Mixed evidence of profit shifting by multinationals

Despite anecdotal evidence, it is very difficult to find substantive empirical evidence on the extent to which multinational companies can reduce their overall tax liabilities by moving profits to lower taxed countries – for example, through transfer pricing manipulation, moving debt to higher taxed countries, or simply not repatriating profit. There have been no studies of UK companies due to lack of detailed data. However, two new studies, published by the European Tax Policy Forum (ETPF), are being presented at a joint conference of the ETPF and the Institute for Fiscal Studies on April 24.

The first study, by Professor Alfons Weichenrieder of the University of Frankfurt, is based on detailed information on German companies collected by the Bundesbank. He examines whether differences in rates of profit declared by German parent companies and their subsidiaries can be explained by profit shifting induced by differences in tax rates. He finds:

- German subsidiaries of non-German parent companies have a higher rate of profit in Germany if the parent company is from a high tax country. Specifically, a 10 percentage point increase in the parent’s home country tax rate is associated with a 0.5 percentage point increase in the profit rate of the German subsidiary.

- The author also compares the profit rate of non-German subsidiaries of German parents, and examines whether the profit rate of subsidiaries is more sensitive to the tax rate if they are wholly-owned – as they would be if German companies shifted profits to subsidiaries in low tax countries. Allowing for differences in debt, there is no difference.

- There is no evidence that German multinationals with subsidiaries in the USA and elsewhere shift profits out of the USA to other subsidiaries.

Profit shifting by UK companies is, if anything, likely to be less significant than for German companies. This is because the UK in principle taxes the worldwide income of UK companies, while the German government taxes only income generated in Germany.

The second study, by Harry Huizinga (Tilburg University), Luc Laeven (IMF) and Gaëtan Nicodème (European Commission), examines the use of debt in European subsidiaries of multinational companies based in Europe. A higher tax rate in one country would lead a subsidiary in that country to increase its borrowing to take advantage of the deductibility of interest for tax purposes. But the multinational may reduce its borrowing elsewhere prevent its overall liabilities from rising too much. This restructuring of debt is one way in which multinational companies can reduce their total tax liabilities.

The authors find that, for multinationals, a 10 percentage point increase in the corporation tax rate in a country is associated with an increased rate of borrowing in that country of 2.7 percentage points, and a reduction in other countries of 0.6 percentage points. While statistically significant, this represents only a small effect.

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Notes to editors:
1. Both papers will be presented at a conference on Monday 24 April, organised by IFS and the ETPF. Please contact the IFS press office on 020 7291 4800 if you would like to attend or would like copies of the papers.

2. The European Tax Policy Forum (ETPF) was set up in 2005 to commission independent academic research into the impact of tax policy on business in Europe.
The ETPF currently has 14 corporate members. Its objectives are to commission independent academic research which will be published and made available to all to educate and inform the public understanding and to provide European governments and others making decisions on tax policy with independent data and research on the effects of tax policy. The ETPF is not a consultative or lobbying group.

ETPF will initially commission a three year programme of research projects from economists from prestigious universities across Europe. The Research Director coordinating the programme is Professor Michael Devereux of the University of Warwick. The joint conference with the Institute for Fiscal Studies marks the culmination of the first phase of research.

More details about the ETPF are available at www.etpf.org.