

Comments on “Trade in services, intangible capital, and the profit shifting hypothesis”

James R. Hines Jr.
University of Michigan and NBER

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Fascinating topic, great data.

- The paper examines international service payments by Italian firms.
- The concern that motivates this paper – and much of the literature – is that payments to related parties can be strategically manipulated to reduce tax obligations.
- The tax play is to create income in low-tax jurisdictions and deductions in high-tax jurisdictions.
- There is no doubt that this happens.
- There is also no doubt that the extent to which this happens has been greatly exaggerated.
- What the literature needs is careful scientific investigation. This paper uses great data that can serve as the foundation of such investigation.

Tax avoidance.

- It is not simple or easy to use service transactions to shift income to low-tax locations.
- Arm's length pricing rules require that transactions between related parties be treated for tax purposes as occurring at arm's length prices.
- Consequently, a multinational firm cannot simply transfer IP to an affiliate in a tax haven – the tax haven affiliate has to acquire the IP.
 - This creates taxable income in the jurisdiction that sells the IP.
- Then if the tax haven affiliate licenses the IP to an Italian corporation, the royalty payment is supposed to be determined by market prices.
- Taxpayers have incentives to understate the value of IP for the purpose of selling it to a tax haven affiliate, and then overstating it when determining appropriate royalties.
- The concern with royalties for IP and headquarter services is that it can be difficult to know what genuine market prices would be.

Profit shifting.

- There is well-founded concern that, because IP is difficult to value, it is the main way in which taxable profits are shifted from high-tax countries to low-tax countries.
- There are estimates of the magnitude of profit-shifting. But one challenge that all such estimates encounter is the problem that we do not know where profits would have been earned in the absence of shifting.
 - Studies address this problem in various ways, mostly pretty unsuccessfully.
 - A second challenge is that tax haven profits are double-counted.
- For example, employment or labor compensation is a very bad proxy for where profits are earned.
 - It is kind of obvious that this would be a bad proxy.
 - If you run a cross-sectional regression across firms with profits on the left and labor expense on the right, you usually get a negative sign (e.g., Hines, European Economic Review, 2010).
 - The labor proxy makes sense only if there is no alternative.

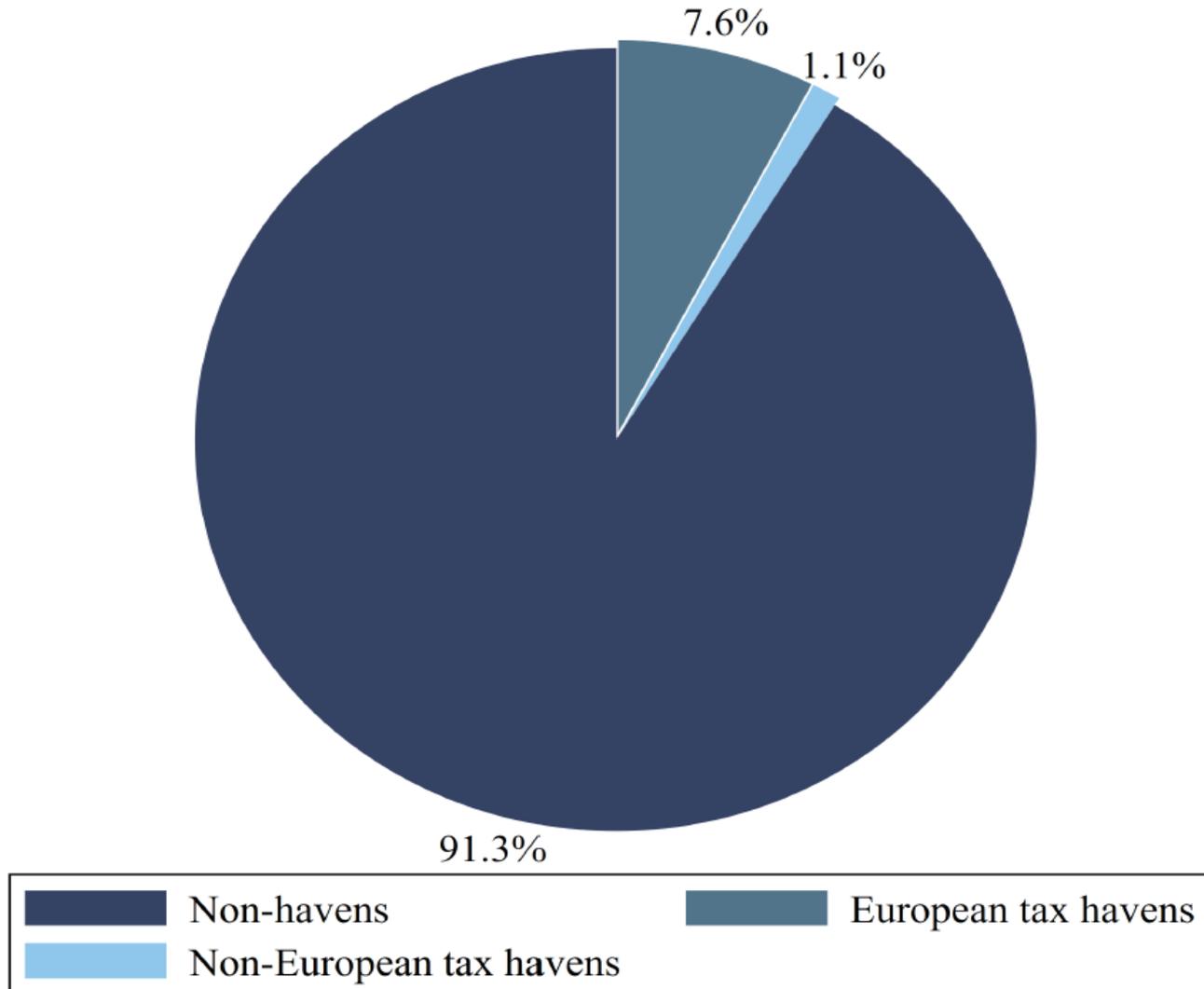
More on profit shifting.

- It is evident that firms arrange their financing (borrow in high tax places, lend in low tax places) to reduce taxes, and also use IP strategically to locate as many profits in tax havens as they can.
- But the extent of profit shifting is nonetheless quite limited.
- Setting up an affiliate in a tax haven is easy and almost costless, yet surprisingly few multinationals have any tax haven affiliates.
 - Fewer than half of U.S. multinational firms have any tax haven affiliates.
 - In slightly older data, only 20 percent of German multinationals have any tax haven affiliates.
 - This tells you that it cannot be easy to shift profits to tax havens.
- There is extensive evidence, over a long period of time, that high tax rates discourage FDI, and low tax rates encourage it.
 - The estimated elasticities of FDI with respect to tax rates are in the neighborhood of 2.0-2.5, much larger than any other kind of investment.
 - If it were easy to shift profits this would not be true, because firms would locate FDI without regard to tax rates and then shift profits to havens.

Example: German multinationals.

- Germany effectively has a territorial tax system that gives firms strong incentives to attribute their profits to affiliates located in low-tax countries.
- Nevertheless, only 20 percent of German multinationals have tax haven affiliates.
- Among the 333 largest German multinationals the fraction with tax haven affiliates is much higher, but even among these firms, they report that less than 9 percent of their 2016-2017 income was earned in tax havens.
 - “Corporate profit shifting and the role of tax havens: Evidence from German country-by-country reporting data,” by Clemens Fuest, Felix Hugger, and Florian Neumeier (all University of Munich), CESifo Working Paper No. 8838, January 2021.

Figure 5: Global distribution of German MNEs' profits



The way forward.

- We already know that IP is used to shift profits to low tax places.
- What we need to know is under what circumstances firms do so – and when they do not.
 - What observable factors – in addition to size and industry – are associated with the extent to which firms pay royalties to tax haven affiliates?
 - Many firms have negative taxable income in a given year. This is a sign of uncertainty (and is a circumstance in which you do not have an incentive to shift profits out). To what extent are IP payments and receipts associated with reported losses?
 - Is it the case that firms that pay IP royalties to tax haven affiliates also receive royalties from them, or are these different firms? Are they entirely distinct?
 - What observable factors are associated with Italian affiliates receiving royalties for IP, where the payor is an affiliate in a tax haven?
 - To what extent do patterns of service payments differ based on the nationality of foreign-owned firms?
- There are interesting published studies, such as Dharmapala and Riedel JPubE 2013, and Clausing 2001, that might serve as empirical models.
- Dharmapala has a nice survey of the evidence on multinational use of tax haven affiliates in a recent book.
- This is an exciting project, and I look forward to seeing what comes next.