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

National Tax Association Annual Conference
November 9, 2017
Dhammika Dharmapala
University of Chicago Law School
Outline

Summary: 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

Comments: 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?


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?
- \( = (\text{Revenue Loss}) \times (\lambda - 1), \) where \( \lambda = \text{MCPF} \)?
- Misallocation of talent to tax planning?

Mismeasurement of trade flows:
- Does this matter?
- Welfare consequences?
Both papers use the ALP as the counterfactual

- The ALP is important because of its role in tax law and transfer pricing regulation

ALP → 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

Product

$2/unit shifted from A to B

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

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

Arm’s-length price: $p_{AL} = $20
Tax transfer price: $p_T = $18

Conventional story: using ALP as the counterfactual → 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 → taxes and transfer pricing regulations entail profit shifting to the high-tax jurisdiction.