

EFFECTIVE TAX MODEL (ETR): AN APPROACH TO ACCOUNTING, LEGAL, FINANCIAL, AND ADMINISTRATIVE EFFECTIVENESS IN ECUADORIAN ORGANIZATIONS.

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Abstract

Over time, most state governments worldwide have incorporated a series of fiscal policies into their administration, with tax exemptions being a strategy that seeks to encourage and promote business development. This research aimed to diagnose the use of tax exemptions by private companies in different sectors and economic activities, as well as to determine the main aspects and factors that contribute to their implementation. The findings were achieved through the application of a quantitative research approach combining a deductive method, variable correlation, and linear regression. The analysis of data from 384 elements led to the conclusion that all fiscal policies are aimed at a common benefit, but for these guidelines to fulfill their purpose, they must be widely understood in their entire context. Therefore, in the case of tax exemptions, companies must have personnel with extensive expertise in legal, tax, and accounting/financial matters so that this fiscal policy reflects favorable numerical results in the financial statements and allows them to be competitive in the market. In addition, a mathematical model is proposed that argues for the usefulness of tax exemptions as an optimal financial strategy.

Keywords: Accounting effects, financial indicators, tax exemptions, fiscal policies, private enterprise.

• Introduction

Fiscal policies, and tax exemptions in particular, are considered a motivating initiative by the state for business development. Therefore, studying the implications of tax burdens and their effect on the accounting and financial aspects of private companies is of paramount importance, especially when a series of financial strategies depend on their correct understanding and interpretation.

Currently, many governments around the world use these tax benefits to promote

development in their various economic activities, which brings with it greater investment, greater market expansion for products, an increase in GDP (Gross Domestic Product), an improvement in employment indicators, greater tax generation from other sources, and a better quality of life for their citizens. There are many studies on tax exemptions from different perspectives, but this study focuses on considering tax exemptions as a fundamental pillar in the financial achievements and results that companies attain if they make assertive decisions. As Scholes et al. (1992)

rightly point out in their work entitled *Taxes and Business Strategy*, emphasizing that tax management plays an important role in business strategies. Similarly, Myres and Stewart (1984) and Modigliani et al. (1958) consider tax management to be one of the factors in the valuation of companies in their research.

From a financial point of view, management decisions must include tax planning as part of their actions, with a focus on knowledge and mastery of tax incentives, but without this leading to tax evasion or avoidance, because these would involve risks and possible contingent legal expenses, taking as an argument what Jensen and Meckling (1976) propose about Agency Theory, visualizing that senior management must identify the benefits in a positive way and not rather as a guideline that generates opportunism for one party and affects the other. Ball (2016), in his study conducted in the accounting area, highlights the crucial importance of managing tax exemptions and benefits in the financial profitability of organizations based on the proper accounting application of these items.

Through this study, with an in-depth analysis of all the factors that encompass tax exemptions, their effective accounting record, and financial impact, the *Effective Tax Rate (ETR)* model is proposed. or *Tax Optimization Model* that seeks to strengthen and support a differential competitive strategy.

• Literature Review

.1 Tax incentives in the economic development of organizations.

Given that taxes are mandatory financial contributions that a state requires its citizens to pay in order to provide public services, and that in most countries these can take the form of taxes, fees, and contributions, they have become one of the state's main sources of income, as Andara (2020) points out.

The state requires resources to carry out the functions entrusted to it by the legal system, especially those related to the provision of public services that require large sums of money. This need for financing is not only permanent but also tends to increase every year (p. 39).

However, many countries around the world offer tax incentives to help organizations achieve certain advantages, one of which is the reduction of their tax burden in order to achieve greater price competitiveness and, above all, so that these benefits drive higher sales and, therefore, higher revenues, which will lead to an increase in the activity and management of all stakeholders involved.

Barreix and Velayos (2021) state that "Latin American and Caribbean (LAC) countries use corporate income tax (CIT) rate reductions to promote investment" (p. 1). Therefore, this tax trend is a strategy that, if properly oriented and channeled, can lead to significant development opportunities throughout the environment.

On the international stage, guidelines for tax incentives such as *nearshoring* have emerged. Zavaleta (2024) mentions that "Nearshoring is a strategy that seeks to strengthen global value chains through the integration of nearby countries." For Arroyo (2023),

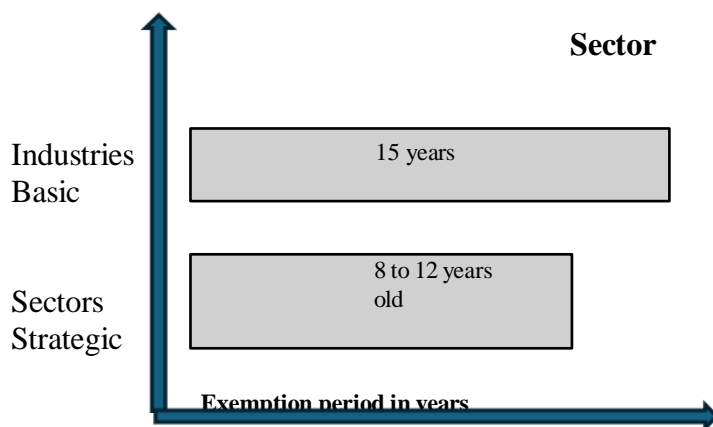
"nearshoring is the transfer of services or production from a distant location to a closer one." This aspect, accompanied by technological development and the promotion of environmental protection and conservation, has been a factor in promoting this benefit in relation to taxes. Another dynamic that has been implemented is the Global Minimum Tax (GMT), which is an agreement between countries that have signed a convention with the aim of boosting demand for the products they offer and, above all, contributing to the promotion of different sectors such as tourism, agriculture, and renewable energy, among others.

In Latin America and the Caribbean, the most commonly applied tax incentives are: tax credits, reduced income tax rates, reduced value-added tax (VAT) rates, reduced tariff rates, and tax exemptions on foreign trade.

With regard to a series of empirical studies on the positive or negative effect of tax implications, Meyer, Prakken, and Varvares (1993) state that "Empirical evidence supports the use of the neoclassical investment model and shows, in general, a positive correlation between capital stock and its cost of use, with magnitudes around 0.6," meaning that achieving a 10% optimization in the cost of capital use allows for a 6% increase in capital stock in the long term, logically if there is no variation in the interest rate on capital acquisition.

In Ecuador, the main tax incentives for 2024 are: income tax exemption for new productive investments, benefits for micro-enterprises, incentives for tourism, benefits for entities or organizations in the popular and solidarity economy, special economic development zones, incentives for hiring women, incentives for promotion, advertising, and sponsorship for certain sectors, value-added tax (VAT) benefits, tax debt forgiveness, exemption from foreign exchange exit tax, and payment facilities. The graph and table show the characteristics of tax incentives in Ecuador.

Figure 1. Income Tax. Exemption on New Productive Investments



Note. Ecuador Internal Revenue System 2024

Table 1. Characteristics. Tax Incentives

| Tax incentive | Characteristics |
|---|--|
| Benefits for Microenterprises | Exemption from income tax for the first three years |
| Incentive for tourism | 0% VAT rate for accommodation services for foreign tourists; the entity must have a Single Annual Operating License |
| Benefits for Popular and Solidarity Economy Organizations | Deduction of up to 10% on expenses incurred by companies that purchase goods and services from Popular and Solidarity Economy Organizations |
| Special economic development zones | Exemption from customs duties, transfers, and imports with 0% IVA rate. |
| IVA benefit | IVA refund on the purchase of goods or services intended for the construction of real estate projects. Reduction of IVA to 5% on construction materials, steel, aggregates, concrete, and prefabricated materials. 0% IVA on solar panels. Reduction to 8% on holidays for tourist activities, 0% IVA on pet food. |
| New productive investments | Income tax exemption for 15 years for basic industries and 8 to 12, years in strategic sectors |
| Other tax benefits | Incentives for hiring young people between the ages of 18 and 29 with a 50% deduction from the income tax base, increasing to 75% for employees who are graduates of public universities or public educational institutions |
| Incentives. Hiring women | Deduction on remuneration and social security contributions, 100% additional for 6 consecutive months, 120% additional for 6 consecutive months, 130% additional for 7 consecutive months, 130% additional for 8 consecutive months, and 140% additional for 10 consecutive months |
| Incentives for promotion, advertising, and sponsorship | Deduction of up to 150% of the income tax base for athletes and sporting events, programs against child malnutrition, care for people with disabilities, public educational institutions, and support for low-income students. |
| Benefits to boost investment | Tax debt forgiveness, exemption from foreign exchange tax, and payment facilities. |

Note: Prepared based on the Ecuador 2024 Internal Revenue System

Based on the above, it can be argued that tax incentives favor the development of organizations, especially private companies, allowing them to be an adequate channel for reducing costs and expenses, thus facilitating greater productivity and competitiveness, especially in the generation of attractive prices. What must be considered is that these incentives create additional administrative expenses for the tax control entity, which must

design and implement processes that allow for adequate control and supervision of the application of these fiscal policies.

.2 Implications of tax exemptions in financial statements.

González, García, and Guatibonza (2022) clearly state the difference between tax exemptions, benefits, discounts, and amnesties, noting that "Discounts are an incentive for the early payment of tax obligations" (p. 134), that is, they are a fiscal policy that encourages immediate collection, generating liquidity for the state. Amnesties "are a way of recovering part of the difficult-to-collect obligations owed by taxpayers who have failed to meet their tax obligations to the state." This incentive sends a message aimed at motivating taxpayers to change their non-payment behavior and generate unrecoverable income for the state. Tax benefits "constitute a partial or total reduction in an obligation contracted with the public administration." This is a broader tax issue that contemplates benefits for all taxpayers, whether individuals or legal entities, and tax exemption "is an attraction for companies that consists of a reduction in part of the tax obligation" (p.134). Therefore, exemptions are focused on achieving and encouraging the generation of economic activities by promoting business development and seeking a win-win situation throughout the value chain.

Tax exemptions as a strategy from an accounting and financial point of view have implications from two angles: one from the perspective of the state, which seeks to encourage the development of various targeted economic activities with the aim of generating higher revenues once implemented, thereby generating new tax revenues for all those involved in this development and contributing to the state budget's revenue account; the other aspect is that it has an impact on private companies, which, with a thorough understanding of each of the guidelines for its application, will enable them to achieve an advantage in reducing their tax burden, thereby reducing their tax expenses and allowing them to offer more competitive products at attractive prices, leading to growth in sales that will translate into economic benefits for all stakeholders.

Thus, the accounting effects will be reflected in the Statement of Financial Position and the Statement of Income, formerly known as the Balance Sheet and Income Statement, respectively.

The accounting accounts involved in private companies will be tax expenses with a direct impact on net income, retained earnings, or reserves that will consolidate better equity and positively affect cash flow, which, by not generating a higher tax payment, will contribute to the availability of organizational liquidity. However, for the accounting application of tax exemptions to be effective, highly trained personnel must be available to properly interpret and execute the regulations so that legal conflicts do not arise, causing other types of expenses, such as legal fees, in the event of a defense against notifications of inconsistencies in tax compliance by the tax supervisory body. This is the case presented by Yzaguirre, and Morales (2022) in their work entitled *Restrictive Interpretation of Tax Exemption*

The way in which tax texts establishing exemptions are interpreted has been repeatedly addressed by the courts of justice. The following case illustrates the type of issues discussed in them. In Chile, according to Article 12, E, No. 17 of Decree Law 825 of the Ministry of Finance, "income in foreign currency received by hotel companies registered with the tax authorities for services provided to foreign tourists

without domicile or residence in Chile is exempt from Value Added Tax (VAT)" (p. 109).

Against the backdrop of this Chilean tax policy, the following controversy arose due to differing interpretations of the rule by those involved in the present case, as mentioned by Yzaguirre and Morales (2022).

The duly registered company Services Truistical y Hostellers Paloma Lodge Limitada provided accommodation, sport fishing, excursions, horseback riding, and similar services to a group of foreign tourists. The company understood that all these services—paid for in dollars—were covered by the exemption. The tax authority, on the other hand, stated that the exemption covered only hotel services and that these corresponded solely to accommodation, so that additional services (excursions, horseback riding, etc.) should be taxed. In response, the company argued that the law clearly states that the exemption applies to all foreign currency income earned by these companies, provided that they are registered and the services are provided to foreigners without residence in Chile, all of which had occurred. The dispute was finally resolved by the Chilean Supreme Court on October 20, 2005, case number 680/2005, in favor of the tax administration. To this end, it argued that the exemption is an exceptional situation and that, in this context, "the principle of hermeneutics, according to which provisions that depart from the general criteria adopted in a body of law, regulating exceptional cases, must be interpreted restrictively" (p. 109) was important.

Similar cases of controversy have been seen in Spain, Argentina, and Mexico, reinforcing the fact that the application of tax exemptions by private companies requires extensive knowledge and proper interpretation of the law, so that it is truly a benefit and not a problem that causes legal conflicts, generating contingent expenses that are not contemplated in business development.

.3 Tax exemptions and management decisions.

According to Marchán (2010), tax exemptions "are fiscal policy instruments aimed at encouraging production or consumption, promoting investment, employment, and the equitable distribution of wealth, among other things" (p. 72). With this precept, managers of private companies should consider tax exemptions as a financial strategy that affects profitability and liquidity with a view to being well applied, logically measuring the operational and procedural risk of their execution, because it is not a matter of evading or avoiding taxes, but rather a tax planning tool that allows for improved productivity in reducing the tax burden and an increase in financial value for the entity.

Currently, tax exemptions are considered a key factor in some aspects, such as: the location of companies' operating points in free trade zones, the acquisition of goods from abroad in the case of tax-exempt goods, the hiring of young people and women, and the generation of new productive activities that allow for the expansion of new lines of business or market coverage.

Supported by the financial thinking of Bodie Zvi and Robert Merton's Theory (1999), which develops a postulate focused on understanding decision-making in conditions of risk and uncertainty, it is important to emphasize that management decisions must be based on

knowledge and experience in order to minimize uncertainty and generate all possible outcomes, which are the paths that frame probable scenarios for optimizing opportunities. and tax exemptions should be seen as alternatives that lead to a series of paths that project an increase in revenue, profits, profitability, market share, and a reduction in costs and expenses with an emphasis on adequate productivity.

• **Methodology**

This study is based on a quantitative approach under the precepts outlined by Hernández, Fernández, and Baptista (2003), which "uses data collection to test hypotheses based on numerical measurement and statistical analysis to prove or explain theories" (p. 4). The hypothesis proposed in this research is based on the premise that the inadequate application of tax exemptions affects the accounting and financial situation of companies that can make use of this benefit.

The population under study consists of 1,246,162 private companies in Ecuador in 2023 in all economic activities, with a focus on companies engaged in foreign trade, agricultural production and marketing, and hotel services. Relevant objective findings were obtained regarding the accounting and financial implications of tax exemptions, highlighting that social science research seeks to achieve the greatest possible objectivity through the application of quantitative methods, tools, and instruments, as Acosta (2023) points out in his work *Research Approaches in the Social Sciences*:

The quantitative approach is characterized by its objectivity, as it seeks to explain and predict phenomena through the analysis of numerical data, also employing standardization and replicability. (p.91).

The method that ensured the obtaining of results is the deductive method, coinciding with Dávila (2006), who states that "Deductive reasoning uses three moments of deduction: 1) Axiomatization (1st principle), starting from axioms; truths that do not require proof, 2) Postulation, referring to postulates, assimilated or created doctrines, and 3) Demonstration, referring to the scientific act of mathematicians, logicians, and philosophers... Deductions made from theory can provide hypotheses that are an essential part of scientific research" (p. 185).

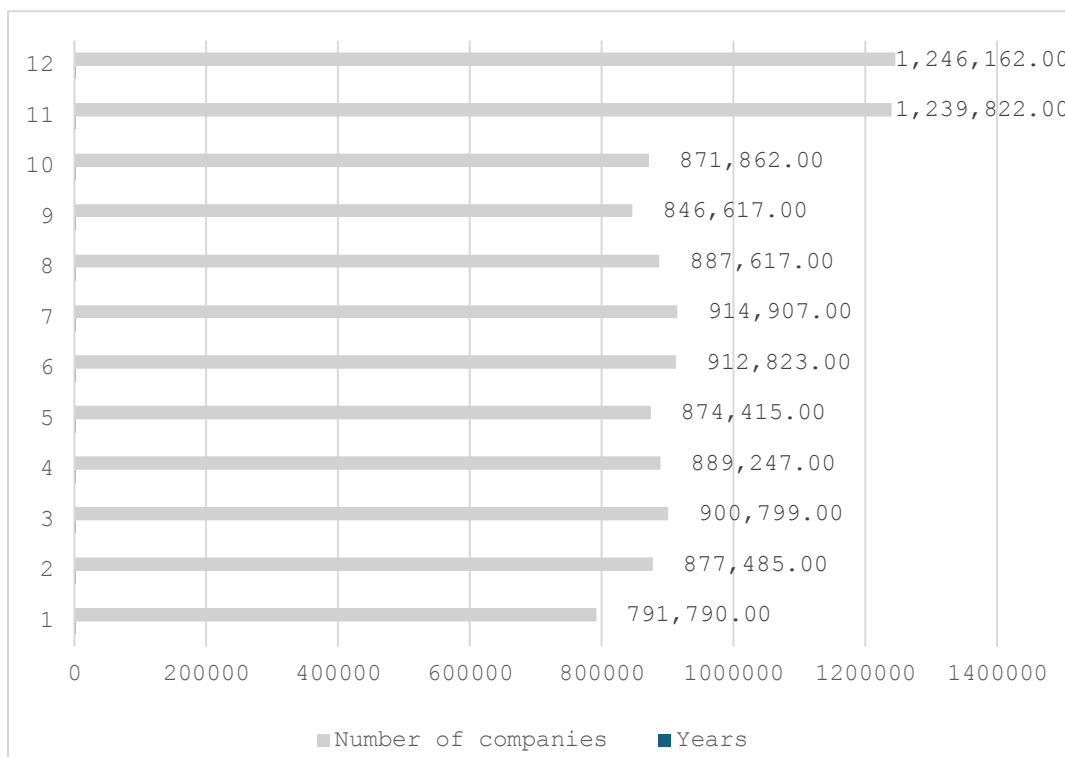
The techniques applied were surveys and analysis of financial indicators using instruments such as questionnaires and statistical data. These instruments were validated using Cronbach's alpha, which "is a measure of internal consistency, that is, how closely related a set of items are as a group. It is considered a measure of the reliability of the scale" (Pérez, 2022, p.1).

Chi-square and variable correlation in SPSS (Statistical Package for the Social Sciences) supported the verification of the hypothesis and determined the respective findings.

• **Results**

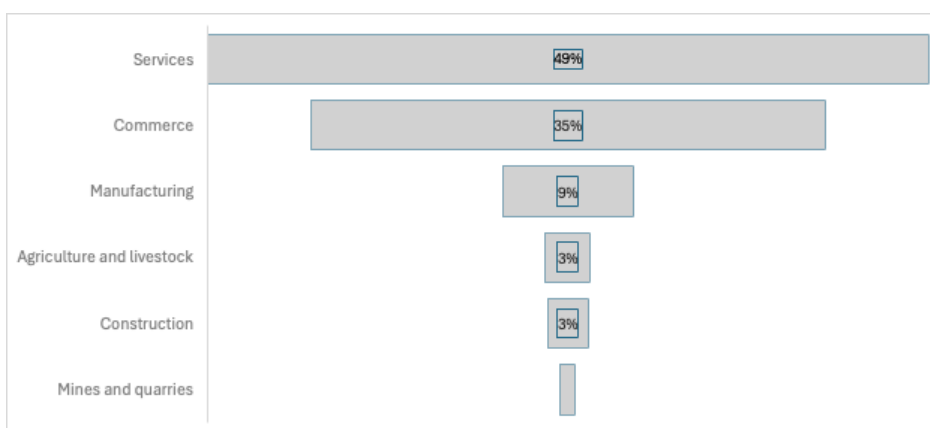
The population under study is based on an analysis of the growth of private companies in Ecuador from 2012 to 2023, with 1,246,162 active entities, considering the economic activities of services, commerce, manufacturing, agriculture and livestock, construction, mining, and quarrying.

Table 2. Population. Active companies 2012-2023 Ecuador



Note. Active Ecuadorian companies. Extracted from INEC 20

Figure 2. Companies by economic activity

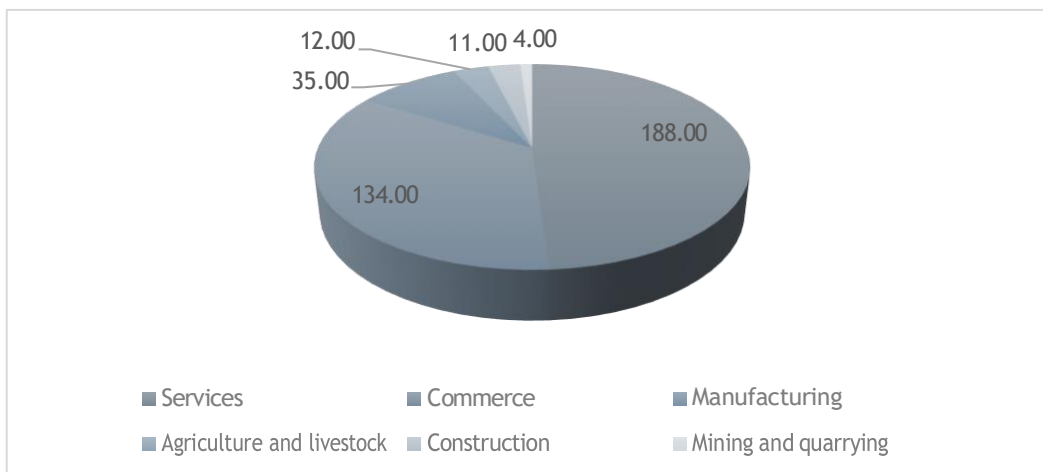


Note. Extracted from the National Institute of Statistics and Census of Ecuador 2023
Given the large population of Ecuadorian private companies, the study focused its

efforts on determining a representative sample by relevant sectors and statistically applying the calculation of infinite populations, as there are more than 100,000 elements under study. Cochran (1977) establishes the method of application for these cases using the following formula, generating a value of 384 companies to be evaluated in the factors included in this study.

$$n = \frac{Z^2 \cdot p \cdot q}{e^2}$$

Figure 3. Sample. Ecuadorian companies



Note. Prepared based on infinite population significance.

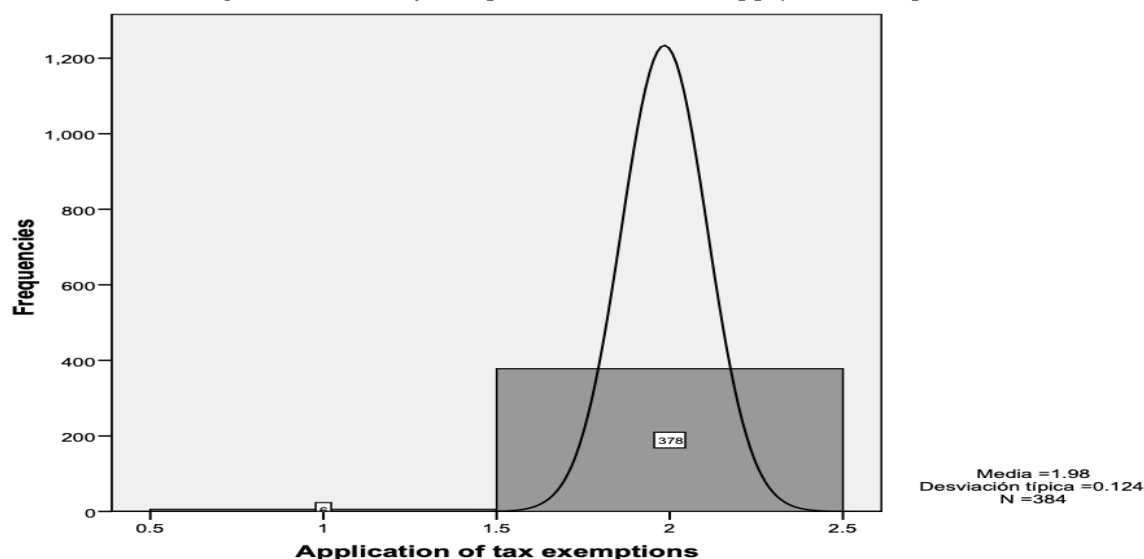
After designing the data collection instruments, Cronbach's alpha was applied to validate their reliability.

Reliability statistics

| Cronbach's Alpha | N of elements |
|------------------|---------------|
| ,906 | 12 |

One of the first findings is that 98% of companies do not apply tax exemptions in Ecuador. There are many factors that influence this, but it should also be noted that less formal companies, such as SMEs and micro-enterprises, are not very clear about the concept and characteristics of this fiscal policy.

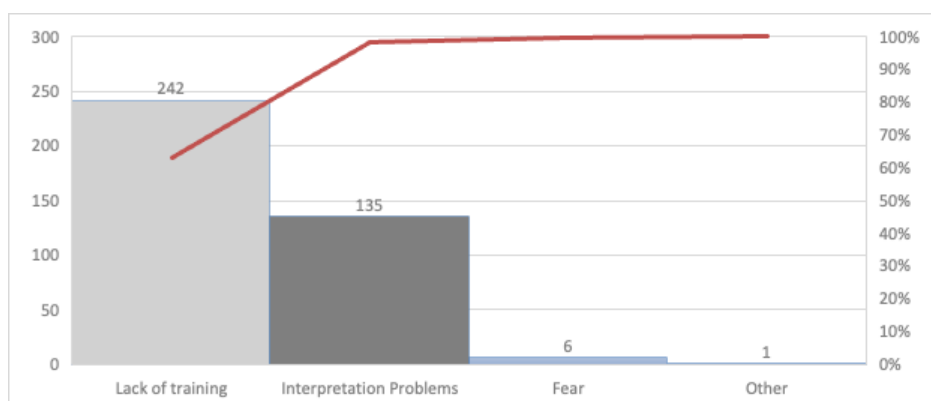
Figure 4. Trend of companies that do not apply tax exemptions



Note: Companies that do not apply tax exemptions. Ecuador 2024

The lack of training of legal advisors, accounting, and financial personnel in most Ecuadorian private companies means that they do not have *the expertise* to handle the details of each of the guidelines involved in tax exemptions. There are also problems in interpreting each of the conditions for the proper management of this fiscal alternative, which seeks to promote and support business development.

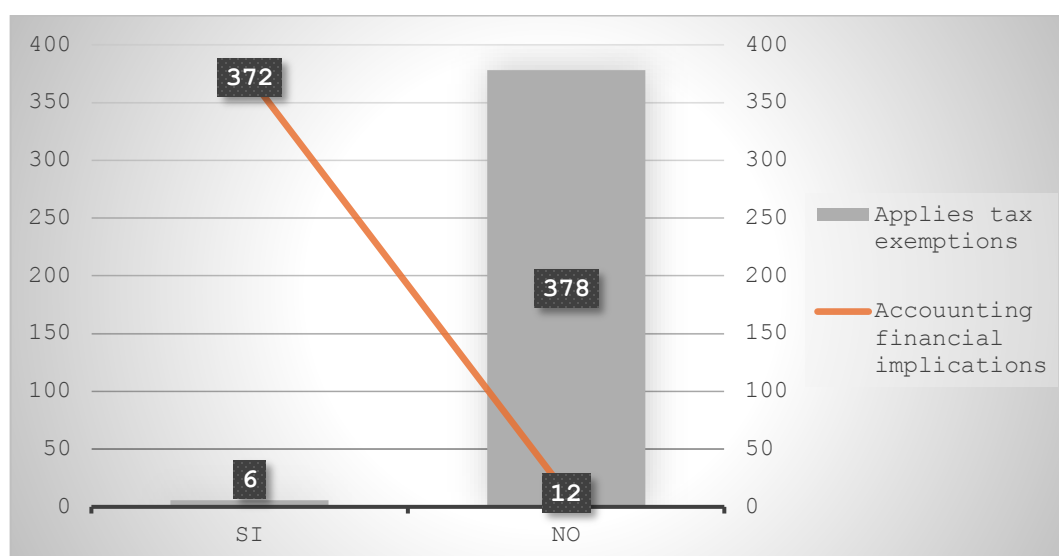
Figure 5. Factors for the non-application of tax exemptions



Note. Companies that do not apply tax exemptions. Ecuador 2024

Under the circumstances described above, it is evident that the non-application of tax exemptions by a large percentage of Ecuadorian private companies means that do not have the advantage of optimizing their tax burden, which is one of the causes of the country's lack of productivity.

Figure 6. Incidence of Variables



Note: Prepared based on fieldwork

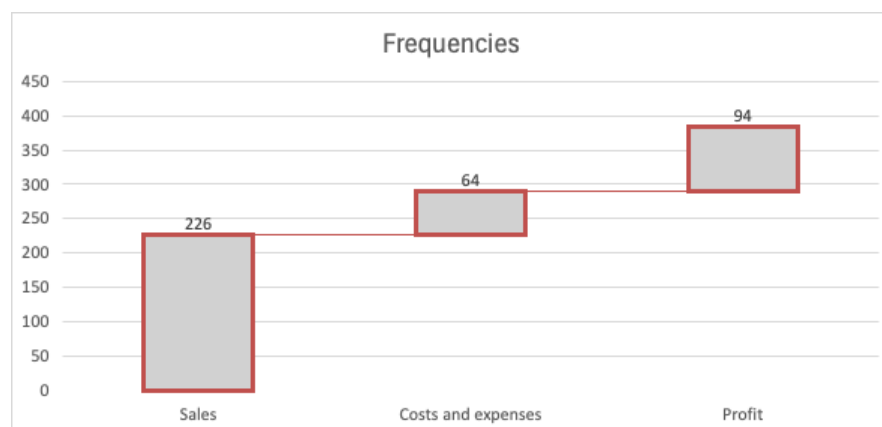
The main accounting accounts affected in terms of favorable conditions are sales, costs, expenses, and profits. Unfortunately, the implications of this type of item cause companies to have unfavorable financial indicators, basically in terms of profitability, liquidity, and productivity.

Table 3. Accounting accounts affected by not applying tax exemptions

| | | Frequency Percentage | | Valid percentage | Cumulative percentage |
|-------|-------------------|----------------------|-------|------------------|-----------------------|
| | | e | | | |
| Valid | Sales | 226 | 58.9 | 58.9 | 58.9 |
| | Costs and Expense | 64 | 16.7 | 16.7 | 75.5 |
| | s Profit | 94 | 24.5 | 24.5 | 100.0 |
| | Total | 384 | 100.0 | 100.0 | |

Note. Information as of 2024. Ecuador

Figure 7. Priority of affected accounting accounts



Note. Information as of 2024. Ecuador.

• Discussion

With the findings and thanks to the combination of methods, techniques, and statistical tools, it was verified that the hypothesis stated The *inadequate application of tax exemptions affects companies accounting and financially* is accepted, arguing with a Spearman's Rho value of 0.814 with a significant correlation between the two variables, which are tax exemptions and the accounting and financial impact on private companies.

Table 4. Correlations_ Hypothesis verification

| | | Application of tax exemptions | Accounting and financial impact of not applying tax exemptions |
|----------------|--|----------------------------------|--|
| Spearman's rho | Application of tax exemptions | Correlation coefficient 1.000 | .814(**) |
| | | Sig. (two-tailed) . | ,000 |
| | | N 384 | 384 |
| | Accounting and financial impact of not applying tax exemptions | Correlation coefficient .814(**) | 1.000 |
| | | Sig. (two-tailed) ,000 | . |
| | | N 384 | 384 |

** The correlation is significant at the 0.01 level (bilateral).

Similarly, to corroborate the data, Pearson's chi-square test was applied, and the same conclusion was reached, fulfilling the condition that when sig. asymptotic is less than 0.05, the proposed hypothesis is approved. As Perez (2005) points out, "If the sig value is less than 0.05 ($p < 0.05$): The null hypothesis H_0 of independence is rejected. This means that the association between the variables is not due to chance; therefore, there is a significant relationship between them. In other words, the hypothesis that the variables are related is supported by the data."

Table 5. Chi-Square Tests

| | Value | df | Asymptotic significance (two-tailed) | Exact significance (two-tailed) | Exact significance (one-tailed) |
|------------------------------|------------|----|--------------------------------------|---------------------------------|---------------------------------|
| Pearson's chi-square | 254.653(b) | 1 | .000 | | |
| Continuity adjustment(a) | 194,085 | 1 | ,000 | | |
| Reason for plausibility | 36,835 | 1 | ,000 | | |
| Fisher's exact statistic | | | | ,000 | .000 |
| Linear association by linear | 253,989 | 1 | ,000 | | |
| Number of valid cases | 384 | | | | |

a Calculated only for a 2x2 table.

b 2 cells (50.0%) have an expected frequency of less than 5. The minimum expected frequency is .06.

• **Theoretical contribution and practical implications.**

In line with the basic objective of all research, which is to generate previously validated knowledge, this study generates a model based on the linear regression technique called *Effective Tax Rate (ETR)* or *Tax Optimization Model*, which is set out in the following statement:

$$Y = f(x)$$

$$Imp_{c-f}^+ = Et_{op}(x)$$

From where:

Imp^+_{c-f} = Positive accounting and financial impact

Et_{op} = Tax exemptions applied optimally

Table 6. Model summary

| Model | R | R squared | Corrected R-squared | Standard error of the estimate |
|-------|---------|-----------|---------------------|--------------------------------|
| 1 | .814(a) | .663 | .662 | .072 |

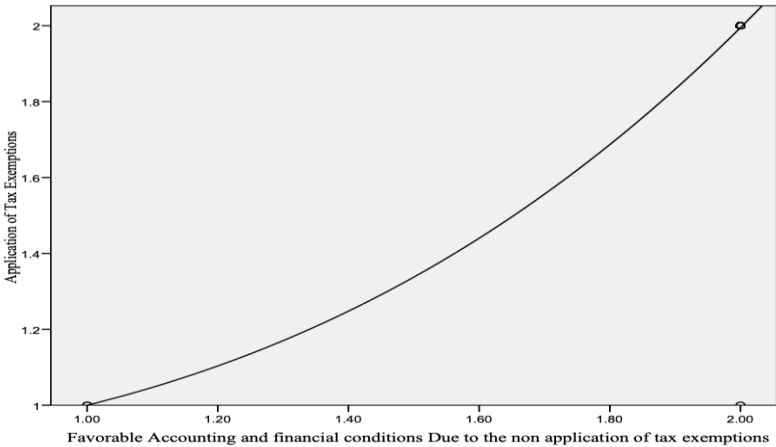
a Predictor variable: (Constant), Favorable accounting and financial conditions due to not applying tax exemptions

Table 7. Model description

| | | | |
|--|-------|--|--|
| Model name | MOD_3 | | |
| Dependent variable | 1 | Application of tax exemptions | |
| Equation | 1 | Linear | |
| Independent variable | | Favorable accounting and financial conditions due to not applying tax exemptions | |
| Constant | | Included | |
| Variable whose values label the observations in the graphs | | Not specified | |

Note. Statistical support for model argument.

Figure 8. Graphical validation of the model



Note. Statistical support for model argument.

The proper application of tax exemptions in private companies directly contributes to improving the items in the balance sheet and income statement, thus significantly contributing to the financial indicators of organizations. It is a strategic guideline that all private entities should consider in order to generate competitive advantage.

- **Limitations**

Throughout the research process, the following contextual limitations were found: Its scope does not consider public companies or entities because the focus is more on the benefits of tax exemptions for private companies; in addition, for a specific study and applicability, the legal and tax guidelines of each country must be considered.

Further research in this area is recommended, as it is a crucial element that guides achievements and results for organizations and all stakeholders.

- **Conclusions**

Tax exemptions in many countries around the world have been designed and implemented with the aim of achieving joint results. In the first instance, the state seeks to increase its tax revenues and contribute to the source of income for its state budget by encouraging business development. With the right impetus from this fiscal policy, private companies will be able to offer more competitive prices, boosting their sales and achieving better conditions in the market. However, it should be noted that, in practice, all legal aspects must be taken into account in order to minimize operational risks that could lead to unforeseen contingent expenses, as Yzaguirre and Osorio (2022) point out "Part of Ibero-American tax jurisprudence considers that exemptions should be interpreted restrictively because each one has its own characteristics and conditions" (p. 133). Tokman, Rodriguez, and Marshall (2006) express a similar view, stating that "As a public policy tool, tax exemptions have costs and benefits" (p. 72).

For states, fiscal policies should be a tool that motivates private companies to grow, but to do so, they must consider holistic elements such as adequate dissemination of regulations and a control and supervision process that guarantees their efficiency, in agreement with González, García, and Guatibonza (2021), who point out that "The use of tax exemptions has been one of the main instruments used by municipal administrations to attract businesses and generate employment" (p. 151).

The vast majority of private companies do not apply the tax exemptions offered by their state governments. This is due to a lack of knowledge of tax regulations or policies, the application of erroneous interpretations, and the fear of their officials to implement new processes. These factors are the most critical and are the responsibility of these organizations to take advantage of these benefits, which can contribute significantly to their development.

The implications for the state of affairs and income statement accounting items thanks to the effective implementation of tax exemptions are expenses for tax burden minimization, net profit, cash from not paying more taxes, cost reduction in the case of labor cost deductions, and less investment in the acquisition of goods.

Profitability, liquidity, and productivity are the main financial indicators favored by the tax exemption policy for private companies, logically argued in a correct implementation. Based on the proposed mathematical model called *Effective Tax Rate (ETR)* or *Tax Optimization Model*, the accounting and financial implications for a private company from a tax perspective are a function of tax exemptions implemented effectively and correctly.

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