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Taxing multinationals in the presence of internal capital markets☆

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ABSTRACT

There is ample evidence that internal capital markets incur efficiency costs for multinational enterprises (MNEs). This paper analyzes whether tax avoidance behavior interacts with these costs and how policies of competing governments respond to it. We show that the interaction in itself may lead to profit taxes that are inefficiently high (low), provided the costs are attenuated (magnified) by higher profit taxes. Further, internal efficiency costs might render infrastructure provision inefficiently low. We also clarify the implications of the decision to set up an internal capital market and of external finance for the behavior of competing governments. The results are consistent with empirical findings that are not inherently related to the notion of fiscal competition.

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1. Introduction

There is considerable evidence that cross-country tax rate differences incentivize multinational enterprises (MNEs) to adopt tax avoidance strategies.[3] MNEs might run an internal capital market which allows the headquarter of the MNE to flexibly locate capital between divisions of the MNE.[4] The MNE can thereby exploit unforseen investment opportunities in divisions in the same way as relocating capital from high-tax countries to low-tax countries.[5] The tax avoidance behavior raises concerns about the ability of governments to tax MNEs, prompting governments to engage in a 'race to the bottom' in tax competition by setting corporate taxes at an inefficiently low level. See Keen and Konrad (2013) for a review of the literature.

In this paper, we evaluate the role of internal capital markets for incentives of governments to compete for capital. We expand the literature by considering that internal capital markets do not

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[3] MNEs adjust investment behavior, the pricing of intra-firm trade or financial policy to exploit international tax differentials, see Hines (1997) and Gresik (2001), among others, for an overview of the literature. Egger et al. (2010) show that MNE face a significantly lower tax burden than comparable firms which do not have access to international tax avoidance strategies. On average, foreign ownership reduces the tax burden by about 56%. Mintz and Smart (2004) find multidivisional firms to have an elasticity of taxable income with respect to tax rates of 4.9, compared with 2.3 for other, comparable firms that are constrained in shifting income through the use of a consolidated corporate tax base.

[4] There are numerous highly publicized cases where MNEs internally relocate capital. For instance, car manufacturers such as Volkswagen or General Motors typically resize investments in their different production plants when new car models are added to the product line, where the most productive location produces the new car series at the expense of deinvestments in the remaining locations. Fiscal incentives might also be involved in decisions to internally relocate capital. Recently, Nokia closed its production in Bochum, Germany and moved it to Romania where the investment was eligible for subsidies while subsidy eligibility in Germany had expired.

[5] See, e.g., Desai et al. (2005a), Hubbard and Palia (1999) and Egger et al. (2014) on the working of internal capital markets in MNEs and, in particular, Desai et al. (2005a) and Egger et al. (2014) on how internal capital markets facilitate corporate tax avoidance.

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only allow for a flexible allocation of capital (the so-called bright side of the internal capital market), but might also entail efficiency costs for the MNE, the so-called dark side of internal capital markets (Gertner and Scharfstein, 2013). There is ample evidence that internal capital markets incur efficiency costs for MNEs which capitalize in firm values. For instance, consistent with this notion of frictions in internal capital markets, Lang and Stulz (1994) and Berger and Ofek (1995) find that conglomerates trade at a discount relative to comparable stand-alone firms that do not have access to an internal capital market. Further, business units of the conglomerate overinvest and show a sensitivity of investment to Tobin's Q lower than that of matched stand-alone firms (Berger and Ofek, 1995; Rajan et al., 2000; and Ozbas and Scharfstein, 2010, among others). Glaser et al. (2013) empirically document that more powerful division managers influence internal decisions and receive larger capital allocations. The latter are not related to managerial ability or better investment opportunities, thereby reflecting an inefficiency in how capital is internally allocated. Relatedly, social connections to the CEO facilitate inefficient capital allocations in practice, in particular when corporate governance is weak (Duchin and Sosyura, 2013).

The dark side of the internal capital market is not insulated from taxation. Taxes influence the allocation of capital in MNEs and might lead to tax-induced cash holdings in low-tax divisions where the excess cash is inefficiently used due to agency problems. In fact, Foley et al. (2007) document that US-based MNEs with higher tax costs of channeling foreign funds to US divisions keep higher levels of funds abroad. The market places a discount on these funds which is related to agency conflicts (Hanlon et al., 2015, Harford et al., 2015).[6] It thus appears that investors associate foreign cash holdings with less funds being available in the internal capital market in the future due to agency problems in MNEs, an effect which capitalizes in firm value.[7] Also, the relocation of capital (possibly due to tax policy) undermines incentives of managers in divisions, which expect to lose capital, to work hard and to contribute to the cash pool of the internal capital market (Wang and Ye, 2014). Arguments based on these insights influence tax reform discussions in the US where a reduction of the repatriation tax has been advocated as a remedy to tax-induced agency costs.[8] The view is supported by the finding that MNEs for which tax-induced agency costs are highest respond most to tax incentives (Blouin and Krull, 2009).

Using these insights, we set up a model of a MNE that has divisions in two tax jurisdictions. The MNE runs an internal capital market which allows the MNE to flexibly allocate capital across divisions, thereby adding value to the firm. At the same time, however, it lowers productive effort provision by division managers. Managers exert effort to generate funds internally. Anticipating that these funds may be re-allocated through the internal capital market undermines effort provision by division managers. This reduces the amount of internal funds that the MNE uses to finance investments in its divisions. The disincentive effect, thereby, depresses firm value. We analyze how the efficiency costs respond to fiscal policies by the two jurisdictions and how this in turn influences the non-cooperative choice of fiscal policies. We show that efficiency costs may provide an upward pressure on profit taxes in fiscal competition, inducing governments to adopt policies that are not as starkly associated with fiscal competition as conjectured. The finding conforms to the empirical finding that the effective marginal corporate tax rate (which is the relevant tax measure in our context) has not dropped too much in recent decades and that the welfare gains from tax coordination might be limited.[9] Further, the analysis provides an explanation for the empirical finding that there is no tax-induced substitution between capital stocks of divisions of a MNE or that capital stocks are even complements (see Desai et al., 2005b, 2009 for instance). We show that the efficiency costs create resource linkages across divisions of a MNE which introduce a tendency that divisional capital stocks co-move in response to a higher tax in one jurisdiction. The forces we identify for the co-movement of capital stocks apply when both retained earnings and external finance are the marginal source of funds. The implications of endogenous managerial effort choices are central to the paper's results and are different to the standard implications of a model with fixed effort (or a fixed factor endowment).[10]

We find that a higher tax in one jurisdiction may lower investments in the other jurisdiction; a negative externality which turns out to be stronger when internal and external capital markets intertwine in providing funds to divisions. This is in contrast with the standard notion of tax competition which predicts that, by lowering taxes, a country attracts capital at the expense of investments in other countries. This reasoning conforms with the view that MNEs' worldwide investments are fixed due to resource constraints, for instance. As shown here, internal investment budgets might not be fixed, but responsive to government policy. The implied negative investment externality among divisions of a MNE is in line with empirical findings in Becker and Riedel (2012). They show that a 10 percentage point increase in corporate taxes lowers capital stocks of affiliate divisions in foreign countries by 5.6%. The negative effect neutralizes a significant fraction of the otherwise-prevailing tax competition externality. Relatedly, the analysis might be helpful in understanding more recent empirical evidence on profit shifting, suggesting relatively low levels of profit shifting elasticities. This is a puzzling observation since it contrasts anecdotal evidence on widespread tax planning of MNEs as well as predictions of conventional models of MNE behavior (Dharmapala, 2014). The paper offers a possible explanation for it. Profit shifting devices such as transfer pricing make taxable profits more elastic to tax rate differentials. As shown in the paper, this effect might be counteracted by investment responses that are related to efficiency cost changes.

We provide additional results related to the use of internal capital markets for tax savings for MNEs, the public provision of infrastructure services, and the way efficiency costs induce cross-border tax effects on investments in divisions of MNEs. By providing a structural modeling of the benefits and the costs of internal capital markets, we show that, although an internal capital market allows for tax savings, a MNE will not always opt for an internal capital market when profit taxes rise. Key to understanding the finding is that not only the benefits but also the efficiency costs of using an internal capital markets rise when profit taxes increase. Further, the efficiency costs of internal capital markets provide a downward pressure on infrastructure provision, i.e. infrastructure provision might be inefficiently low. The inter-divisional resource linkage implies that more

[6] The findings are in line with anecdotal evidence. Microsoft acquired Skype, which was headquartered in Luxembourg, and financed the deal using its trapped foreign off-shore profits. Analysts commented that even shareholders who are interested in tax-efficient solutions were hurt by this deal, which lowered the amount of internal capital funds for Microsoft in the future: "Microsoft made this bone-headed deal not because it was the best fit available for the company. They made the deal because it was a tax-efficient shot in the arm. If you're a Microsoft investor, this should scare you." (Eric Bleeker, Microsoft's Quarter: One Big Tax Dodge, Daily Finance, July 22, 2011).

[7] Note, the deferral of taxes when keeping cash abroad lowers the discounted value of tax payments and should increase firm value.

[8] Martin Sullivan, chief economist of Tax Analysts and former staff of the U.S. Treasury Department and of the Joint Committee on Taxation, writes "There is strong evidence supporting the idea that international tax rules increase agency costs and that the tax holiday [as part of the American Jobs Creation Act of 2004] provided economic benefits through the reduction in those costs." (Martin Sullivan, Tax Analysts — The Economic Case for Unlocking Foreign Profits, July 5, 2012, p. 3).

[9] See Devereux et al. (2002) and Sorensen (2004), for instance.

[10] With fixed effort, the model will reduce to a conventional model of (a)symmetric fiscal competition. Such a model cannot explain the empirical findings which we review above and which are not inherently related to the notion of fiscal competition.

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