**Policy brief**

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# International Profit Shifting and Multinational Firms in Developing Economies

## In brief

- Raising tax revenue is an important goal of many developing economies. The taxation of multnational firms operating in developing economies are an important potential source of tax revenue. However, multinational firms engage in tax planning and use debt financing or transfer pricing to shift income from high-tax to low-tax countries.
- Developing eonomies are thought to be particularly vulnerable to this type of tax avoidance as they often lack the resources to effectively protect the domestic tax base.
- This study examines the behaviour of German multinational firms and their operations regarding debt financing to shift income and whether this tax planning differs between affiliates located in developing and developed countries.
- There is higher sensitivity of financial structures with respect to tax rates in developing countries. The authors find that intra-company loans to affiliates in developing countries respond more to tax rate changes than loans to affiliates in developed countries.
- If a developing country increases its tax rate the increase in debt financing of local affiliates of multinationals is on average twice as large as the increase in debt financing that would occur in a developed country.
- Both anti-tax avoidance legislation, in particular thin capitalisation rules and controlled foreign companies legislation, and administrative capacity in international corporate taxation should be addressed. Tax rate cuts and broadening tax bases might increase tax revenue collected from multinational firms.



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## Policy Motivation

*"We ask whether firms use debt financing to shift income from high to low tax countries and whether this tax planning differs between affiliates located in developing and developed countries"*

Developing economies face difficulties in raising tax revenues, and the taxation of multinational firms operating in these countries is an important potential source of tax revenue. But multinational firms may engage in tax planning and use debt financing or transfer pricing to shift income from high-tax to low-tax countries. The view is widespread that developing economies are particularly vulnerable to this type of tax avoidance because their tax authorities often lack the resources to effectively protect the domestic tax base. In this project, we exploit a particular data set which covers all German multinational firms and their worldwide operations. We ask whether these firms use debt financing to shift income from high to low tax countries and whether this tax planning differs between affiliates located in developing and developed countries.

## Policy Impact

As a result of this work, tax authorities in both developing and developed countries may want to reconsider their anti tax avoidance legislation in the area of thin capitalisation rules and controlled foreign companies legislation.

## Audience

Tax policy makers and administrators working in the area of international corporate taxation.

## Policy Implications

### Higher sensitivity of financial structures with respect to tax rates in developing countries

*"Intra company loans to affiliates in developing countries respond more to tax rate changes than loans to affiliates in developed countries"*

Our main result is that intra company loans to affiliates in developing countries respond more to tax rate changes than loans to affiliates in developed countries. If a developing country increases its tax rate the increase in debt financing of local affiliates of multinational firms is on average twice as large as the increase in debt financing that would occur in a developed country, as a result of the same tax rate increase. At the same time, the decline in debt financing in response to tax rate cuts is also larger.

## Implementation

### Both legislation and administrative capacity in international corporate taxation should be addressed

Among the factors which may explain the higher sensitivity of financing structures to tax rate differences, two are particularly relevant for policy. Firstly, developing countries may want to consider a reform of their anti tax avoidance legislation related to debt financing, in particular thin capitalisation rules and controlled foreign companies legislation. Secondly, they may want to investigate whether the resources devoted to the auditing of multinational firms and their financing structures are sufficient. Reforms of anti tax avoidance legislation in developing countries will be more effective if implemented in cooperation with partner countries in double taxation agreements.

*"In developing countries, corporate tax reforms reducing tax rates and broadening tax bases may increase tax revenue collected from multinational firms more than in developed countries"*

It is possible that limited administrative capacity is an important constraint on these steps. A possible way of addressing this would be to consider the outsourcing of part of the auditing to private sector accounting firms.

### Tax rate cut cum base broadening reforms might increase tax revenue collected from multinational firms

Our results suggest that, in developing countries, corporate tax reforms reducing tax rates and broadening tax bases may increase tax revenue collected from multinational firms more than in developed countries because the lower tax rates will have a larger positive effect on profits declared in the country.

## Brief Summary of Research

In this project we exploit a particular data set which covers all German multinational firms and their worldwide operations. We ask whether these firms use debt financing to shift income from high to low tax countries and whether this tax planning differs between affiliates located in developing and developed countries. We focus on intra company debt because this type of debt is particularly suitable for tax planning purposes. Our results suggest that the reaction of financing structures to tax rate differences is indeed stronger in developing countries. We find that an increase in the host country corporate income tax by ten percentage points increases the ratio of intra company debt to overall assets by 2.7 percentage points in developing countries. In developed countries, the same tax increase would raise the debt ratio only by 1.1 percentage points. We also investigate whether the response of debt financing to tax rate differences differs between firms with and without a presence in countries classified as tax havens. We find no such difference in the data.

## Further Readings


Fuest, C. and N. Riedel (2010). Tax Evasion and Tax Avoidance in Developing Countries: The Role of International Profit Shifting, Oxford University Centre for Business Taxation Working Paper 10/12, June 1st, 2010.

Tanzi, Vito and Howell Zee (2001), Tax Policy for developing Countries, IMF Economic Issues No 27, March 2001.

## About the authors

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