Discussion: “Profit Shifting”
- Liu, Schmidt-Eisenlohr, and Guo
- Flaaen

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Outline

<u>Summary:</u> Two thorough and thoughtful papers

- Use high-dimensional FEs to address identification issues
- Plus quasi-experiments:
  - UK tax reform in 2009
  - US AJCA/HIA in 2004

<u>Comments</u>: Empirical analysis is generally convincing; focus on broader conceptual questions:

- Efficiency costs of transfer "mispricing"
- Is the ALP the appropriate counterfactual?

Some Specific Questions: Flaaen

- AJCA: PRE constraint on round-tripping?
  - Limit on qualifying repatriations related to the amount designated as PRE in 2003
- Why a -ive effect for foreign-owned US affiliates (p. 20)?
  - "Competition" with US-owned firms not convincing if the latter used repatriations primarily for share repurchases
- How does magnitude compare to Bradley (2016)?
  - "Modest" round-tripping effect
- Hartman (1985) model is less relevant when passive investments are feasible (Weichenrieder, 1996)

The Models

Data question: Why do these data sources (HMRC and LFTDD) record p_T rather than p_I? Not obvious that they would do so – how do we know this?

A

Product

B

Internal transfer price: p_I

Tax transfer price: p_T

MC = $10
Profits = ?
Tax rate = 20%

The models ignore p_I
Implicitly, "one-book" models

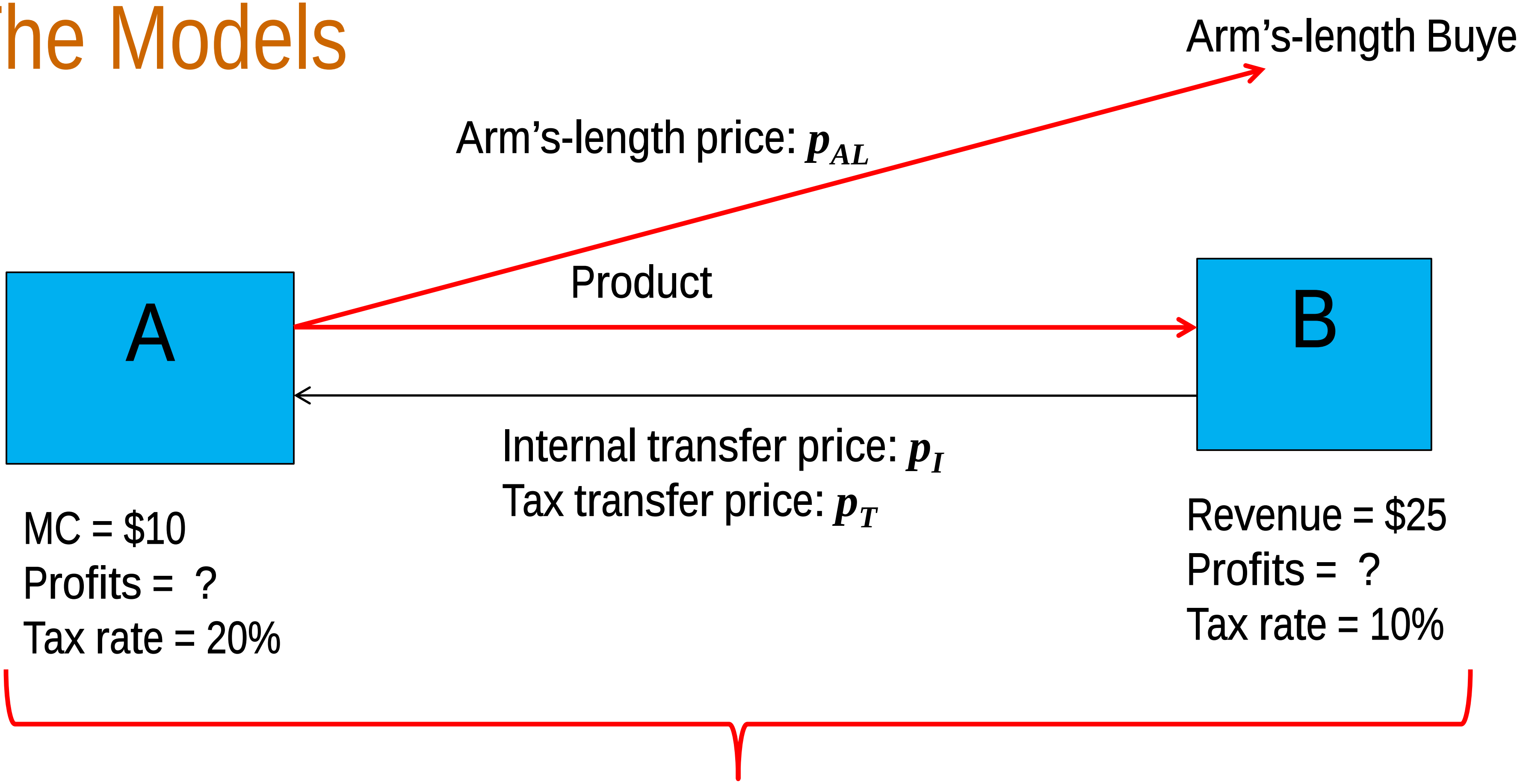
Revenue = $25
Profits = ?
Tax rate = 10%

Distortions: "One-book" model $\longrightarrow$ inefficient choices by managers

(Elitzur and Mintz, 1996; Haufler and Schjelderup, 2000)

But, p_T affects managers' decisions even when p_I and p_T can be "decoupled" (as p_T affects after-tax cash flows) - e.g. Baldenius, Melumad and Rechelstein, 2004

The Models



Why do the *same* firms engage in both related-party and arm's-length sales of the *same* products in the *same* years to the *same* country?

- OLI framework: might suggest that only one of these would be optimal
- Is this a very special setting? Can we generalize from it?

Efficiency Costs of Transfer “Mispricing”

What are the efficiency costs?

- = (Revenue Loss)*(λ - 1), where λ = MCPF?
- Misallocation of talent to tax planning?

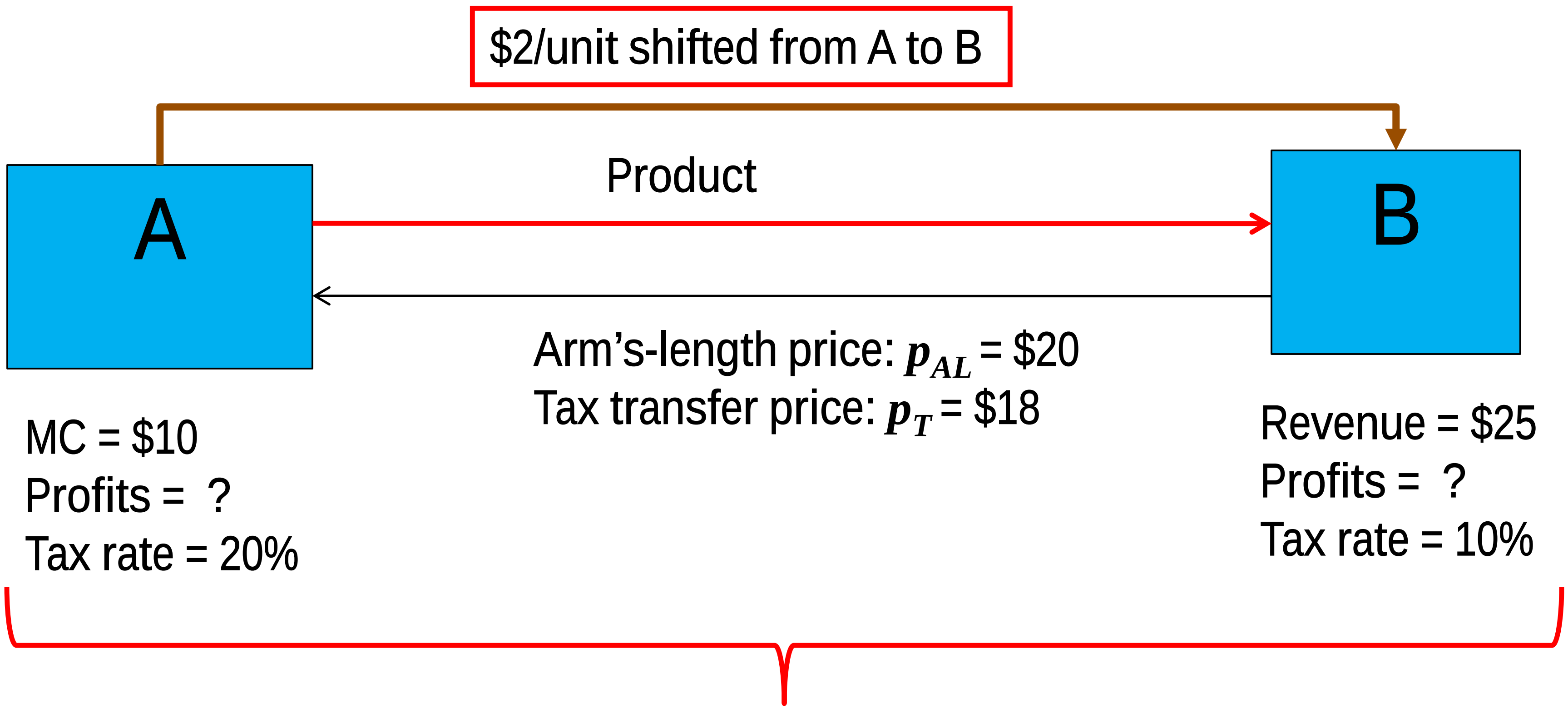
Mismeasurement of trade flows:

- Does this matter?
- Welfare consequences?

Counterfactual

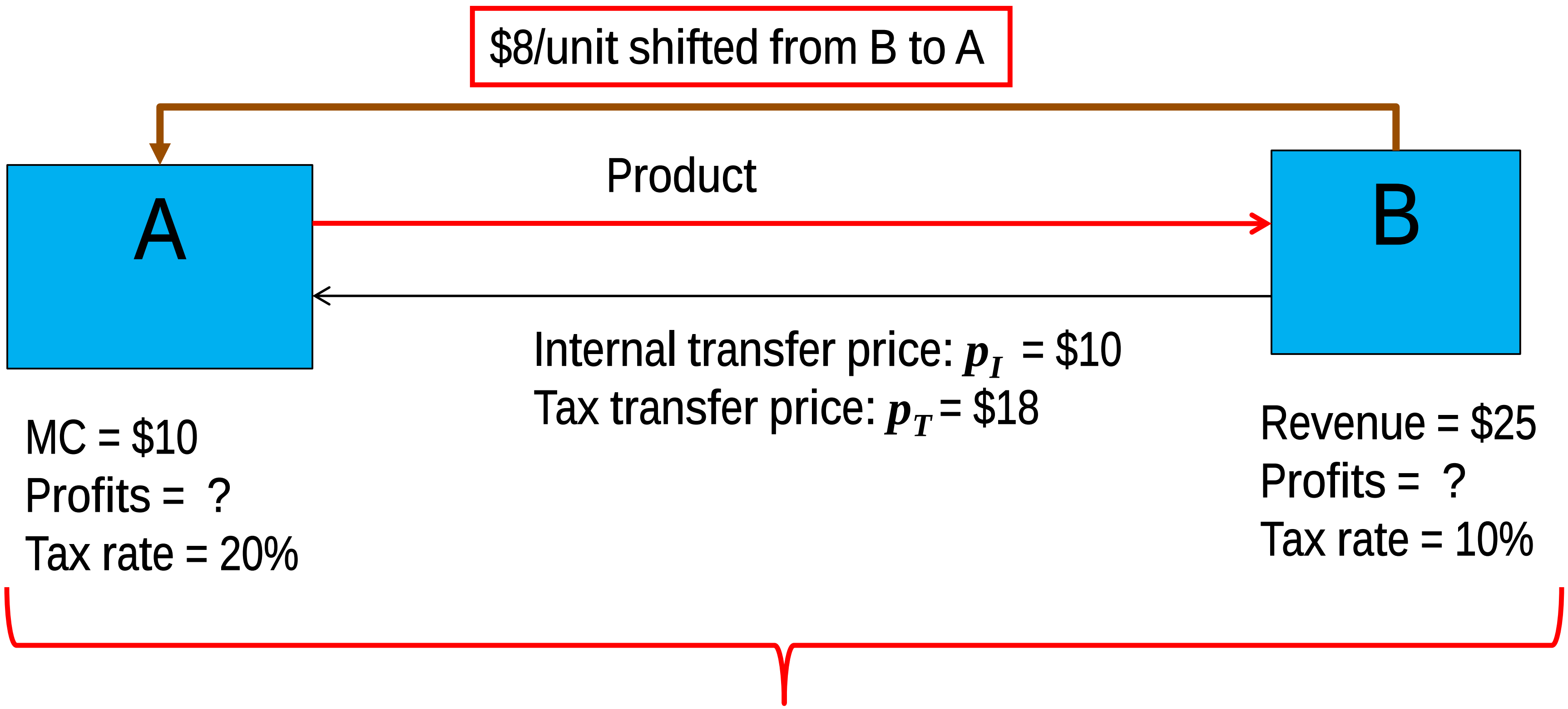
- Both papers use the ALP as the counterfactual
  - The ALP is important because of its role in tax law and transfer pricing regulation
- ALP $\longrightarrow$ counterfactual is that taxes are unchanged while MNC affiliates transact at arm's length
  - Relevant for some purposes
    - e.g. prohibiting cross-border investment
- But, the usual counterfactual in public finance is to imagine that taxes do not exist while holding everything else (including ownership structure) fixed
  - Should p_I be the counterfactual? (Desai and Dharmapala, 2011)

Legal Counterfactual: ALP



Conventional story: using ALP as the counterfactual $\longrightarrow$ transfer "mispricing" leads to profit shifting to the low-tax jurisdiction

Economic Counterfactual: p_I



Alternative story: the counterfactual (absent taxes and transfer pricing regulations) is the internal price, which in a wide range of cases is p_I = MC (Hirshleifer, 1956). Using this counterfactual $\longrightarrow$ taxes and transfer pricing regulations entail profit shifting to the high-tax jurisdiction