal{T}} q^s_{i,t}I^s_{i,t} + b_{i,t+1} - b_{i,t}, \end{aligned}$$

where τ_p is the profit tax and τ^s_k is the capital tax on type-s capital (e.g. property tax).

Emissions. We assume that production generates emissions as a byproduct. More specifically, firm i's carbon emissions are $E_{i,t} \equiv e_i y_{i,t}$, where e_i is the emission rate. Total emissions in the economy are thus $E_t = \sum_i E_{i,t}$.

Government, Market Clearing and Equilibrium

We conclude the description of the model with government policies and market-clearing conditions. In every period, the government collects taxes, issues risk-free bonds $B_{g,t+1}$ and sets lump-sum taxes to satisfy the budget constraint

$$TR_t + B_{g,t+1} = (1 + r_{t-1})B_{g,t} + T_t, \tag{8}$$

where tax revenues TR_t are given by

$$\begin{aligned} TR_t \equiv & \tau_c \sum_{i\in\mathcal{N}} p_{i,t}c_{i,t} + \tau_h w_t L_t + \tau_h \Big(r_{t-1}B_{g,t} + \sum_{i\in\mathcal{N}} (1-\lambda_i) r^b_{i,t} b_{i,t}\Big) \\ & + \sum_{i\in\mathcal{N}} \Big\{ \tau_d[(1-\rho_i-\lambda_i)(d_{i,t}+Q_{i,t}) - Q_{i,t-1}] + TP_{i,t} + \sum_{s\in\mathcal{S}} \tau^s_k q^s_{i,t} k^s_{i,t} \Big\}, \end{aligned}$$

where $TP_{i,t}$ are revenues from profit taxes in sector i[25] and where we have used the fact that, in every period, a mass λ_i of firms in sector i is liquidated and a mass $(\rho_i + \lambda_i)$ in sector i is in default.

Equilibrium. An equilibrium is a collection of household and firm decisions, prices and government policies (i.e. tax rates, bond issuance, and lump-sum transfers) such that every agent optimizes, the government budget constraint is satisfied, and markets clear.

In particular, the goods-market in each sector and the labor market must clear:

$$y_{i,t} = c_{i,t} + \sum_{j\in\mathcal{N}} x_{ji,t} + \sum_{\substack{s\in\mathcal{S}\\ j\in\mathcal{N}}} i^s_{ji,t} \tag{9}$$

and

$$L_t = \sum_{i\in\mathcal{N}} \ell_{i,t}; \tag{10}$$

in addition, the markets for risk-free bonds and, for each sector, the markets for corporate bonds, equity and used capital must all clear.

[25] We have $TP_{i,t} \equiv \tau_p[p_{i,t}y_{i,t} - \sum_{j\in\mathcal{N}} p_{j,t}x_{ij,t} - w_t\ell_{i,t} - \sum_{s\in\mathcal{I}} q^s_{i,t}I^s_{i,t} - \sum_{s\in\mathcal{T}} \delta^s_i q^s_{i,t}k^s_{i,t} - \sum_{s\in\mathcal{S}} \tau^s_k q^s_{i,t}k^s_{i,t} - r^b_{i,t}b_{i,t}]$.

3.1 Results

Let's start with the household problem. At the optimum, consumption of the good produced by sector i satisfies

$$p_{i,t}c_{i,t} = \theta_i P_t C_t, \tag{11}$$

where $P_t \equiv \prod_i (p_{i,t}/\theta_i)^{\theta_i}$ is the price of the consumption basket, which we normalize to 1. Optimal choice of labor, L_t, satisfies the standard intra-temporal condition:

$$\frac{V'(L_t)}{U'(C_t)} = \frac{1-\tau_h}{1+\tau_c} w_t. \tag{12}$$

Finally, we consider the portfolio problem. From the choice of risk-free bonds we obtain the Euler equation:

$$U'(C_t) = \beta(1 + (1-\tau_h)r_t)U'(C_{t+1}).$$

In addition, optimal choices of corporate bonds and equity deliver two asset-pricing conditions for, respectively, corporate-bond rates and equity returns:

$$r^b_{i,t+1} = \frac{\lambda_i + (1-\tau_h)r_t}{(1-\tau_h)(1-\lambda_i)} \equiv r_t + \xi^D_{i,t+1} \tag{13}$$

and

$$r^e_{i,t+1} \equiv \frac{d_{i,t+1} + Q_{i,t+1}}{Q_{i,t}} - 1 = \frac{(1-\tau_d)(\rho_i + \lambda_i) + (1-\tau_h)r_t}{(1-\tau_d)(1-\rho_i-\lambda_i)} \equiv r_t + \xi^E_{i,t+1}, \tag{14}$$

where we let $\xi^D_{i,t+1}$ and $\xi^E_{i,t+1}$ be the extra compensation, over and above the risk-free rate, that corporate bonds and equity must pay due to default risk and taxes. Remember that $r^b_{i,t+1}$ represents the ex-post compensation for holders of risky debt, *conditional* on the firm not being liquidated at time t. Similarly, $r^e_{i,t+1}$ represent the ex-post equity return, conditional on no default. Since there is no aggregate risk, the expected (i.e. unconditional) net compensation to investors, both for risky debt and for equity, must be equal to the net interest rate on risk-free debt.

In what follows, we assume that $\xi^E_{i,t+1} \geq \xi^D_{i,t+1}$ for all industries. This assumption, which is satisfied by virtually all industries in our calibration, requires ρ_i, i.e. the probability of restructuring, is sufficiently high relative to λ_i, i.e. the probability of liquidation. In fact, in the absence of taxes, it would be equivalent to $\rho_i \geq \lambda_i$.

Finally, the household problem implies that the equilibrium stochastic discount factor is $\varphi_t = (1-\tau_d)^{t+1}/\Pi_{j=0}^{t-1}(1-\tau_d+(1-\tau_h)r_{t+j})$.[26] Note that, since aggregate risk is absent, future dividends are discounted with the risk-free interest rate adjusted for taxes.

We now turn to the firm's problem. To derive closed-form expressions, we work with a Cobb-Douglas production function:

$$\mathcal{F}_i\left(z_i, \{x_{i,j,t}\}_j, \ell_{i,t}, \{k_{i,t}^s\}_s\right) = z_i\zeta_i\Big(\prod_{j\in\mathcal{N}} x_{i,j,t}^{\alpha_{ij}}\Big)^{1-\gamma_i}\Big(\ell_{i,t}^{\phi_i^\ell}\prod_{s\in\mathcal{S}}\left(k_{i,t}^s\right)^{\phi_i^s}\Big)^{\gamma_i}, \tag{15}$$

with $\gamma_i, \phi_i^\ell, \phi_i^s, \alpha_{ij} \in [0,1]$, and ζ_i is a constant that simplifies expressions below.[27] Constant returns to scale requires $\phi_i^\ell + \sum_s \phi_i^s = 1$ and $\sum_j \alpha_{ij} = 1$.

The optimal choices of labor and intermediate goods are static and satisfy the first-order conditions

$$\mu_i\phi_i^\ell\gamma_i = \frac{w_t\ell_{i,t}}{p_{i,t}y_{i,t}} \tag{16}$$

and

$$\mu_i\alpha_{ij}(1-\gamma_i) = \frac{p_{j,t}x_{ij,t}}{p_{i,t}y_{i,t}}, \tag{17}$$

respectively, where $\mu_i \equiv (\sigma_i - 1)/\sigma_i$ is the inverse of the markup. Also, conditional on total investment $I_{i,t}^s$, the optimal choice of $i_{i,j,t}^s$ is also static and satisfies

$$i_{i,j,t}^s = \frac{1}{p_{j,t}}\omega_{ij}^s q_{i,t}^s I_{i,t}^s, \tag{18}$$

with the price of capital given by $q_{i,t}^s \equiv \prod_j (p_{j,t}/\omega_{ij}^s)^{\omega_{ij}^s}$.

The only dynamic choice is the one about investment $I_{i,t}^s$. The optimal choice of tangible capital, i.e. type-s capital with $s \in \mathcal{T}$, satisfies:

$$\mu_i\phi_i^s\gamma_i = R_{i,t}^s\frac{q_{i,t}^s k_{i,t}^s}{p_{i,t}y_{i,t}}, \tag{19}$$

[26] To simplify notation, we use the convention $\Pi_{j=0}^{-1}(1-\tau_d+(1-\tau_h)r_j) = 1$.

[27] $\zeta_i \equiv (\gamma_i\phi_i^\ell)^{-\gamma_i\phi_i^\ell}\prod_j((1-\gamma_i)\alpha_{ij})^{-(1-\gamma_i)\alpha_{ij}}\prod_s(\gamma_i\phi_i^s)^{-\gamma_i\phi_i^s}$.

where the rental rate $R^s_{i,t+1}$ is given by

$$R^s_{i,t+1} \equiv \delta^s_i + \tau^s_k + r^b_{i,t+1}\frac{\psi_{i,s}}{1+r^b_{i,t+1}} + \frac{1}{1-\tau_p} r^e_{i,t+1}\left(1-\frac{\psi_{i,s}}{1+r^b_{i,t+1}}\right) + \frac{1}{1-\tau_p}(1+r^e_{i,t+1})\left(\frac{q^s_{i,t}}{q^s_{i,t+1}}-1\right). \tag{20}$$

The expression for intangible capital is analogous and we report it in the appendix.

The rental rate represents the cost of capital to the firm. It is the sum of depreciation, the tax on capital, and the financing cost that the firm must incur to purchase capital, coming from both debt and equity. The last term captures the fact that the cost of using capital increases if the price of capital decreases over time, it becomes more costly for the firm to use capital. Finally, notice that the factor $1/(1-\tau_p)$ multiplies only the equity terms. This is due to the fact that debt enjoys a tax shield, thus, all other things equal, the rental rate falls if firms can issue more debt.

3.2 Calibration

We focus on the corporate sector, excluding the government and housing. We consider exports as final consumption and assume that all output is produced domestically. We study counterfactuals using "exact hat algebra" (Dekle, Eaton, and Kortum, 2008; Costinot and Rodríguez-Clare, 2014), that is, we express equilibrium relations in terms of changes from the baseline equilibrium. Thus, for example, letting $X'_{i,t}$ and $X_{i,t}$ denote an endogenous variable before and after the policy change, respectively, we express equilibrium relations in terms of the proportional change $\hat{X}_{i,t} \equiv X'_{i,t}/X_{i,t}$.

We let $U(C) = C^{1-\sigma}/(1-\sigma)$ and $V(L) = L^{1+1/\epsilon}/(1+1/\epsilon)$. Here, σ and ϵ parameterize, respectively, the strength of income effect on labor supply and the Frisch elasticity of labor supply. We set $\sigma = 1.7$ and $\epsilon = 0.5$ (Chetty, 2012). We also set $\beta = 0.975$ to target a risk-free real interest rate in steady state of about 2.5%.

To calibrate the remaining parameters, we combine several datasets. First, from the BEA Input-Output database we obtain yearly data, for the period 1997-2018, on (i) the use of commodities both by industries (as intermediate inputs) and by final users (as personal consumption and investment), and (ii) the value added and its composition by industry. Second, from the BEA Fixed Assets database we obtain data on (i) fixed assets owned by firms and asset-specific depreciation rates, and (ii) the aggregate price of capital goods. Third, from Compustat North America, we obtain sector-specific data on corporate debt, corporate rates and total assets for the period 1997-2018. Finally, data on carbon emissions, for the year 2016, is from Trucost, as described in Section 2.1.

The Cobb-Douglas specification implies that, at the optimum, θ_i will coincide with the share in consumption of sector i. Similarly, γ_i will correspond to the value added share of sector i, while ϕ_i^ℓ, ϕ_i^s and α_{ij} with, respectively, the labor share, the type-s capital share, and the intermediate-input share in value added. To calibrate the investment-network parameters ω_{ij}, we follow the methodology proposed in Lehn and Winberry (2020).[28] We use sector-level data on 31 different types of assets (25 different types of equipment, 2 types of non-residential structures, and 4 types of intellectual property assets). We aggregate these assets into three types of capital: equipment, non-residential structures, and intangible assets.

The parameters governing leverage, interest rates and rental rates of capital are of special interest. We use financial data from Compustat to calibrate leverage—defined as the sector-specific ratio of long-term debt over assets—and corporate rates—defined as the sector-specific ratio of total interest payments over long-term debt. We let $\psi_{i,s} = \bar{\psi}_i + \hat{\psi}_s$ and use the fact that condition (7) holds with equality to estimate $\hat{\psi}_s$ by regressing leverage on sector-specific shares of structures and equipment over total assets. We obtain $\hat{\psi}_s = 0.19$ for equipment and $\hat{\psi}_s = 0.24$ for non-residential structures. We finally estimate $\bar{\psi}_i$ as the residual of the regression.

To compute rental rates, we use formula (20). In particular, for each of the 31 types of assets, we use data on depreciation rates, prices of capital, tax rates, interest rates and leverage and compute the rental rate as a function of sector i's return on equity $r^e_{i,t+1}$. We then estimate the latter using the fact that value added must equal total payments to labor, capital and profits. This estimation strategy is the one proposed in Karabarbounis and Neiman (2019). We extend their analysis along two dimensions. First, while the focus of that paper is on aggregate variables, we allow rental rates to vary with the type of capital and with the firm's sector; in addition, we estimate sector-specific equity returns. Second, our formula separately accounts for interest expenses—which are shielded from the profit tax—and equity payouts—which are subject to the profit tax.

[28]We are grateful to the authors for kindly sharing their data and providing detailed information on their methodology.

Finally, we take tax rates from McGrattan (2020) and set $\tau_c = 0.074$ for the consumption tax, $\tau_h = 0.22$ for the labor income tax (which also equals the tax on interest income), $\tau_d = 0.144$ for the tax on dividends and capital gains, $\tau_p = 0.35$ for the profit tax, $\tau_k^s = 0.003$ for the property tax on non-residential structures (and set $\tau_k^s = 0$ for all other types of capital).

3.3 A Counterfactual Economy Without the Tax Shield

We use the model to simulate several counterfactual experiments. We begin by removing the tax shield on debt, that is, we simulate an economy in which firms cannot deduct interest expenses on corporate debt. We compare steady states, before and after the change in fiscal treatment of debt, computing the relative change in output, inputs, and emissions, both in the aggregate and for each sector. We first produce results using the full model with, in particular, the input-output network for intermediate inputs. We later discuss the role of input-output linkages in amplifying or dampening the impact of policy on aggregate emissions.

Overall, following the removal of the tax shield, aggregate output in steady state falls by 2.18%, while aggregate consumption decreases by 1.82%. This change is brought about mostly by a reduction in steady-state capital; the variation in aggregate labor is, instead, very small (−0.12%). The fall in output is accompanied by a much larger reduction in total emissions (−3.91%), which suggests that the reduction in output is not uniform across sectors. Intuitively, since sector-level emissions are proportional to sector's output, the percentage change in total emissions equals the average change in output plus a term involving the cross-sector covariance between changes in production and carbon intensity. This covariance term, which reflects the heterogeneity across sectors that we documented in our empirical analysis, is negative in our economy—following a tax reform that eliminates the tax shield of debt, production of more carbon-intensive sectors falls relatively more. The mechanism works through tangible capital and leverage. Remember from Section 2.4.4 that firms in carbon-intensive sectors tend to own more tangible capital and, thus, they have a higher leverage and pay relatively lower taxes due to the fiscal advantage of debt. A policy reform that removes the tax shield is thus particularly costly for such firms, as they experience a substantial increase in the cost of capital. As a result, they cut down production.

[INSERT FIGURE 3]

Figure 3 illustrates the response of different sectors. The bars plot the total change in output and the breakdown into different inputs for the six most carbon-intensive sectors. We plot only these sectors to make the figure more readable; however, they account for roughly 85% of total emissions and, in addition, the behavior of all other sectors is analogous. The figure confirms that the behavior at the sectoral level is the mirror image of the aggregate one. More specifically, once the tax shield is removed, firms reduce their inputs and, hence, their output. What is more, the biggest response comes from tangible capital (both structures and equipment). In fact, the variation in labor and intangible capital is negligible (labor increases by a tiny amount in many sectors).

A more formal intuition for the large response of tangible capital comes from the formula for the rental rate (20), which in steady state reduces to (we remove the time subscript to denote steady-state variables)

$$R_i^s = \delta_i^s + \tau_k^s + r^b \frac{\psi_{i,s}}{1+r^b} + \frac{1}{1-\tau_p} r^e \Big(1 - \frac{\psi_{i,s}}{1+r^b}\Big),$$

for $s \in \mathcal{T}$. When the tax shield is removed, the term related to the cost of debt (i.e. the third term) gets multiplied by the factor $1/(1-\tau_p)$, exactly like the term capturing the cost of equity (i.e. the last term), therefore, tangible capital becomes more expensive. The same force is at work for intangible capital, but it is weaker for two reasons. First, even when the tax shield is removed, firms can still deduct R&D expenditures (i.e. investment in intangible capital). Second, due to its inability to serve as collateral in the event of liquidation, firms must use relatively more equity to finance intangible capital; as a result, intangible capital is less sensitive to variations in the cost of debt.

No intermediate-goods network. Results are essentially unaffected if we remove the network for intermediate inputs and assume that output is used only for household consumption or investment. Aggregate output and consumption fall by 1.80% and 1.42%, respectively; aggregate labor is, again, mostly unaffected by the change in policy (it changes by −0.14%); finally, the fall in output causes a reduction in emissions of -3.86%. Although quantitatively small, the effect of the intermediate-goods network is to amplify the impact of the policy change on output. Note, however, that this bigger impact on output is accompanied by a less than proportional fall in emissions.

4 Conclusion

This paper studies the role of corporate profit taxation for carbon emissions. We document that, counter to optimal taxation in the presence of pollution externalities, dirty firms pay lower profit taxes. This carbon bias of profit taxation stems from the fiscal advantage of corporate debt, since dirty firms use more tangible capital, which allows them to borrow more. Finally, we build a general equilibrium framework in which carbon emissions are a byproduct of firm activity and study the aggregate implications of different corporate taxation schemes. The model suggests that a simple policy that removes the tax shield of debt can substantially reduce carbon emissions in steady state.

References

Acemoglu, D., P. Aghion, L. Bursztyn, and D. Hémous (2012): "The Environment and Directed Technical Change," *American Economic Review.*

Akey, P., and I. Appel (2020): "The Limits of Limited Liability: Evidence from Industrial Pollution," *Journal of Finance.*

——— (2021): "Environmental Externalities of Activism," *Working Paper.*

Andersson, J. J. (2019): "Carbon taxes and CO 2 emissions: Sweden as a case study," *American Economic Journal: Economic Policy*, 11(4), 1–30.

Auerbach, A. J. (2006): "Who Bears the Corporate Tax? A Review of What We Know," *Tax Policy and the Economy*, 20, 1–40.

Baker, M., D. Bergstresser, G. Serafeim, and J. Wurgler (2022): "The pricing and ownership of US green bonds," *Annual Review of Financial Economics, forthcoming.*

Baker, S. R., S. T. Sun, and C. Yannelis (2019): "Corporate Taxes and Retail Prices," *Working Paper.*

Baqaee, D., and E. Farhi (2020): "Productivity and Misallocation in General Equilibrium," *Quarterly Journal of Economics.*

Bartram, S. M., K. Hou, and S. Kim (2022): "Real effects of climate policy: Financial constraints and spillovers," *Journal of Financial Economics*, 143(2), 668–696.

Baylis, K., D. Fullerton, and D. H. Karney (2013): "Leakage, Welfare, and Cost-Effectiveness of Carbon Policy," *American Economic Review*, 103(3), 332–37.

——— (2014): "Negative Leakage," *Journal of the Association of Environmental and Resource Economists*, 1(1/2), 51–73.

Bigio, S., and J. La'O (2020): "Distortions in Production Networks," *Quarterly Journal of Economics.*

Boadway, R., and N. Bruce (1984): "A general proposition on the design of a neutral business tax," *Journal of Public Economics*, 24(2), 231–239.

Bolton, P., and M. Kacperczyk (2021a): "Carbon Disclosure and the Cost of Capital," *Working Paper*.

——— (2021b): "Do investors care about carbon risk?," *Journal of Financial Economics*, 142(2), 517–549.

——— (2021c): "Global Pricing of Carbon-Transition Risk," *Working Paper*.

Bovenberg, A. L., and L. H. Goulder (1996): "Optimal Environmental Taxation in the Presence of Other Taxes: General- Equilibrium Analyses," *The American Economic Review*, 86(4), 985–1000.

Bruvoll, A., and B. M. Larsen (2004): "Greenhouse gas emissions in Norway: do carbon taxes work?," *Energy Policy*, 32(4), 493–505, An economic analysis of climate policy: essays in honour of Andries Nentjes.

Busch, T., M. Johnson, and T. Pioch (2018): "Consistency of corporate carbon emission data," *University of Hamburg Report WWF Deutschland*.

Chava, S. (2014): "Environmental externalities and cost of capital," *Management science*, 60(9), 2223–2247.

Chetty, R. (2012): "Bounds on elasticities with optimization frictions: A synthesis of micro and macro evidence on labor supply," *Econometrica*, 80(3), 969–1018.

Costinot, A., and A. Rodríguez-Clare (2014): "Trade theory with numbers: Quantifying the consequences of globalization," in *Handbook of international economics*, vol. 4, pp. 197–261. Elsevier.

De Haas, R., and A. Popov (2020): "Financial Development and Green Growth," *ECB Working Paper*.

Dekle, R., J. Eaton, and S. Kortum (2008): “Global rebalancing with gravity: Measuring the burden of adjustment,” *IMF Staff Papers*, 55(3), 511–540.

Devereux, M., and H. Freeman (1991): “A General Neutral Profits Tax,” *Fiscal Studies*, 12(3), 1–15.

Douenne, T., and A. Fabre (Forthcoming): “Yellow Vests, Pessimistic Beliefs, and Carbon Tax Aversion,” *American Economic Journal: Economic Policy*.

Dyck, A., K. V. Lins, L. Roth, and H. F. Wagner (2019): “Do institutional investors drive corporate social responsibility? International evidence,” *Journal of Financial Economics*, 131(3), 693–714.

Faccio, M., and J. Xu (2015): “Taxes and Capital Structure,” *Journal of Financial and Quantitative Analysis*, 50(3), 277–300.

Faulkender, M., and J. M. Smith (2016): “Taxes and leverage at multinational corporations,” *Journal of Financial Economics*, 122(1), 1–20.

Fuest, C., A. Peichl, and S. Siegloch (2018): “Do Higher Corporate Taxes Reduce Wages? Micro Evidence from Germany,” *American Economic Review*, 108(2), 393–418.

Giglio, S., B. Kelly, and J. Stroebel (2021): “Climate Finance,” *Annual Review of Financial Economics*, 13(1), 15–36.

Giroud, X., and J. Rauh (2019): “State Taxation and the Reallocation of Business Activity: Evidence from Establishment-Level Data,” *Journal of Political Economy*, 127(3), 1262–1316.

Golosov, M., J. Hassler, P. Krusell, and A. Tsyvinski (2014): “Optimal Taxes on Fossil Fuel in General Equilibrium,” *Econometrica*.

Graham, J. R. (1996): “Debt and the marginal tax rate,” *Journal of Financial Economics*, 41(1), 41–73.

Harberger, A. C. (1962): “The Incidence of the Corporation Income Tax,” *Journal of Political Economy*, 70(3), 215–240.

Heider, F., and A. Ljungqvist (2015): "As certain as debt and taxes: Estimating the tax sensitivity of leverage from state tax changes," *Journal of Financial Economics*, 118(3), 684–712, NBER Symposium on New perspectives on corporate capital structures.

Hsu, P.-H., K. Li, and C.-Y. Tsou (2020): "The pollution premium," *Working Paper*.

Ivanov, I., L. Pettit, and T. M. Whited (2020): "Taxes Depress Corporate Borrowing: Evidence from Private Firms," *Working Paper*.

Jouvenot, V., and P. Krueger (2021): "Mandatory Corporate Carbon Disclosure: Evidence from a Natural Experiment," *Working Paper*.

Karabarbounis, L., and B. Neiman (2019): "Accounting for factorless income," *NBER Macroeconomics Annual*, 33(1), 167–228.

Kim, T., and Q. Xu (2021): "Financial Constraints and Corporate Environmental Policies," *Review of Financial Studies*.

King, M., B. Tarbush, and A. Teytelboym (2019): "Targeted carbon tax reforms," *European Economic Review*, 119, 526–547.

King, M. A. (1974): "Taxation and the Cost of Capital," *The Review of Economic Studies*, 41(1), 21–35.

Klenert, D., L. Mattauch, E. Combet, O. Edenhofer, C. Hepburn, R. Rafaty, and N. Stern (2018): "Making carbon pricing work for citizens," *Nature Clim Change*, 8, 669–677.

Lehn, C. v., and T. Winberry (2020): "The investment network, sectoral comovement, and the changing US business cycle," *The Quarterly Journal of Economics*.

Liu, E. (2019): "Industrial Policies in Production Networks," *Quarterly Journal of Economics*.

McGrattan, E. R. (2020): "Intangible capital and measured productivity," *Review of Economic Dynamics*, 37, S147–S166.

Metcalf, G. E., and J. H. Stock (2020): "Measuring the macroeconomic impact of carbon taxes," in *AEA Papers and Proceedings*, vol. 110, pp. 101–06.

Parry, I. W. H., and K. A. Small (2005): "Does Britain or the United States Have the Right Gasoline Tax?," *The American Economic Review*, 95(4), 1276–1289.

Piazessi, M., M. Papoutsi, and M. Schneider (2021): "How unconventional is green monetary policy?," *Working Paper*.

Rajan, R. G., and L. Zingales (1995): "What do we know about capital structure? Some evidence from international data," *The Journal of Finance*, 50(5), 1421–1460.

Shapiro, J. S. (2020): "The Environmental Bias of Trade Policy*," *The Quarterly Journal of Economics*, 136(2), 831–886.

Shive, S., and M. Forster (2020): "Corporate Governance and Pollution Externalities of Public and Private Firms," *Review of Financial Studies*.

Stiglitz, J. E. (1973): "Taxation, corporate financial policy, and the cost of capital," *Journal of Public Economics*, 2(1), 1–34.

Suárez Serrato, J. C., and O. Zidar (2016): "Who Benefits from State Corporate Tax Cuts? A Local Labor Markets Approach with Heterogeneous Firms," *American Economic Review*, 106(9), 2582–2624.

Tirole, J. (2010): *The theory of corporate finance*. Princeton University Press.

Titman, S., and R. Wessels (1988): "The Determinants of Capital Structure Choice," *The Journal of Finance*, 43(1), 1–19.

Trucost (2019): "Trucost Data Methodology Guide," Discussion paper, S&P Global.

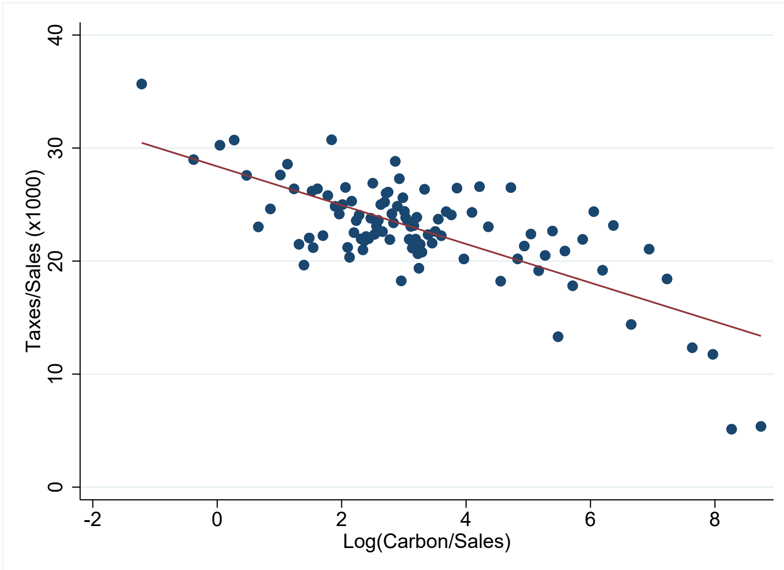
World Bank (2018): "State and trends of carbon pricing 2018," Discussion paper.

Zerbib, O. D. (2019): "The effect of pro-environmental preferences on bond prices: Evidence from green bonds," *Journal of Banking & Finance*, 98, 39–60.

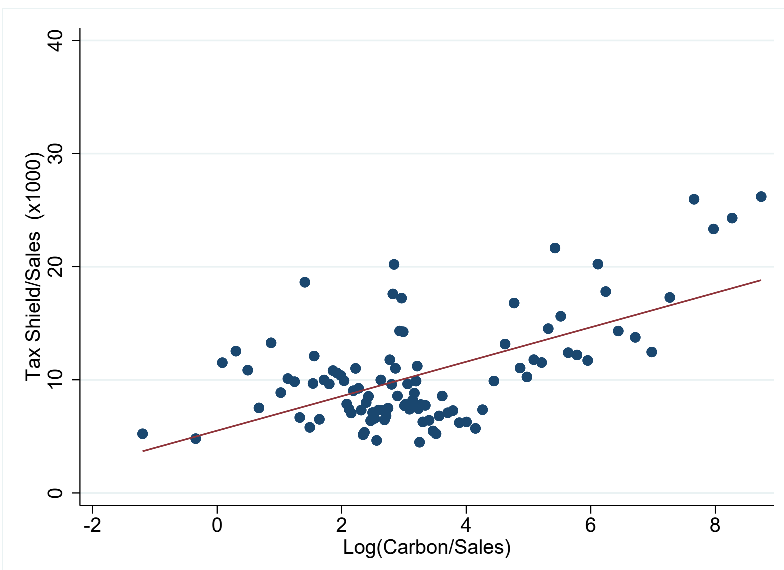
Figures and Tables

Figure 1. The tax advantage of carbon-intensive firms

Panel A. Profit Taxes (TXPD over Sales)



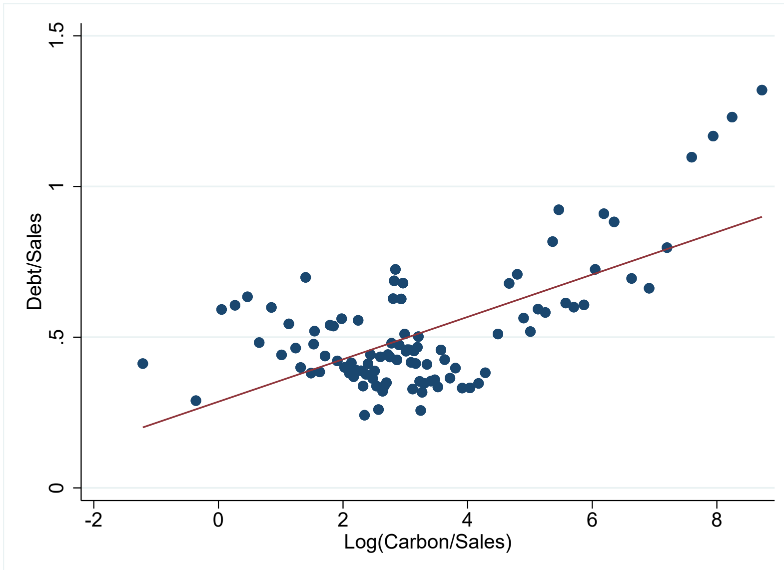
Panel B. Tax Shield (Interest×Tax Rate/Sales)



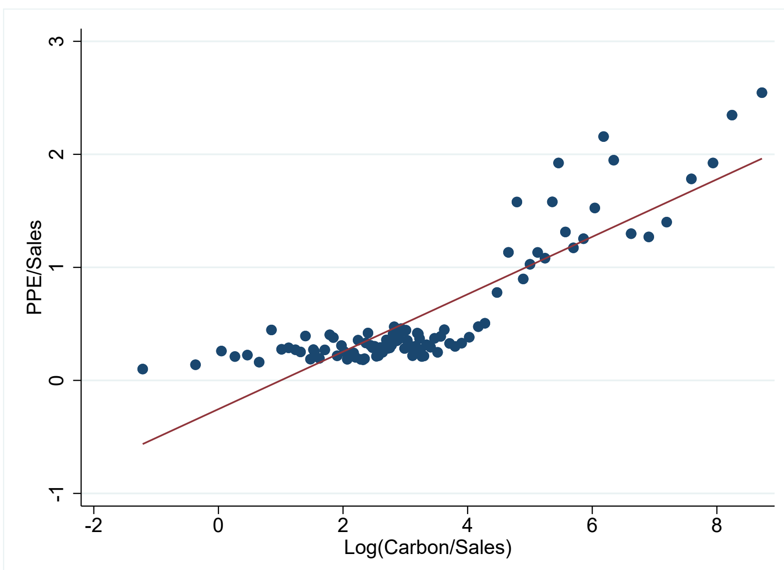
Note: This scatter plot reports the relationship between the logarithm of firms' carbon emissions over total sales and respectively corporate taxes over sales (Panel A), and tax shield over sales (Panel B) over the sample period 2004-2019, after absorbing year fixed effects. Each dot represents an equal size bin of firms' carbon emissions over total sales (100 bins). Tax shield is computed as interest payments times the firm-level statutory tax rate scaled by firm sales. The firm-level statutory tax rate is the weighted average of the domestic and foreign tax rate. The domestic tax rate is the federal tax rate plus the weighted-average state-level tax rate faced by firms depending on the location of firms' employees and sales across U.S. states. The foreign tax rate is the sales weighted average country-level tax rate. Data on carbon emissions are from Trucost. Financial data are from Compustat. Information on firms' employees and sales across states are retrieved from Infogroup, on sales by country from Factset, and on tax rates from Tax Foundation.

Figure 2. Carbon-intensity, leverage, and asset tangibility

Panel A. Leverage

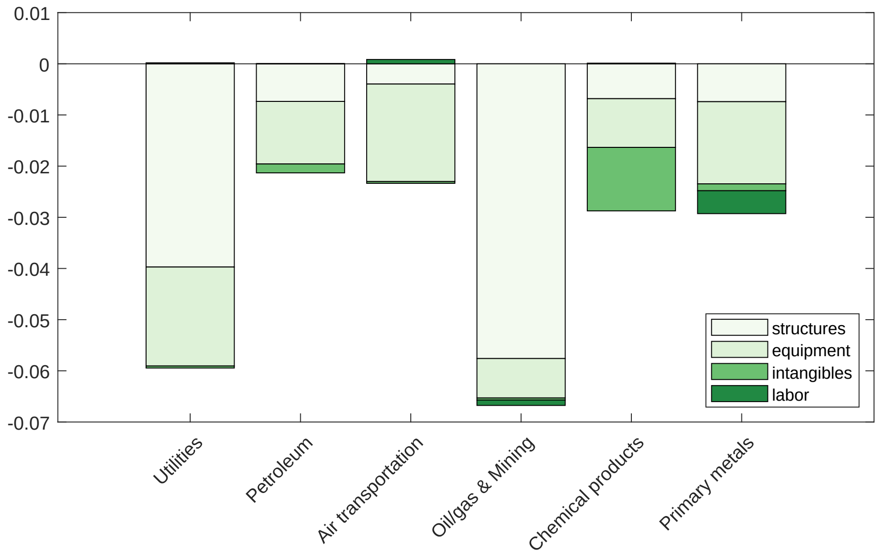


Panel B. Asset Tangibility



Note: This scatter plot reports the relationship between the logarithm of firms' carbon emissions over total sales and either debt over sales (in Panel A) or property, plant, and equipment over sales (in Panel B) over the sample period 2004-2019, after absorbing year fixed effects. Each dot represents an equal size bin of firms' carbon emissions over total sales (100 bins). Debt over sales is defined as Compustat variables DLC and DLTT over sales. Property, plant, and equipment is Compustat PPENT over sales. Data on carbon emissions are from Trucost. Financial data are from Compustat North America Fundamentals.

Figure 3. Counterfactul economy without the tax shield



Note: Response of output and different inputs to a policy that removes the tax shield of debt, for the six most carbon-intensive sectors.

Table 1. Summary statistics

	(1)	(2)	(3)	(4)	(5)	(6)
	Obs.	Mean	SD	p1	p50	p99
Carbon Emissions						
Carbon/Sales (tonnes of CO_2 per k. Sales)	13,675	0.227	0.728	0.000	0.019	4.691
Taxes paid by U.S. corporations						
Tax/Sales	13,675	0.023	0.027	-0.023	0.016	0.131
Tax Shield/Sales	13,675	0.010	0.014	0.000	0.005	0.064
(Tax+Tax Shield)/Sales	13,675	0.033	0.029	-0.009	0.026	0.151
Firm (Statutory) Tax Rate (in %)	13,675	35.195	5.748	22.586	36.362	43.840
Other variables						
Sales (in USD Million)	13,675	11,360	31,891	37	2,993	146,916
Firm Age	13,675	46.836	30.169	4.000	41.000	128.000
EBITDA/Sales	13,675	0.155	0.270	-0.976	0.158	0.619
Share Foreign	13,675	0.256	0.272	0.000	0.172	0.932
Debt/Sales	13,675	0.534	0.662	0.000	0.316	3.662
Interest Rate (Interest/Debt, in %)	13,675	6.731	5.244	1.281	5.593	32.680
PPE/Sales	13,675	0.562	0.902	0.010	0.204	4.359

Note: This table presents summary statistics for our sample, which consists of 13,675 firm-year observations between 2004 and 2019. There are 1,872 Compustat firms in this sample for which we observe carbon emissions in at least one year over the sample period. Data on carbon emissions are from Trucost. Financial data are from Compustat North America Fundamentals. The main variable of interest Carbon/Sales is expressed in tonnes of CO_2 equivalent per thousands of sales. Taxes are Compustat item TXPD, Debt is the sum of short term debt (Compustat item DLC) and long term debt (Compustat item DLTT). Share Foreign is the share of sales outside the U.S. retrieved from Factset. Property, plant, and equipment (PPE) is Compustat item PPENT, interest payments are Compustat item XINT. Tax shield is computed as interest payments times the firm-level statutory tax rate. The firm-level statutory tax rate is the weighted average of the domestic and foreign tax rate. The domestic tax rate is the federal tax rate plus the weighted-average state-level tax rate faced by firms depending on the location of firms' employees and sales across U.S. states. The foreign tax rate is the sales weighted average country-level tax rate. Data on carbon emissions are from Trucost. Financial data are from Compustat North America Fundamentals. Information on firms' employees and sales across states are retrieved from Infogroup, on sales by country from Factset, and on state and country-level tax rates from Tax Foundation.

Table 2. Corporate taxes and carbon emissions

	(1)	(2)	(3)	(4)	(5)	(6)
	Corp. Taxes per k. Sales					
Carbon Intensity	-4.472***	-4.875***	-4.834***	-4.349***	-6.489***	-6.607***
(tonnes of CO_2 per k. Sales)	(0.458)	(0.521)	(0.490)	(1.011)	(1.059)	(0.985)
Year FE	Y	Y		Y	Y	
HQ State x Year FE			Y			Y
Firm Controls		Y	Y		Y	Y
Size Weights				Y	Y	Y
r2	0.065	0.148	0.201	0.041	0.342	0.419
N	13,675	13,675	13,675	13,675	13,675	13,675

Note: This table presents estimates from pooled OLS specifications of firms' corporate taxes paid over sales on the ratio of firms' carbon emissions over sales. Columns (1), (2), (4), and (5) include year fixed effects, whereas Columns (3) and (6) include (firms' headquarters) state-year fixed effects. Columns (2), (3), (5), and (6) further include profit (scaled by firms' sales), firm size, firm age, and the share of foreign sales as control variables. Specifications are weighted with firms' lagged sales in Columns (4) to (6). Information about firms' headquarters are retrieved from Infogroup. Standard errors clustered at the 2-digit SIC industry level are reported in parentheses. *, **, and *** denote significance at the 10%, 5%, and 1%, respectively.

Table 3. Tax shield and carbon emissions

	(1)	(2)	(3)	(4)	(5)	(6)
	Tax Shield			Hypothetical Taxes Assuming 100% Equity		
	Interest×Tax Rate/Sales (× 1,000)			(Tax+Tax Shield)/Sales (× 1,000)		
Carbon Intensity	4.533***	4.831***	4.835***	0.072	-0.415	-0.405
(tonnes of CO_2 per k. Sales)	(0.548)	(0.540)	(0.474)	(0.679)	(0.704)	(0.709)
Year FE	Y	Y		Y	Y	
HQ State x Year FE			Y			Y
Firm Controls		Y	Y		Y	Y
r2	0.044	0.134	0.192	0.046	0.102	0.150
N	13,675	13,675	13,675	13,675	13,675	13,675

Note: This table presents estimates from pooled OLS specifications of tax shield and hypothetical taxes assuming firms are 100% equity financed (scaled by firms' sales) on firms' carbon emissions over sales. Tax shield is computed as interest payments times the firm-level statutory tax rate, and is then scaled by firm sales. The firm-level statutory tax rate is the weighted average of the domestic and foreign tax rate. The domestic tax rate is the federal tax rate plus the weighted-average state-level tax rate faced by firms depending on the location of firms' employees and sales across U.S. states. The foreign tax rate is the sales weighted average country-level tax rate. Hypothetical taxes assuming firms are 100% equity financed are computed as the sum of corporate taxes paid and tax shield scaled by firms' sales. Columns (1), (2), (4), and (5) include year fixed effects, whereas Columns (3) and (6) include (firms' headquarters) state-year fixed effects. Columns (2), (3), (5), and (6) further include profit (scaled by firms' sales), firm size, firm age, and the share of foreign sales as control variables. Information about firms' headquarters are retrieved from Infogroup. Standard errors clustered at the 2-digit SIC industry level are reported in parentheses. *, **, and *** denote significance at the 10%, 5%, and 1%, respectively.

Table 4. Decomposition of the tax shield advantage of carbon-intensive firms

	(1) Tax Shield (× 1000)	(2) Debt/Sales	(3) Interest	(4) Tax Rate
Carbon Intensity	4.835***	0.223***	-0.022	0.100
(tonnes of CO_2 per k. Sales)	(0.474)	(0.022)	(0.069)	(0.068)
HQ State x Year FE	Y	Y	Y	Y
Firm Controls	Y	Y	Y	Y
r2	0.192	0.155	0.132	0.758
N	13,675	13,675	13,675	13,675

Note: This table presents estimates from pooled OLS specifications of tax shield over sales in Column (1), debt over sales in Column (2), interest rate on debt in Column (3), and firm-level profit tax rate in Column (4), on firms' carbon emissions over sales. Tax shield is computed as interest payments times the firm-level statutory tax rate, and is then scaled by firm sales. Debt is the sum of short term and long-term debt. Interest rate is defined as the ratio of interest payments over beginning-of-period debt. The firm-level statutory tax rate is the weighted average of the domestic and foreign tax rate. The domestic tax rate is the federal tax rate plus the weighted-average state-level tax rate faced by firms depending on the location of firms' employees and sales across U.S. states. The foreign tax rate is the sales weighted average country-level tax rate. All Columns include (firms' headquarters) state-year fixed effects, as well as profit (scaled by firms' sales), firm size, firm age, and the share of foreign sales as control variables. Information about firms' headquarters are retrieved from Infogroup. Standard errors clustered at the 2-digit SIC industry level are reported in parentheses. *, **, and *** denote significance at the 10%, 5%, and 1%, respectively.

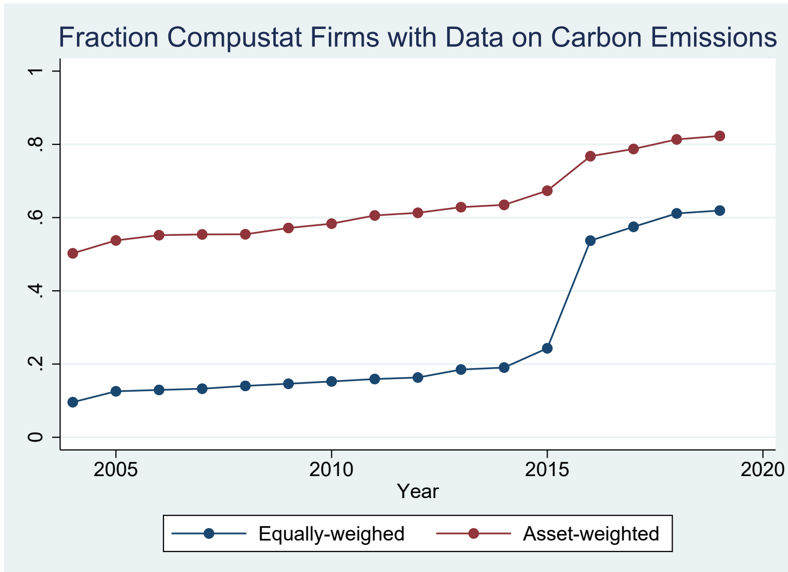
Table 5. Carbon-intensity, debt and asset tangibility

	(1)	(2)	(3)	(4)	(5)
	PPE/Sales	Debt/Sales		Tax Shield ($\times$ 1,000)	
Carbon Intensity	0.516***	0.223***	-0.013	4.835***	-0.091
(tonnes of CO_2 per k. Sales)	(0.052)	(0.022)	(0.039)	(0.474)	(0.897)
PPE/Sales			0.458***		9.657***
			(0.040)		(0.924)
HQ State x Year FE	Y	Y	Y	Y	Y
Firm Controls	Y	Y	Y	Y	Y
r2	0.328	0.155	0.439	0.192	0.391
N	13,675	13,675	13,675	13,675	13,675

Note: This table presents estimates from cross-sectional specifications of plant, property and equipment over sales in Column (1), debt over sales in Columns (2) to (3), and tax shield in Columns (4) to (5), on firms' carbon emissions over sales. Tax shield is computed as interest payments times the firm-level statutory tax rate, and is then scaled by firm sales. The firm-level statutory tax rate is the weighted average of the domestic and foreign tax rate. The domestic tax rate is the federal tax rate plus the weighted-average state-level tax rate faced by firms depending on the location of firms' employees and sales across U.S. states. The foreign tax rate is the sales weighted average country-level tax rate. All Columns include (firms' headquarters) state-year fixed effects, as well as profit (scaled by firms' sales), firm size, firm age, and the share of foreign sales as control variables. Information about firms' headquarters are retrieved from Infogroup. Standard errors clustered at the 2-digit SIC industry level are reported in parentheses. *, **, and *** denote significance at the 10%, 5%, and 1%, respectively.

A Appendix: Supplemental Empirical Analyses

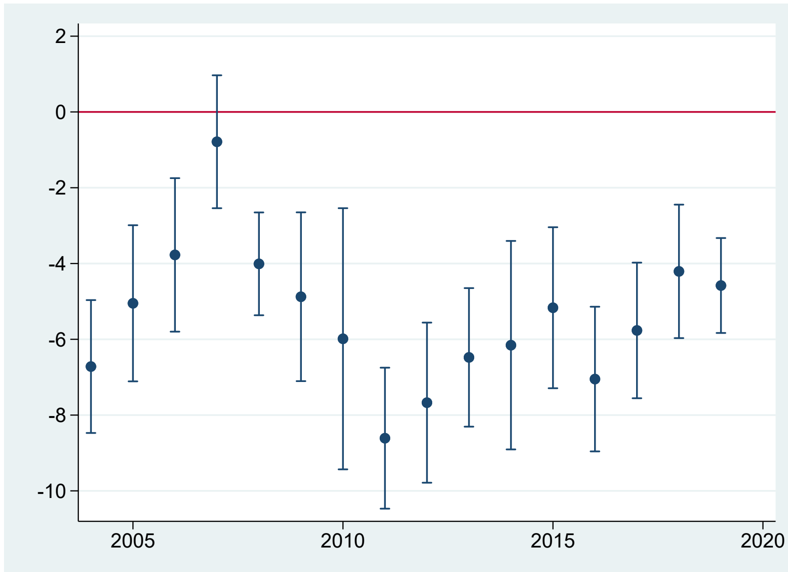
Figure A.1. Coverage of Compustat firms with data on carbon emissions in Trucost



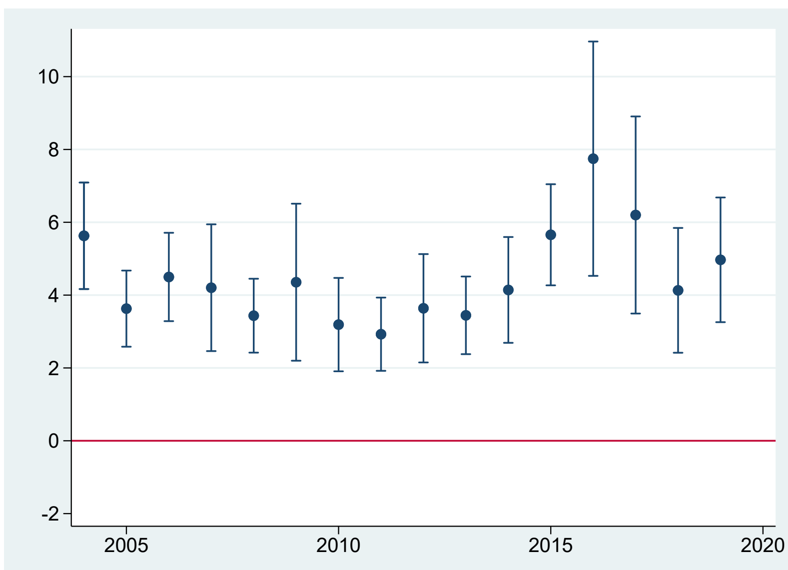
Note: This figure reports the fraction of Compustat firms for which we observe information on carbon emissions in Trucost.

Figure A.2. The tax advantage of carbon-intensive firms - yearly estimates

Panel A. Profit Taxes



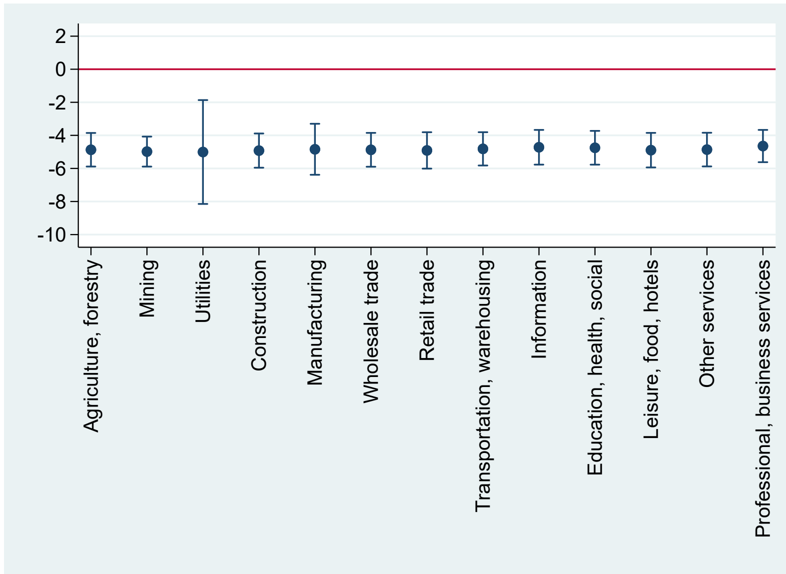
Panel B. Tax Shield



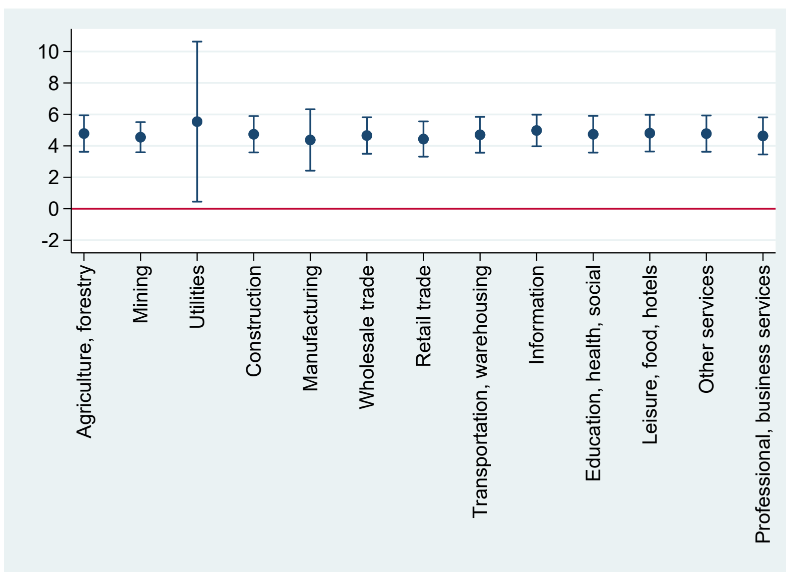
Note: This figure displays yearly estimates of cross-sectional regressions of respectively corporate taxes over sales (Panel A), and tax shield over sales (Panel B) on the ratio of firms' carbon emissions over sales for the sample period 2004-2019, after absorbing (headquarter) state fixed effects and controlling for profit over sales, firm size, firm age, and the share of foreign sales. Standard errors are clustered at the 2-digit industry level. The firm-level statutory tax rate is the weighted average of the domestic and foreign tax rate. The domestic tax rate is the federal tax rate plus the weighted-average state-level tax rate faced by firms depending on the location of firms' employees and sales across U.S. states. The foreign tax rate is the sales weighted average country-level tax rate. Data on carbon emissions are from Trucost. Financial data are from Compustat North America Fundamentals. Information on firms' employees and sales across states are retrieved from Infogroup, on sales by country from Factset, and on tax rates from Tax Foundation.

Figure A.3. The tax advantage of carbon-intensive firms - leave-one-out sector

Panel A. Profit Taxes



Panel B. Tax Shield



Note: This figure displays estimates of pooled OLS regressions of respectively corporate taxes over sales (Panel A), and tax shield over sales (Panel B) on the ratio of firms' carbon emissions over sales for the sample period 2004-2019 in leave-one-out specifications in which we exclude observations for firms in a given BEA sector, after absorbing (headquarter) state-year fixed effects and controlling for profit over sales, firm size, firm age, and the share of foreign sales. Standard errors are clustered at the 2-digit industry level. Tax shield is computed as interest payments times the firm-level statutory tax rate scaled by firm sales. The firm-level statutory tax rate is the weighted average of the domestic and foreign tax rate. Data on carbon emissions are from Trucost. Financial data are from Compustat. Information on firms' employees and sales across states are retrieved from Infogroup, on sales by country from Factset, and on tax rates from Tax Foundation.

Table A.1. Taxes, tax shield and carbon emissions - Log Carbon/Sales

	Taxes per k. Sales			Tax Shield per k. Sales		
Log(Carbon Intensity)	-1.804***	-1.926***	-1.721***	1.576**	1.665**	1.562**
	(0.536)	(0.519)	(0.613)	(0.727)	(0.719)	(0.752)
Year FE	Y	Y		Y	Y	
HQ State x Year FE			Y			Y
Firm Controls		Y	Y		Y	Y
r2	0.067	0.149	0.199	0.037	0.126	0.179
N	13,675	13,675	13,675	13,675	13,675	13,675

Note: This table presents estimates from pooled OLS specifications of firms' corporate taxes paid and tax shield over sales on the logarithm of the ratio of firms' carbon emissions over sales. Tax shield is computed as interest payments times the firm-level statutory tax rate, and is then scaled by firm sales. The firm-level statutory tax rate is the weighted average of the domestic and foreign tax rate. The domestic tax rate is the federal tax rate plus the weighted-average state-level tax rate faced by firms depending on the location of firms' employees and sales across U.S. states. The foreign tax rate is the sales weighted average country-level tax rate. Columns (1), (2), (4), and (5) include year fixed effects, whereas Columns (3) and (6) include (firms' headquarters) state-year fixed effects. Columns (2), (3), (5), and (6) further include profit (scaled by firms' sales), firm size, firm age, and the share of foreign sales as control variables. Information about firms' headquarters are retrieved from Infogroup. Standard errors clustered at the 2-digit SIC industry level are reported in parentheses. *, **, and *** denote significance at the 10%, 5%, and 1%, respectively.

Table A.2. Corporate taxes, tax shield and carbon emissions - Robustness

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Panel A:	Corp. Taxes per k. Sales							
Carbon Intensity	-3.525***	-4.261***	-4.252***	-6.834***	-4.217***	-4.327***	-4.043***	
(tonnes of CO_2 per k. Sales)	(0.837)	(0.685)	(1.359)	(1.350)	(0.796)	(0.531)	(0.530)	
r2	0.277	0.256	0.229	0.365	0.206	0.193	0.193	
N	2633	4604	9199	2330	11311	13921	13921	
Panel B:	Tax shield per k. Sales							
Carbon Intensity	4.891***	4.383***	5.174***	3.653***	4.843***	4.387***	3.646***	3.792***
(tonnes of CO_2 per k. Sales)	(0.727)	(0.529)	(1.277)	(0.494)	(0.785)	(0.506)	(0.644)	(0.364)
r2	0.338	0.246	0.155	0.500	0.187	0.192	0.185	0.190
N	2450	4396	8737	2294	10699	13248	13248	12666
HQ State x Year FE	Y	Y	Y	Y	Y	Y	Y	Y
Firm Controls	Y	Y	Y	Y	Y	Y	Y	Y
Private	Y							
Domestic		Y						
International			Y					
Reported				Y				
Estimated					Y			
Scope 1 + 2						Y		
Scope 1 + 2 + 3							Y	
Marginal Tax Rate								Y

Note: This table presents estimates from pooled OLS specifications of firms' corporate taxes paid (Panel A) and tax shield over sales (Panel B) on firms' carbon emissions over sales. Column (1) presents estimates from a sample of private firms from Refinitiv. Column (2) restricts the sample to domestic firms, column (3) to multinational firms, column (4) to firms with reported carbon emission data, and column (5) to firms with estimated carbon emission data. Column (6) considers the sum of scope 1 and 2 emissions to measure carbon intensity, while column (7) uses the sum of scope 1, scope 2, and scope 3 emissions. All columns include (firms' headquarters) state-year fixed effects and profit (scaled by firms' sales), firm size, firm age, and the share of foreign sales as control variables. Information about firms' headquarters are retrieved from Infogroup. Standard errors clustered at the 2-digit SIC industry level are reported in parentheses. *, **, and *** denote significance at the 10%, 5%, and 1%, respectively.

Table A.3. Carbon-intensity, debt and asset tangibility - Controlling for other determinants of leverage

	(1)	(2)	(3)	(4)	(5)	(6)
		Debt/Sales			Tax Shield (× 1,000)	
Carbon Intensity	0.224***	0.178***	-0.023	4.615***	3.835***	-0.312
(tonnes of CO_2 per k. Sales)	(0.024)	(0.021)	(0.038)	(0.482)	(0.444)	(0.905)
PPE/Sales			0.434***			9.068***
			(0.033)			(0.905)
Rated		0.393***	0.235***		8.771***	5.500***
		(0.059)	(0.032)		(1.542)	(0.844)
Dividend Payer		0.027	-0.046*		0.079	-1.503**
		(0.043)	(0.024)		(0.998)	(0.637)
M/B		-0.055***	-0.019**		-1.144***	-0.328
		(0.016)	(0.009)		(0.423)	(0.228)
Cash-Flow Volatility		0.105	0.094*		8.414**	8.135***
		(0.120)	(0.049)		(3.958)	(2.424)
Depreciation/Assets		0.864	-1.384**		32.422	-14.652
		(0.921)	(0.587)		(23.347)	(16.675)
RD/Sales		0.794***	0.467**		14.688**	7.063
		(0.296)	(0.196)		(6.498)	(4.429)
Advertising/Sales		-0.082	0.389		-8.950	4.688
		(0.372)	(0.385)		(7.508)	(6.078)
EBITDA/Sales		0.277	0.018		-1.395	-7.455*
		(0.283)	(0.176)		(6.148)	(3.915)
Log(Sales)		-0.068***	-0.012		-2.209***	-1.044***
		(0.019)	(0.011)		(0.461)	(0.300)
Log(Firm Age)		-0.060**	-0.057**		-1.116	-0.970
		(0.030)	(0.024)		(0.803)	(0.682)
Share Foreign		-0.216**	-0.032		-7.868***	-3.994***
		(0.095)	(0.065)		(1.932)	(1.382)
HQ State x Year FE	Y	Y	Y	Y	Y	Y
r2	0.139	0.253	0.476	0.111	0.270	0.422
N	14229	14031	14028	13607	13425	13422

Note: This table presents the same specifications as in Columns (2) and (4) of Table 5 in which we further control for a series of other determinants of firm leverage: a dummy variable to indicate if the firm has a credit rating *Rated*, a dummy variable set to one if the firm pays a dividend *Dividend Payer*, the market-to-book ratio M/B, the volatility of firms' cash-flows (scaled by assets) computed over the past five years, depreciation expenses, research and development expenses, and advertising expenses.

Table A.4. Tangibility, debt, tax shield, taxes and carbon emissions - Industry effects

	(1) PPE/Sales	(2) Debt/Sales	(3) Tax Shield/Sales	(4) Taxes/Sales
Implied Industry Carbon Intensity	0.784^{***}	0.318^{***}	6.772^{***}	-6.924^{***}
	(0.085)	(0.055)	(1.158)	(0.703)
Firm Residual Carbon Intensity	0.248^{***}	0.122^{***}	1.990^{***}	-2.178^{***}
	(0.082)	(0.031)	(0.742)	(0.734)
HQ State x Year FE	Y	Y	Y	Y
Firm Controls	Y	Y	Y	Y
r2	0.357	0.160	0.200	0.196
N	13918	13873	13248	13921

Note: This table presents estimates from pooled OLS specifications of firms' tangibility, leverage, tax shield and corporate taxes paid over sales on the industry carbon intensity implied by firms' sales across different industries and firms' residual carbon intensity. Implied industry carbon intensity is computed as the weighted-average industry carbon intensity across firms' business units. (SIC4) industry carbon intensity is computed as the average carbon scaled by sales ratio across firms operating only in one industry. Firm residual carbon intensity are the residuals of regressing firm-level carbon intensity on implied industry carbon intensity. Tax shield is computed as interest payments times the firm-level statutory tax rate, and is then scaled by firm sales. The firm-level statutory tax rate is the weighted average of the domestic and foreign tax rate. The domestic tax rate is the federal tax rate plus the weighted-average state-level tax rate faced by firms depending on the location of firms' employees and sales across U.S. states. The foreign tax rate is the sales weighted average country-level tax rate. All columns include (firms' headquarters) state-year fixed effects and profit (scaled by firms' sales), firm size, firm age, and the share of foreign sales as control variables. Information about firms' headquarters are retrieved from Infogroup. Standard errors clustered at the 2-digit SIC industry level are reported in parentheses. *, **, and *** denote significance at the 10%, 5%, and 1%, respectively.

Table A.5. Tangibility, debt, tax shield, taxes and carbon emissions - Energy sector

	(1) PPE/Sales	(2) Debt/Sales	(3) Tax Shield/Sales	(4) Taxes/Sales
Carbon Intensity	0.091**	0.093***	1.396***	-2.119**
(tonnes of CO_2 per k. Sales)	(0.037)	(0.020)	(0.419)	(1.029)
Year FE	Y	Y	Y	Y
Firm Controls	Y	Y	Y	Y
r2	0.801	0.610	0.435	0.433
N	354	354	353	354

Note: This table presents estimates from pooled OLS specifications of firms' tangibility, leverage, tax shield and corporate taxes paid over sales on carbon intensity within the energy sector. We use Compustat Segments data and restrict the sample to firms' with at least 80% of their sales in power generation (SIC industries 4911, 4931, 4939). Tax shield is computed as interest payments times the firm-level statutory tax rate, and is then scaled by firm sales. The firm-level statutory tax rate is the weighted average of the domestic and foreign tax rate. The domestic tax rate is the federal tax rate plus the weighted-average state-level tax rate faced by firms depending on the location of firms' employees and sales across U.S. states. The foreign tax rate is the sales weighted average country-level tax rate. All columns include (firms' headquarters) state-year fixed effects and profit (scaled by firms' sales), firm size, firm age, and the share of foreign sales as control variables. Information about firms' headquarters are retrieved from Infogroup. Standard errors clustered by firm are reported in parentheses. *, **, and *** denote significance at the 10%, 5%, and 1%, respectively.

B Appendix: Proofs

Household. We begin with the household problem. We first minimize total expenditures

$$\sum_i \int_0^1 p_{f,t} c_{f,t} d\mathcal{F}_i(f),$$

subject to achieving some level of aggregate consumption $C_t = \prod_{i=1}^N c_{i,t}^{\theta_i}$. We obtain the standard demand schedule

$$c_{f,t} = \left(\frac{p_{f,t}}{p_{i,t}}\right)^{-\sigma_i} c_{i,t}, \tag{B.1}$$

where $i = \mathcal{J}(f)$ denotes firm i's sector and where $p_{i,t} \equiv \left(\int_0^1 p_{f,t}^{1-\sigma_i} d\mathcal{F}_i(f)\right)^{\frac{1}{1-\sigma_i}}$ is the appropriate sector-level price index. In addition, the Cobb-Douglas specification implies

$$p_{i,t} c_{i,t} = \theta_i C_t, \tag{B.2}$$

where we normalize $P_t \equiv \prod_i (p_{i,t}/\theta_i)^{\theta_i} = 1$. The latter coincides with (11).

Next, we choose C_t. Letting φ_t be the Lagrange multiplier on the household's budget constraint, we obtain

$$U'(C_t) = (1 + \tau_c)\varphi_t. \tag{B.3}$$

Similarly, the optimal choice of L_t satisfies the first-order condition

$$V'(L_t) = (1 - \tau_h)\varphi_t w_t. \tag{B.4}$$

Combining (B.3) and (B.4), we obtain (12). Finally, we consider the portfolio problem. Since default and liquidation shocks are i.i.d. across firms, in every period there will be exactly a fraction $\rho_i + \lambda_i$ of firms in default and a fraction λ_i of firms in liquidation. The first-order conditions for the optimal choices of risk-free bonds, corporate bonds and equity are, respectively,

$$\varphi_t = \varphi_{t+1}(1 + (1 - \tau_h) r_t),$$

$$\varphi_t = \varphi_{t+1} + \varphi_{t+1}(1-\lambda_i)(1-\tau_h)r^b_{i,t+1} - \varphi_{t+1}\lambda_i(1-\tau_h),$$

and

$$\varphi_t Q_{i,t} = \varphi_{t+1}(1-\rho_i-\lambda_i)(1-\tau_d)(d_{i,t+1}+Q_{i,t+1}) + \varphi_{t+1}\tau_d Q_{i,t}.$$

Combining the first two conditions, we obtain

$$r^b_{i,t+1} = \frac{\lambda_i + r_t}{1-\lambda_i} \equiv r_t + \xi^D_{i,t},$$

which coincides with (13). Similarly, the first and third conditions give

$$r^e_{i,t+1} \equiv \frac{d_{i,t+1}+Q_{i,t+1}}{Q_{i,t}} - 1 = \frac{(\rho_i+\lambda_i)(1-\tau_d)+(1-\tau_h)r_t}{(1-\rho_i-\lambda_i)(1-\tau_d)} \equiv r_t + \xi^E_i, \tag{B.5}$$

which is (14).

Note that the expected net return on equity is

$$(1-\rho_i-\lambda_i)(1-\tau_d)r^e_{i,t+1} + (\rho_i+\lambda_i)(-1)(1-\tau_d) = (1-\tau_h)r_t,$$

thus, it coincides with the net risk-free return. An analogous expression holds for corporate bonds.

Firms. We now turn to the firm problem. In the main text, to ease notation we considered the representative firm in each sector, removing explicit reference to a specific firm within the sector. Here, we focus on the problem of the generic firm f in sector $i = \mathcal{J}(f)$. The firm maximizes

$$\mathbb{E}\sum_{t=0}^{\infty}\varphi_t d_{f,t},$$

subject to the process for dividends

$$\begin{aligned} d_{f,t} =& (1-\tau_p)\left(p_{f,t}y_{f,t} - \sum_{j\in\mathcal{N}} p_{j,t}x_{f,j,t} - w_t\ell_{f,t} - \sum_{s\in\mathcal{S}}\tau^s_k q^s_{i,t}k^s_{f,t}\right) \\ & -(1-\tau_r\tau_p)r^b_{i,t}b_{f,t} - \sum_{s\in\mathcal{S}}(1-\tau^s_{x,t}\tau_p)q^s_{i,t}I^s_{f,t} + b_{f,t+1} - b_{f,t}, \end{aligned} \tag{B.6}$$

the production function

$$y_{f,t} = z_{i,t}\zeta_i \left(\prod_{j\in\mathcal{N}} x_{f,j,t}^{\alpha_{ij}}\right)^{1-\gamma_i} \left(\ell_{f,t}^{\phi_i^\ell} \prod_{s\in\mathcal{S}} (k_{f,t}^s)^{\phi_i^s}\right)^{\gamma_i}, \tag{B.7}$$

the law of motion for capital

$$k_{f,t+1}^s = (1-\bar{\delta}_i^s)k_{f,t}^s + I_{f,t}^s, \tag{B.8}$$

where investment is given by

$$I_{f,t}^s = \prod_{j\in\mathcal{N}} (i_{f,j,t}^s)^{\omega_{ij}^s} \tag{B.9}$$

the borrowing constraint

$$b_{f,t+1} \leq \frac{1}{1+r_{i,t+1}^b} \sum_{s\in\mathcal{S}} \psi_{i,s} q_{i,t+1}^s k_{f,t+1}^s, \tag{B.10}$$

and the demand schedule

$$y_{f,t} = \left(\frac{p_{f,t}}{p_{i,t}}\right)^{-\sigma_i} y_{i,t}, \tag{B.11}$$

where $q_{i,t}^s$ is the price of the investment bundle in type-s capital for sector i, which we define below. Note that monopolistic competitive firms take demand for their goods into account when choosing production, this is why (B.11)—which follows from (B.1) using goods-market clearing—enters the maximization problem.

We begin with the choice of labor $\ell_{f,t}$. Substituting (B.7) and (B.11) into (B.6) and taking the first-order condition with respect to $\ell_{f,t}$, we obtain

$$\mu_i\gamma_i\phi_i^\ell = \frac{w_t\ell_{f,t}}{p_{f,t}y_{f,t}}. \tag{B.12}$$

Similarly, the first-order condition for the optimal choice of $x_{f,j,t}$ gives

$$\mu_i(1-\gamma_i)\alpha_{ij} = \frac{p_{j,t}x_{f,j,t}}{p_{f,t}y_{f,t}}. \tag{B.13}$$

In a symmetric equilibrium all firms in a sector make the same choices, thus, the latter conditions become (16) and (17), respectively. Finally, conditional on total investment $I_{f,t}^s$ in type-s capital, the optimal choice of $i^s_{f,j,t}$ is static and satisfies the first-order condition

$$p_{j,t} i^s_{f,j,t} - \lambda^s_{f,t} \omega_{ij} I^s_{f,t} = 0,$$

where $\lambda^s_{f,t}$ is the Lagrange multiplier on (B.9). As a result,

$$\sum_{j \in \mathcal{N}} p_{j,t} i^s_{f,j,t} = q^s_{i,t} I^s_{f,t},$$

where $q^s_{i,t} \equiv \prod_j (p_{j,t}/\omega^s_{ij})^{\omega^s_{ij}}$ is the price index of sector i's investment bundle. Therefore,

$$i^s_{f,j,t} = q^s_{i,t} \omega^s_{ij} I^s_{f,t} \frac{1}{p_{j,t}}. \tag{B.14}$$

In a symmetric equilibrium, (B.14) becomes (B.14).

Consider now the choice of debt and investment. The assumption that $r^e_{i,t+1} \geq r^b_{i,t+1}$, for all i, together with the fact that debt enjoys a tax advantage imply that, if given the choice, firms will prefer borrowing through debt rather than equity. It follows that the borrowing constraint (B.10) will hold with equality, pinning down the optimal choice of debt. Finally, using (B.8) to replace $I^s_{f,t}$ into (B.6), the optimal choice of $k^s_{f,t+1}$, in a symmetric equilibrium, satisfies the first-order condition

$$-(1-\tau^s_{i,t}) q^s_{i,t} + \frac{1}{1+r^b_{i,t+1}} \psi_{i,s} q^s_{i,t+1} + \frac{1}{1+r^e_{i,t+1}} (1-\tau_p) \left\{ \mu_i \gamma_i \phi^s_i p_{f,i,t+1} y_{f,i,t+1} \frac{1}{k^s_{f,i,t+1}} \right\}$$
$$+ \frac{1}{1+r^e_{i,t+1}} \left\{ -(1-\tau_r) \frac{r^b_{i,t+1}}{1+r^b_{i,t+1}} \psi_{i,s} q^s_{i,t+1} + (1-\tau^s_{i,t+1}\tau_p)(1-\bar{\delta}^s_i) q^s_{i,t+1} - \frac{1}{1+r^b_{i,t+1}} \psi_{i,s} q^s_{i,t+1} \right\} = 0,$$

where we have used (B.5). The latter condition can be rewritten as

$$\mu_i \gamma_i \phi^s_i = R^s_{i.t+1} \frac{q^s_{i,t+1} k^s_{i,t+1}}{p_{i,t+1} y_{i,t+1}}, \tag{B.15}$$

where

$$R^s_{i,t+1} \equiv \frac{1-\tau^s_{i,t+1}\tau_p}{1-\tau_p}\bar{\delta}^s_i + \frac{1-\tau_r}{1-\tau_p} r^b_{i,t+1}\frac{\psi_{i,s}}{1+r^b_{i,t+1}} + \frac{1}{1-\tau_p} r^e_{t+1}\left(1-\frac{\psi_{i,s}}{1+r^b_{i,t+1}}\right)$$
$$+\frac{\tau_p}{1-\tau_p}\tau^s_{i,t+1} + \frac{1}{1-\tau_p}(1+r^e_{i,t+1})\left((1-\tau^s_{i,t}\tau_p)\frac{q^s_{i,t}}{q^s_{i,t+1}}-1\right).$$

is the appropriate rental rate of type s capital.

Steady state. We now solve for the steady state of the economy. Steady-state variables do not bear a time subscript. Combining equations (B.2) and (B.13) gives

$$\frac{\theta_j/c_j}{\theta_i/c_i} = \frac{p_j}{p_i} = \mu_i \frac{y_i}{x_{i,j}}(1-\gamma_i)\alpha_{ij}$$

or

$$x_{j,i} = \mu_j y_j (1-\gamma_j)\alpha_{ji}\frac{\theta_j c_i}{c_j \theta_i}. \tag{B.16}$$

Summing across goods,

$$\sum_{j\in\mathcal{N}} x_{j,i} = \frac{c_i}{\theta_i}\sum_{j\in\mathcal{N}}\mu_j y_j(1-\gamma_j)\alpha_{ji}\frac{\theta_j}{c_j}.$$

Also, in steady state equation (B.15) simplifies into

$$\mu_i\gamma_i\phi^s_i = \frac{R^s_i q^s_i k^s_i}{p_i y_i},$$

where the steady-state rental rate is

$$R^s_i \equiv \frac{1-\tau^s_i\tau_p}{1-\tau_p}(\bar{\delta}^s_i + r^e_i) - \frac{1}{1-\tau_p}[r^e_i - (1-\tau_r)r^b_i]\frac{\psi_{i,s}}{1+r^b_i}.$$

Combining the latter with (B.14) yields

$$\frac{p_j i^s_{i,j}}{p_i y_i} = \mu_i\gamma_i\phi^s_i\omega^s_{ij}\frac{\bar{\delta}^s_i}{R^s_i}. \tag{B.17}$$

Using equation (B.2) with (B.17) we obtain

$$\frac{\theta_j/c_j}{\theta_i/c_i} = \frac{p_j}{p_i} = \mu_i\gamma_i\phi_i^s\omega_{ij}^s\frac{\bar{\delta}_i^s}{R_i^s}\cdot\frac{y_i}{i_{i,j}^s}$$

or

$$i_{j,i}^s = \mu_j\gamma_j\phi_j^s\omega_{ji}^s\frac{\bar{\delta}_j^s}{R_j^s}y_j\frac{\theta_j c_i}{c_j\theta_i}. \tag{B.18}$$

Summing across goods and types of capital,

$$\sum_{s\in\mathcal{S}}\sum_{j\in\mathcal{N}} i_{j,i}^s = \frac{c_i}{\theta_i}\sum_{s\in\mathcal{S}}\sum_{j\in\mathcal{N}}\mu_j y_j\gamma_j\phi_j^s\omega_{ji}^s\frac{\bar{\delta}_j^s}{R_j^s}\cdot\frac{\theta_j}{c_j}.$$

Using the resource constraint (9) yields

$$y_i = c_i + \frac{c_i}{\theta_i}\sum_{j\in\mathcal{N}}\mu_j y_j(1-\gamma_j)\alpha_{ji}\frac{\theta_j}{c_j} + \frac{c_i}{\theta_i}\sum_{s\in\mathcal{S}}\sum_{j\in\mathcal{N}}\mu_j y_j\gamma_j\phi_j^s\omega_{ji}^s\frac{\bar{\delta}_j^s}{R_j^s}\cdot\frac{\theta_j}{c_j}. \tag{B.19}$$

It is convenient to rewrite the expressions using matrix notation. Given a vector $\boldsymbol{x}$, we let $\operatorname{diag}(\boldsymbol{x})$ denote the diagonal matrix whose main diagonal is given by $\boldsymbol{x}$. Equation (B.19) can then be rewritten as

$$\boldsymbol{y} = \boldsymbol{c} + \operatorname{diag}(\boldsymbol{c})\operatorname{diag}(\boldsymbol{\theta})^{-1}\Delta\operatorname{diag}(\boldsymbol{\theta})\operatorname{diag}(\boldsymbol{c})^{-1}\boldsymbol{y},$$

where $\Delta \equiv A'\operatorname{diag}(\boldsymbol{\mu})\operatorname{diag}(\mathbf{1}-\boldsymbol{\gamma}) + \sum_s(\Omega^s)'\operatorname{diag}(\boldsymbol{\mu})\operatorname{diag}((\boldsymbol{R}^s)^{-1})\operatorname{diag}(\bar{\boldsymbol{\delta}}^s)\operatorname{diag}(\boldsymbol{\phi}^s)\operatorname{diag}(\boldsymbol{\gamma})$. Thus, letting $I_\mathcal{N}$ denote the identity matrix of dimension $|\mathcal{N}|\times|\mathcal{N}|$,

$$\boldsymbol{y} = (I_\mathcal{N} - \operatorname{diag}(\boldsymbol{c})\operatorname{diag}(\boldsymbol{\theta})^{-1}\Delta\operatorname{diag}(\boldsymbol{\theta})\operatorname{diag}(\boldsymbol{c})^{-1})^{-1}\boldsymbol{c}$$

or, since $(A^{-1}BA)^{-1} = A^{-1}B^{-1}A$,

$$\boldsymbol{y} = \operatorname{diag}(\boldsymbol{c})\operatorname{diag}(\boldsymbol{\theta})^{-1}(I_\mathcal{N} - \Delta)^{-1}\operatorname{diag}(\boldsymbol{\theta})\operatorname{diag}(\boldsymbol{c})^{-1}\boldsymbol{c}.$$

Finally, using $\operatorname{diag}(\boldsymbol{c})^{-1}\boldsymbol{c} = \mathbf{1}$, we obtain

$$\operatorname{diag}(\boldsymbol{\theta})\operatorname{diag}(\boldsymbol{c})^{-1}\boldsymbol{y} = (I_\mathcal{N} - \Delta)^{-1}\boldsymbol{\theta}. \tag{B.20}$$

Consider now equilibrium in the labor market. Combining condition (B.12) and (B.4) yields

$$\ell_i = \frac{1-\tau_h}{1+\tau_c} \cdot \frac{U'(C)C}{V'(L)} \theta_i \phi_i^\ell \gamma_i \mu_i \frac{y_i}{c_i}$$

or, in matrix notation,

$$\boldsymbol{\ell} = \frac{1-\tau_h}{1+\tau_c} \cdot \frac{U'(C)C}{V'(L)} \operatorname{diag}(\boldsymbol{\phi}^\ell) \operatorname{diag}(\boldsymbol{\mu}) \operatorname{diag}(\boldsymbol{\gamma}) \operatorname{diag}(\boldsymbol{\theta}) \operatorname{diag}(\boldsymbol{c})^{-1} \boldsymbol{y}.$$

Using market clearing for labor (10) and equation (B.20) yields

$$\begin{aligned} L = \mathbf{1}'\boldsymbol{\ell} &= \frac{1-\tau_h}{1+\tau_c} \cdot \frac{U'(C)C}{V'(L)} (\boldsymbol{\phi}^\ell)' \operatorname{diag}(\boldsymbol{\mu}) \operatorname{diag}(\boldsymbol{\gamma}) \operatorname{diag}(\boldsymbol{\theta}) \operatorname{diag}(\boldsymbol{c})^{-1} \boldsymbol{y} \\ &= \frac{1-\tau_h}{1+\tau_c} \cdot \frac{U'(C)C}{V'(L)} (\boldsymbol{\phi}^\ell)' \operatorname{diag}(\boldsymbol{\mu}) \operatorname{diag}(\boldsymbol{\gamma}) (I_{\mathcal{N}} - \Delta)^{-1} \boldsymbol{\theta}. \end{aligned} \tag{B.21}$$

Now, if we divide the production function (B.7) by y_i and use the assumption of constant returns to scale, we obtain

$$1 = z_i \zeta_i \prod_{j\in\mathcal{N}} \left(\frac{x_{i,j}}{y_i}\right)^{(1-\gamma_i)\alpha_{ij}} \left(\frac{\ell_i}{y_i}\right)^{\gamma_i \phi_i^\ell} \prod_{s\in\mathcal{S}} \left(\frac{k_i^s}{y_i}\right)^{\gamma_i \phi_i^s}. \tag{B.22}$$

From (B.17),

$$\frac{i_{i,j}^s}{y_i} = \mu_i \gamma_i \phi_i^s \omega_{ij}^s \frac{\bar{\delta}_i^s}{R_i^s} \cdot \frac{\theta_i c_j}{c_i \theta_j}$$

or, since $I_i^s = \prod_j (i_{i,j}^s / \omega_{ij}^s)^{\omega_{ij}^s}$,

$$\frac{I_i^s}{y_i} = \mu_i \gamma_i \phi_i^s \frac{\bar{\delta}_i^s}{R_i^s} \cdot \frac{\theta_i}{c_i} \prod_{j\in\mathcal{N}} \left(\frac{c_j}{\theta_j}\right)^{\omega_{ij}^s}.$$

Finally, using $I_i^s = \bar{\delta}_i^s k_i^s$, we obtain

$$\frac{k_i^s}{y_i} = \mu_i \gamma_i \phi_i^s \frac{1}{R_i^s} \cdot \frac{\theta_i}{c_i} \prod_{j\in\mathcal{N}} \left(\frac{c_j}{\theta_j}\right)^{\omega_{ij}^s}. \tag{B.23}$$

From (B.13) and (B.12), we have

$$\frac{x_{i,j}}{y_i} = \mu_i (1-\gamma_i) \alpha_{ij} \frac{\theta_i c_j}{c_i \theta_j}$$

and

$$\frac{\ell_i}{y_i} = \frac{1-\tau_h}{1+\tau_c} \cdot \frac{U'(C)C}{V'(L)} \theta_i \mu_i \gamma_i \phi_i^\ell \frac{1}{c_i}.$$

Therefore, substituting the last expressions into (B.22) gives

$$c_i = z_i \zeta_i \theta_i \mu_i \prod_{j \in \mathcal{N}} \left((1-\gamma_i) \alpha_{ij} \frac{c_j}{\theta_j} \right)^{(1-\gamma_i)\alpha_{ij}} \left(\gamma_i \phi_i^\ell \frac{1-\tau_h}{1+\tau_c} \cdot \frac{U'(C)C}{V'(L)} \right)^{\gamma_i \phi_i^\ell} \prod_{s \in \mathcal{S}} \left(\gamma_i \phi_i^s \frac{1}{R_i^s} \prod_{j \in \mathcal{N}} \left(\frac{c_j}{\theta_j} \right)^{\omega_{ij}^s} \right)^{\gamma_i \phi_i^s},$$

which, using the definition of ζ_i, can be simplified into

$$\frac{c_i}{\theta_i} = z_i \mu_i \prod_{j \in \mathcal{N}} \left(\frac{c_j}{\theta_j} \right)^{(1-\gamma_i)\alpha_{ij}} \left(\frac{1-\tau_h}{1+\tau_c} \cdot \frac{U'(C)C}{V'(L)} \right)^{\gamma_i \phi_i^\ell} \prod_{s \in \mathcal{S}} \left(\frac{1}{R_i^s} \prod_{j \in \mathcal{N}} \left(\frac{c_j}{\theta_j} \right)^{\omega_{ij}^s} \right)^{\gamma_i \phi_i^s}.$$

Taking logs of both sides,

$$\begin{aligned} &\log(c_i/\theta_i) - (1-\gamma_i) \sum_{j \in \mathcal{N}} \alpha_{ij} \log(c_j/\theta_j) - \gamma_i \sum_{s \in \mathcal{S}} \phi_i^s \sum_{j \in \mathcal{N}} \omega_{ij}^s \log(c_j/\theta_j) \\ =& \log(z_i \mu_i) + \gamma_i \phi_i^\ell \log \left(\frac{1-\tau_h}{1+\tau_c} \cdot \frac{U'(C)C}{V'(L)} \right) - \gamma_i \sum_{s \in \mathcal{S}} \phi_i^s \log R_i^s \end{aligned}$$

or, in matrix notation,

$$\begin{aligned} &\left(I_{\mathcal{N}} - \operatorname{diag}(\mathbf{1}-\boldsymbol{\gamma}) A - \sum_{s \in \mathcal{S}} \operatorname{diag}(\boldsymbol{\gamma}) \operatorname{diag}(\boldsymbol{\phi}^s) \Omega^s \right) (\log \boldsymbol{c} - \log \boldsymbol{\theta}) \\ =& \log \boldsymbol{z} + \log \boldsymbol{\mu} + \operatorname{diag}(\boldsymbol{\gamma}) \boldsymbol{\phi}^\ell \log \left(\frac{1-\tau_h}{1+\tau_c} \cdot \frac{U'(C)C}{V'(L)} \right) - \sum_{s \in \mathcal{S}} \operatorname{diag}(\boldsymbol{\gamma}) \operatorname{diag}(\boldsymbol{\phi}^s) \log(\boldsymbol{R}^s). \end{aligned}$$

As a result,

$$\log \boldsymbol{c} = \log \boldsymbol{\theta} + (I_{\mathcal{N}} - \Gamma)^{-1} \left[\log \boldsymbol{z} + \log \boldsymbol{\mu} + \operatorname{diag}(\boldsymbol{\gamma}) \boldsymbol{\phi}^\ell \log \left(\frac{1-\tau_h}{1+\tau_c} \cdot \frac{U'(C)C}{V'(L)} \right) - \sum_{s \in \mathcal{S}} \operatorname{diag}(\boldsymbol{\gamma}) \operatorname{diag}(\boldsymbol{\phi}^s) \log(\boldsymbol{R}^s) \right],$$

where $\Gamma \equiv \operatorname{diag}(\mathbf{1}-\boldsymbol{\gamma}) A + \sum_s \operatorname{diag}(\boldsymbol{\gamma}) \operatorname{diag}(\boldsymbol{\phi}^s) \Omega^s$. Aggregate consumption is $\log C = \boldsymbol{\theta}' \log \boldsymbol{c}$, thus,

$$\log C = \boldsymbol{\theta}' \log \boldsymbol{\theta} + \boldsymbol{\theta}' (I_{\mathcal{N}} - \Gamma)^{-1} \left[\log \boldsymbol{z} + \log \boldsymbol{\mu} + \operatorname{diag}(\boldsymbol{\gamma}) \boldsymbol{\phi}^\ell \log \left(\frac{1-\tau_h}{1+\tau_c} \cdot \frac{U'(C)C}{V'(L)} \right) - \sum_{s \in \mathcal{S}} \operatorname{diag}(\boldsymbol{\gamma}) \operatorname{diag}(\boldsymbol{\phi}^s) \log(\boldsymbol{R}^s) \right]. \tag{B.24}$$

Counterfactuals with "exact-hat algebra". We consider a change in the rental rate of different types of capital. Let $(R_i^s)'$ be the rental rate of type-s capital in sector i in the new equilibrium and let $\hat{R}_i^s \equiv (R_i^s)'/R_i^s$ the change relative to the original equilibrium. We also assume $U(C) = C^{1-\sigma}/(1-\sigma)$ and $V(L) = L^{1+\epsilon}/(1+\epsilon)$. Using the "hat" notation to denote changes of equilibrium variables relative to their counterparts in the original equilibrium, we can rewrite (B.12) as

$$\hat{\ell}_i = \frac{\hat{C}^{1-\sigma}}{\hat{L}^{\epsilon}} \cdot \frac{\hat{y}_i}{\hat{c}_i}, \tag{B.25}$$

where we used (B.4) to substitute in for the equilibrium wage. From labor-market clearing,

$$\hat{L} = \sum_{i \in \mathcal{N}} \frac{w\ell_i}{wL} \hat{\ell}_i$$

or, using (B.25),

$$\hat{L} = \frac{\hat{C}^{1-\sigma}}{\hat{L}^{\epsilon}} \sum_{i \in \mathcal{N}} \vartheta_i^L \frac{\hat{y}_i}{\hat{c}_i},$$

where $\vartheta_i^L \equiv w\ell_i/wL$. Similarly, we can rewrite (B.16) and (B.18) as

$$\hat{x}_{j,i} = \hat{y}_j \frac{\hat{c}_i}{\hat{c}_j} \tag{B.26}$$

and

$$\hat{i}_{j,i}^s = \frac{1}{\hat{R}_j^s} \hat{y}_j \frac{\hat{c}_i}{\hat{c}_j}, \tag{B.27}$$

respectively. Also, from (B.23), we obtain

$$\frac{\hat{k}_i^s}{\hat{y}_i} = \frac{1}{\hat{R}_i^s} \cdot \frac{1}{\hat{c}_i} \prod_{j \in \mathcal{N}} \hat{c}_j^{\omega_{ij}^s}. \tag{B.28}$$

The resource constraint (9) then becomes

$$\hat{y}_i = \frac{p_i c_i}{p_i y_i} \hat{c}_i + \sum_{j \in \mathcal{N}} \frac{p_i x_{j,i}}{p_i y_i} \hat{x}_{j,i} + \sum_{s \in \mathcal{S}} \sum_{j \in \mathcal{N}} \frac{p_i i_{j,i}^s}{p_i y_i} \hat{i}_{j,i}^s$$

or, using (B.16) and (B.18) with (B.26) and (B.27),

$$\frac{\hat{y}_i}{\hat{c}_i} = \vartheta_i^C + \sum_{j\in\mathcal{N}} \mu_j \alpha_{ji}(1-\gamma_j)\vartheta_{ji}^Y \frac{\hat{y}_j}{\hat{c}_j} + \sum_{s\in\mathcal{S}} \sum_{j\in\mathcal{N}} \mu_j \gamma_j \phi_j^s \omega_{ji}^s \frac{\bar{\delta}_j^s}{R_j^s} \vartheta_{ji}^Y \frac{1}{\hat{R}_j^s} \cdot \frac{\hat{y}_j}{\hat{c}_j}, \tag{B.29}$$

where we let $\vartheta_i^C \equiv p_i c_i / p_i y_i$ and $\vartheta_{ji}^Y \equiv p_j y_j / p_i y_i$.

Also, using (B.25), (B.26) and (B.28), we can rewrite (B.22) as

$$\hat{c}_i = \prod_{j\in\mathcal{N}} (\hat{c}_j)^{(1-\gamma_i)\alpha_{ij}} \left(\frac{\hat{C}^{1-\sigma}}{\hat{L}^{\epsilon}}\right)^{\gamma_i \phi_i^\ell} \prod_{s\in\mathcal{S}} \left(\frac{1}{\hat{R}_i^s} \prod_{j\in\mathcal{N}} \hat{c}_j^{\omega_{ij}^s}\right)^{\gamma_i \phi_i^s}$$

or, taking logs of both sides,

$$\log \hat{c}_i = \sum_{j\in\mathcal{N}} (1-\gamma_i)\alpha_{ij} \log \hat{c}_j + \gamma_i \phi_i^\ell \log \frac{\hat{C}^{1-\sigma}}{\hat{L}^{\epsilon}} - \sum_{s\in\mathcal{S}} \gamma_i \phi_i^s \log \hat{R}_i^s + \sum_{s\in\mathcal{S}} \sum_{j\in\mathcal{N}} \gamma_i \phi_i^s \omega_{ij}^s \log \hat{c}_j. \tag{B.30}$$

Finally, from the definition of aggregate consumption,

$$\hat{C} = \prod_{i\in\mathcal{N}} \hat{c}_i^{\theta_i}$$

and, thus,

$$\log \hat{C} = \sum_{i\in\mathcal{N}} \theta_i \log \hat{c}_i. \tag{B.31}$$

The relative change in inputs, output and consumption in the counterfactual economy are thus described by (B.25), (B.26), (B.27), (B.28), (B.29), (B.30) and (B.31).