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

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Motivation

- **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.

Theoretical background

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.

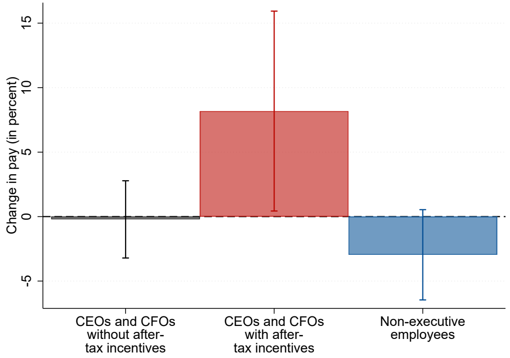
1. I construct a **rich database** containing information on the
   - financial statements,
   - foreign subsidiaries,
   - and executives

   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.

Main results

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

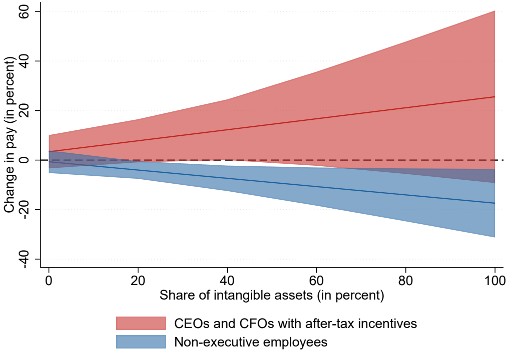


Notes: Point estimates with 95 percent confidence intervals. Standard errors are clustered at the firm level.

- 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 role of intangible assets

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:

www.baptistesouillard.com