Unintended Consequences of Eliminating Tax Havens

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Motivation

- Profit shifting to tax havens by MNCs lowers tax revenues and motivates tax reform
- Question: does eliminating tax havens have unintended consequences for the domestic economy?
  - Specifically, how does such reform affect real economic outcomes, such as domestic investment and employment?
- Contribution to public finance literature
  - Quantifying profit shifting by MNCs
  - Studying real responses of MNCs to international taxation
  - Exploring geographic variation in burden from tax reform

Approach

- Study 1996 repeal of Internal Revenue Code Section 936, which phased-out abilities of US MNCs to shift profits to Puerto Rico
  - Section 936: tax credit for US MNCs if income originated in affiliated corporations in Puerto Rico or other US possessions
  - Accounted for 10-15% of total profits shifted out of US at time of repeal (Clausing, 2009)
- Evaluate effects on investment and employment in the US and establish findings in three steps
  1. Construct model of multnational investment and profit shifting
  2. Test predictions of model using firm-level datasets and DiD methodology
  3. Explore how firm-level responses affect local labor markets differentially

Model of Profit Shifting

- Firms solve tax planning problem:

$$\max_{\{r_j\}} \sum_j K_j \left[(1-t_j)\, r_j - \rho - \frac{\left(r_j - \bar{f}_j\right)^2}{2a} \right] \text{ s.t. } \sum_j \bar{f}_j K_j = \sum_j r_j K_j$$

$$\iff \max_{\{r_j\}} \underbrace{\sum_j \left[(1-t_j)\, f_j\,(K_j) - \rho\, K_j\right]}_{\text{Economic Incentives}} + a \sum_j K_j \underbrace{\left[(1-t_j)\,(\tilde{t} - t_j) - \frac{\left(\tilde{t} - t_j\right)^2}{2} \right]}_{\text{Net Benefit from Profit Sharing}}$$

- Assuming the US is a high-tax country, $\tilde{t} \leq t_{US}$, and capital complements labor, repeal should:
  - Decrease profit shifting toward Puerto Rico and increase reported profits in the US
  - Lower global investment and employment for exposed firms
  - Shift investment and employment from US $\rightarrow$ low tax countries

Firm-Level Effects of Repeal

- Estimate:

$$Y_{ct} = \alpha_i + \gamma_t + \beta^t \text{Exposure§936}_c + \varepsilon_{ict}$$

  - Assumption: firms that took advantage of §936 were not on differential trend, and no other shocks coinciding with the repeal for exposed firms

Figure 5: Repealing §936 Reduced Investment-to-Capital Ratios of Exposed Firms

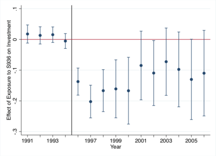


Figure 6: Repealing §936 Increased the Foreign Share of Investment of Exposed Firms

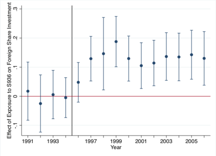


Figure 7: Repealing §936 Reduced CAPX Investment in Exposed Industries

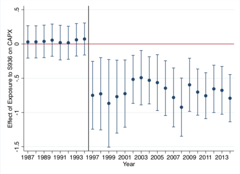
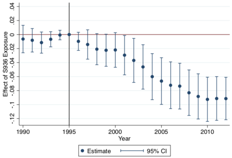


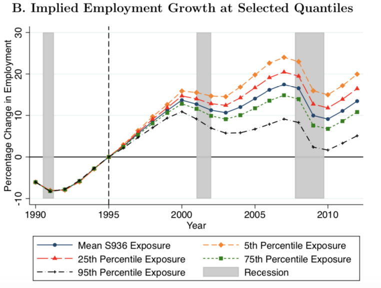
Figure 8: Firm-Level Employment Effects of Repealing of §936



Notes: $(Emp_{it}-Emp_{i1995})/Emp_{i1995}=\alpha_t+\beta_t S936\ Exposure_i+\varepsilon_{it}$. SE's clustered by Firm.

Effects of Repeal on Local Labor Markets

- Tax haven activities seem complementary to domestic employment



- Additional results
  - Tradable jobs were first to decline and were followed by non-tradable jobs and construction, pointing to local employment multipliers
  - More exposed conspumas saw reductions in wage growth, wages of low-skilled workers, rental costs, and home values, while transfers from income replacement programs rose

Conclusion

- Reducing tax attractiveness of Puerto Rico for firms reduced employment and investment in the US
  - Effects are persistent and larger for some local economies than others
- Implications
  - Gaps exist in previous cost-benefit analyses of similar tax reform
  - Policies limiting profit shifting can differentially affect firms based on the nature of their assets (intangible-heavy $\approx$ more mobile?)
  - Caution necessary, as well-intentioned policy may backfire
- Evidence here cannot settle debate over desirability of tax havens
  - Hong and Smart (2010): tax havens can help governments redistribute from domestic firm owners to workers by screening mobile and non-mobile forms of capital
  - Slemrod and Wilson (2009): enforcement costs negate benefits, eliminate all tax havens