ESSAYS ON THE COST OF PROFIT SHIFTING

Chapter 1:
How does transfer-pricing enforcement affect reported profits?

Governments, concerned that they are losing tax revenue to profit shifting by multinational firms, have increasingly put in place regulations designed to make shifting more costly. This paper presents a model that shows that it is possible, and in fact likely, that these regulations actually reduce tax collections. The regulations are designed with a goal of decreasing profit shifting outflows, but they also both decrease profit-shifting inflows and increase the cost of compliance for all firms with related-party transactions. While the reduction in outflows should increase reported profits, the other two effects, the reduction in inflows and the increase in compliance costs, reduce reported profits. Evidence from changes in regulation over time support the predictions of the model. Data from ORBIS on multinational corporations indicate that increased regulation has a negative effect on a multinational firm’s reported local profits. Consistent with the model, the effect is more negative for firms with more higher-tax subsidiaries and is less negative for firms with more lower-tax subsidiaries.

Chapter 2:
Shifting against the tax differential

The literature on profit shifting has generally ignored the determinants of the cost of profit shifting. The fact that models have focused on net shifting (outflows minus inflows) means that papers have not considered the determinants of optimal profit-shifting flows between two affiliates in a multi-country setting. In this paper, I consider the determinants of optimal gross shifting between affiliates, allowing the determinants of the cost of shifting to differ across countries. I show that gross profit shifting will not always move in the direction of the tax differential. If countries differ in how responsive they are to deviations between true profit and reported profit then this can result in profit shifting from lower-tax affiliates to higher-tax affiliates. This tendency to shift from a middle-tax country to a higher-tax country is especially strong when the middle-tax country focuses enforcement efforts towards lower-tax affiliates. This suggests there might be a danger in targeting enforcement efforts at transactions with low-tax affiliates, as it may encourage shifting through a high-tax, low-enforcement affiliate instead.
Chapter 3:
Do information exchange agreements limit profit shifting?

In the last few decades, countries have been increasingly active in signing tax information exchange agreements. The purpose of these agreements is often claimed to be two tier. They are intended to both make taxation for multinationals less risky and to make it harder for these multinationals to avoid paying taxes. There is some evidence that indicates that bilateral agreements have little effect on FDI, but little work has been done to capture the effect these agreements have on tax avoidance. Using information on the date that tax exchange of information agreements entered into force from the Exchange of Information tax portal, I test if the reported profit of a firm changes after its home country enters into information exchange agreements with countries in which it has subsidiaries. If information exchange agreements limit profit shifting then, as the number of lower-tax subsidiaries covered by information exchange agreements increases, the firm should experience an increase in reported profit.