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Why pay more? Corporate tax avoidance through transfer pricing in OECD countries

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Abstract

This paper presents suggestive evidence of income shifting in response to differences in corporate tax rates for a large selection of OECD countries. We use a new method to disentangle the income shifting effects from the effects of tax rates on real activity. Our baseline estimates suggest that a substantial share of the revenues from a unilateral increase in the corporate tax rate is lost because of a decline in *reported* income.

Keywords: Income shifting; Transfer pricing; Corporate tax rates; STAN database

JEL classification: F2; H2

1. Introduction

Policymakers are increasingly worried about cross-country differences in tax rates. In particular, they fear losing real economic activity to other countries if tax rates are too high. Many experts, therefore, predict a ‘race to the bottom’ for taxes on mobile production factors, in particular corporate taxes. Indeed, a recent report by the OECD (2000) tries to identify ‘harmful tax practices’ and to provide a

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platform for the possible cooperation on tax policies with cross-border effects. However, cross-country differences in corporate tax rates may not only induce real activity shifts, they may also lead to pure accounting income shifts between countries. Such income shifts have received much less prominence in the policy debates. Moreover, if policymakers reveal worries about income shifting, then it is about income shifting from the main industrialized economies to the so-called 'tax havens', small countries with very low corporate tax rates. Indeed, most the empirical literature has been concerned with income shifting from the US to such tax paradises (e.g. see Hines and Rice, 1994 and Grubert and Slemrod, 1998).

The purpose of this paper is three-fold. First, we provide empirical results suggesting that the lack of attention for income shifting among OECD countries and other major economies may be unjustified. That income shifting between these countries could be important should not be surprising given the amount of intra-industry trade among these countries (e.g. Stone and Lee, 1995). Moreover, the relevance of the issue likely will increase because of their ongoing economic integration. Indeed, the ensuing empirical analysis indicates an amount of income shifting that is both statistically and economically significant across a variety of different empirical specifications. Back-of-the-envelope calculations based on our baseline estimates suggest that at the margin more than 65% of the additional revenue from a unilateral tax increase is lost due to a decrease in the reported income tax base. Yet, this figure should only be taken as a first indication that income shifting among OECD countries may be large.[1] We explore a large number of variations and extensions of the baseline empirical framework, generally confirming our baseline findings.

Secondly, we develop a novel method for isolating the pure effects of income shifting, by controlling for the effects of taxes and unobserved productivity on the scale of real economic activity. In essence, we do this by regressing the ratio of total value added to wage payments on tax rate differences.

Finally, whereas previous work has either been concerned with individual firm data or country level data (involving the US and a set of tax havens; e.g. Hines and Rice, 1994), this paper takes an intermediate position and considers evidence for disaggregated industrial sectors for a group of OECD countries.

The remainder of the paper is structured as follows. Section 2 discusses the channels and incentives for income shifting. Section 3 motivates the empirical model, while Section 4 describes the data. Section 5 presents the baseline empirical results. In Section 6 we investigate the robustness and a number of extensions of the baseline setup. Finally, Section 7 concludes the main body of the paper.

[1] Based on individual import and export transactions, Pak and Zdanowicz (2001) estimate income shifting (through transfer pricing) out of the US for 2000 at $131 billion or about 18% of total reported corporate profits. The top three countries for shifting income to are Canada, Japan and Mexico. The top 25 contains no tax havens.