

The indirect effect of import competition on corporate tax avoidance

Baptiste Souillard

ECARES, SBS-EM, Université Libre de Bruxelles

MOTIVATION

- Tax dodging has become a major policy concern in a context marked by tax scandals, budget deficits, and rising income inequalities.
- A specific group of enterprises is very often accused of large-scale tax avoidance: multinational enterprises (MNE). They exploit technicalities of the law (e.g., loopholes, mismatches between tax systems) in order to artificially shift profits towards tax-friendly jurisdictions and reduce their tax liability.
- The methods employed to do so are now well-documented. One consists in locating intellectual property rights in low-tax countries and using royalty payments to deflate profits booked in high-tax countries (Beer et al., 2020).
- Determinants of corporate tax avoidance receive growing attention but the role played by output market competition is theoretically unclear.

RESEARCH QUESTION

Does competition affect corporate tax avoidance? If so, how?

APPROACH

I build on 2 strands of the literature: economics and accounting.

- I focus on the China shock → massive shock that differentially exposed sectors within manufacturing and makes possible to use the granting of the Permanent Normal Trade Relation status by the US to China in late 2000 as a quasi-natural experiment to establish causality (Pierce and Schott, 2016).
- I exploit financial statements to construct indicators of tax avoidance and look at their evolution before and after the conferral (De Simone et al., 2019).

DATA

- Sources: Compustat, NBER, Pierce and Schott (2016), and Schott (2008).
- I focus on US-listed manufacturing firms operating between 1990 and 2005.
- I define 4 firm-year complementary variables of corporate tax avoidance:

$$\begin{aligned} ETR_{ijt} &= \frac{\text{Income taxes}_{ijt}}{\text{Pre-tax income}_{ijt}} & CETR_{ijt} &= \frac{\text{Cash income taxes}_{ijt}}{\text{Pre-tax income}_{ijt}} \\ ETR2_{ijt} &= \frac{\text{Non-deferred income taxes}_{ijt}}{\text{Pre-tax income}_{ijt}} & CFM_{ijt} &= \frac{\text{Cash income taxes}_{ijt}}{\text{Operating cash flows}_{ijt}} \end{aligned}$$

Firm i mainly operating in 4-digit SIC industry j in year t .

- Exposure to the import competition shock induced by the granting is sector-specific and given by the difference between the non-normal-trade-relations tariff rate ($NNTR$) and the normal-trade-relations tariff rate (NTR) in 1999.

IDENTIFICATION STRATEGY

I adopt a difference-in-differences methodology:

$$CTA_{ijt} = \alpha + \beta PNTR_{jt} + \gamma X_{ijt} + \mu_i + \nu_t + \epsilon_{ijt}$$

- CTA can be either ETR , $ETR2$, $CETR$, or CFM .
- $PNTR_{jt} = \mathbb{1}_{t \geq 2001} \times (NNTR_{j1999} - NTR_{j1999})$.
- X_{ijt} a vector of confounding factors.
- μ_i and ν_t form a set of firm and year fixed effects.

BASELINE RESULTS

The estimation results indicate a positive average effect of Chinese import competition on corporate tax avoidance:

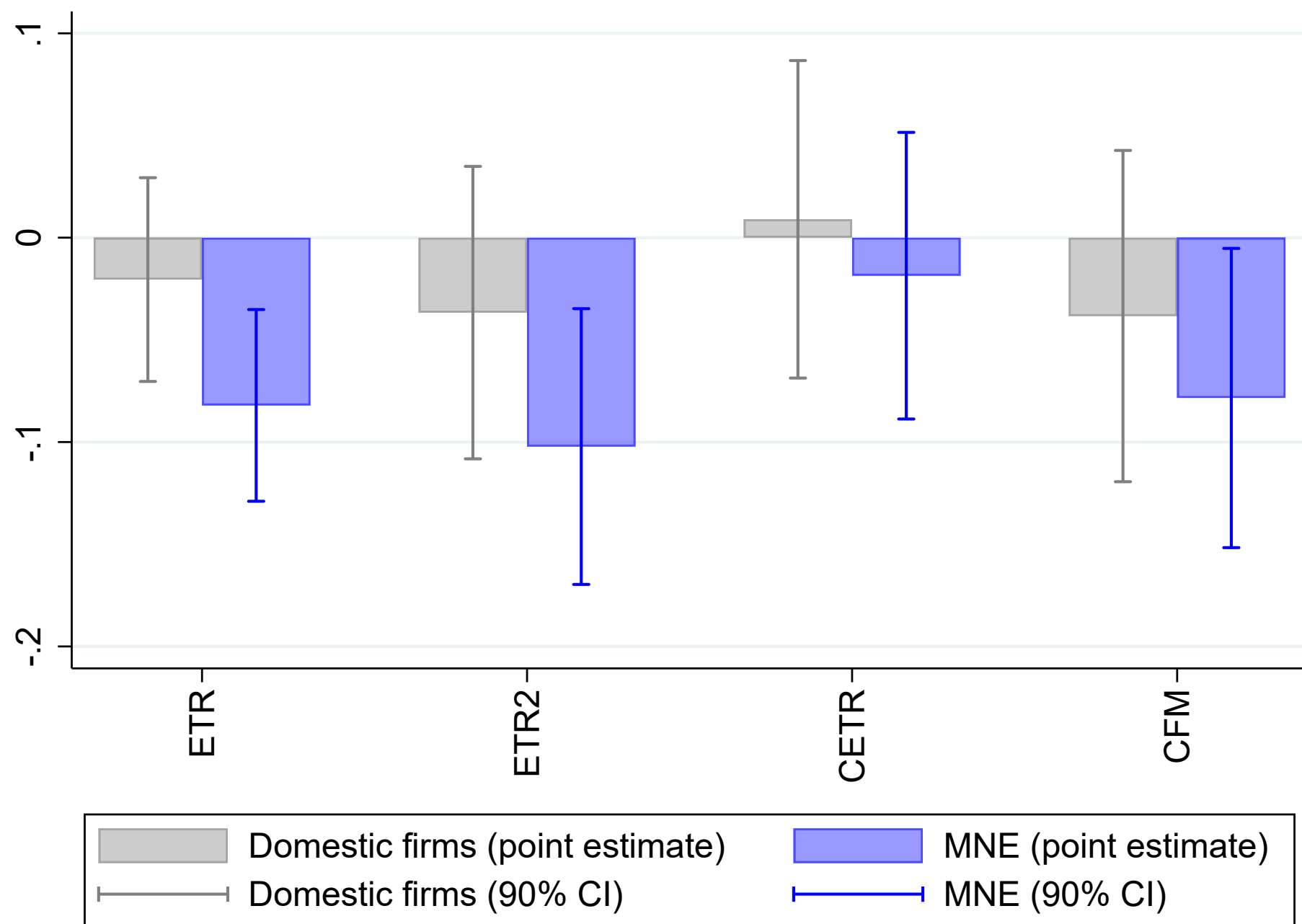
CTA_{ijt}	ETR_{ijt}	$ETR2_{ijt}$	$CETR_{ijt}$	CFM_{ijt}
β	-0.06 ^b	-0.08 ^c	-0.01	-0.07 ^d
Controls	Yes	Yes	Yes	Yes
Firm and year FEs	Yes	Yes	Yes	Yes

Standard errors are clustered at the 4-digit SIC industry. ^d $p < 0.15$, ^c $p < 0.10$, ^b $p < 0.05$, ^a $p < 0.01$.

These results are validated by a series of robustness checks (cf. full paper).

MECHANISM: DOMESTIC FIRMS *VERSUS* MNE

The estimation results also reveal that the average effect is driven by MNE, which is reminiscent of profit shifting activities:



Standard errors are clustered at the 4-digit SIC industry.

MECHANISM: THE ROLE OF INTANGIBLES

	ETR_{ijt}	$intangibles_{ijt}$
$PNTR_{jt}$	-0.03	0.02
$PNTR_{jt} \times MNE_{ijt}$		0.04 ^c
$intangibles_{ijt}$	0.04 ^a	
$intangibles_{ijt} \times MNE_{ijt}$	-0.06 ^b	
Controls	Yes	Yes
Firm and year FEs	Yes	Yes

MNE is a dummy variable equal to 1 if the firm is multinational and $intangibles$ represents the share of intangible assets in total assets at the firm-level. Standard errors are clustered at the 4-digit SIC industry. ^d $p < 0.15$, ^c $p < 0.10$, ^b $p < 0.05$, ^a $p < 0.01$.

Additional estimation results show that:

- MNE avoid taxes by using intangible assets (cf. column 1),
- the China shock pushed MNE to invest in intangible assets and the latter facilitated their tax-dodging strategies (cf. columns 1 and 2),
- investments in intangibles were aimed at escaping Chinese import competition in the first place (cf. full paper).

TAKEAWAY

Chinese import competition shock



Investments in intangible assets by MNE



Intensification of profit shifting activities

POLICY IMPLICATIONS

- The China shock contributed to the decline in the average effective tax rate of US-listed firms observed between 1990 and 2005 (Dyreng et al., 2017).
- Trade, competition, and corporate income taxes are connected → trade, industrial, and fiscal policies should be conducted jointly.

REFERENCES

- Beer, S., de Mooij, R., & Liu, L. (2020). "International corporate tax avoidance: A review of the channels, magnitudes, and blind spots". *Journal of Economic Surveys*, 34(3), 660-688.
- De Simone, L., Nickerson, J., Seidman, J. K., & Stomberg, B. (2019). "How reliably do empirical tests identify tax avoidance?". *Contemporary Accounting Research*, 37(3), 1536-1561.
- Dyreng, S. D., Hanlon, M., Maydew, E. L., & Thornock, J. R. (2017). "Changes in corporate effective tax rates over the past 25 years". *Journal of Financial Economics*, 124(3), 441-463.
- Pierce, J. R., & Schott, P. K. (2016). "The surprisingly swift decline of US manufacturing employment". *American Economic Review*, 106(7), 1632-62.
- Schott, P. K. (2008). "The relative sophistication of Chinese exports". *Economic Policy*, 23(53), 6-49.