Profit Shifting, Employee Pay, and Inequalities: Evidence from US-Listed Companies

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FREEDOM TO RESEARCH

- **Corporate tax avoidance** is under the glare of public spotlight.
- Context: repeated data leaks and tax scandals, persistent budget deficits in the US and in Europe, rise of income inequalities, globalization backlash, pandemic, etc.
- **Multinational enterprises** (MNEs) are accused of large-scale tax avoidance and **profit shifting** (PS), i.e., of artificially booking their profits in low-tax jurisdictions and tax havens.
- The techniques used to this end are well-documented in the literature, but the **consequences** of PS (beyond tax revenues) have received limited attention.
- Little is known on its **distributional impact**. It is often argued that PS aggravates income inequalities, but systematic evidence along these lines remains scarce.

The effect of PS on employee pay can be examined through the lens of **rent sharing models**.

- Plain-vanilla model of collective bargaining: $w = \bar{w} + kS \rightarrow$ PS triggers 2 opposite forces.
  - ⊕ It reduces taxes and thereby increases the surplus (S) to be shared between the MNE and its workers.
  - ⊖ It creates an asymmetric information about profitability that weakens workers' bargaining power (k).
- According to the (theoretical) literature, the adverse effect should dominate.
- However, for executives:
  - ⊕ is more likely to kick in (especially for those paid on an after-tax basis).
  - ⊖ should be negligible (they oversee economic and financial operations).

Testable prediction

We expect PS to have a positive effect on the compensations of executives (notably for those receiving after-tax incentives) and a negative effect on the wages of non-executive employees.

What I do in this paper

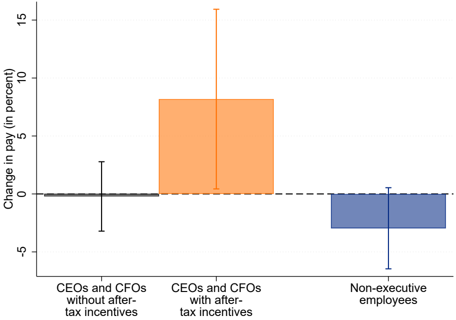
I confront theory and data and **empirically** study the impact of PS on employee pay and inequalities.

1. I construct a **rich database** containing information on the
   - financial statements,
   - foreign subsidiaries,
   - and executives

   of firms listed on the Standard & Poor's (S&P) 1500 index between 1993 and 2013.

2. With an **event study**, I analyze how firm entry into tax havens affects
   - the compensation of executives
   - and overall payments to non-executive employees.

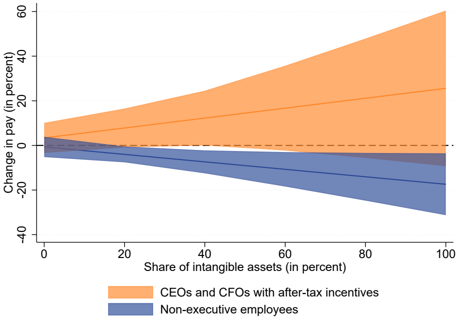
The effect of firm entry into tax havens on employee pay (average effect)



Notes: Point estimates with 95 percent confidence intervals. Standard errors are clustered at the firm level.

- The increase in compensations mostly takes the form of non-equity incentive plans.
- The decrease in payments to non-executive employees is sometimes insignificant, depending on the model's specification ($\rightarrow$ if anything, the impact is negative).

The effect of firm entry into tax havens on employee pay (according to firm intensity in intangible assets)



Notes: Point estimates with 95 percent confidence intervals. Standard errors are clustered at the firm level.

- Compelling evidence shows that **intangible assets** fuel and facilitate profit shifting.
- Is the inequality-deepening effect **most striking in intangible-intensive firms**? It seems so!

Summary

- The analysis confirms that firm entry into tax havens **worsens within-firm pay inequalities**.
  - ⊕ Compensations of CEOs and CFOs remunerated on an after-tax basis grow by 8 percent.
  - ⊖ Total payments to non-executive employees, if anything, decline by 3 percent.

- The inequality-deepening effect is **more pronounced** in **intangible-intensive firms**.

- These findings are robust and have **policy implications**.
  1. They shed light on the distributional impact of profit shifting.
  2. They help explain recent trends in income inequalities and uncover a new mechanism whereby globalization widens income inequalities.
  3. They further support the implementation of anti profit shifting measures.

Thank you for your attention!

Comments, questions, and suggestions are welcome:

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Full paper:

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