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Taxation of MNEs in the Presence of Internal Capital Markets

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Abstract

Previous literature on multinational taxation focuses on the importance of internal debt shifting or the strategic pricing of internal trade for profit taxation. Agency problems are rarely explicitly accounted for. In this paper we consider agency problems in multinational firms and analyze the implications for fiscal competition. In particular, we account for the existence of internal capital markets and its (dis)incentive effects on division manager behavior. The agency problem is in general not neutral for profit taxation. Depending on the profit tax rate differential between countries, the agency problem in itself may lead to too high taxes in fiscal competition.

JEL-Classification: H25, D21, F23

Keywords: fiscal competition, taxation of multinational firms, internal capital markets, corporate governance.

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Extended Abstract

The effects of corporate taxation and of capital income taxation on corporate investment have been extensively discussed within the neoclassical model of firm behavior.[1] The neoclassical framework, however, treats the firm as a "black box", operating so as to maximize the firm value. It thereby disregards tensions between executives' and shareholders' interests which are central to the modern corporate governance literature. The literature rests on the premise that interests of shareholders and the management are misaligned and analyzes the role of incentive pay and the corporate capital structure in limiting the divergence of interests; see Tirole (2006).

This paper deals with the question of how a multinational enterprise (MNE) responds to tax differentials across countries and, importantly, how the tax avoidance strategy is affected by corporate agency problems. The existing literature on MNE and corporate taxation predominantly focuses on the importance of internal debt shifting or the strategic pricing of internal trade for profit taxation (Griffith et al. 2008, Haufler and Schjelderup, 2000). Agency problems are rarely explicitly accounted for in this literature with the exception of Elitzur and Mintz (1996). We consider agency problems in multinational firms and analyze the implications for fiscal competition. In particular, we account for the existence of internal capital markets. A widely perceived benefit of internal capital markets is that they ensure an efficient allocation of resources across divisions. This, however, undermines incentives by division managers to exert productive effort (e.g., Stein, 1997, Scharfstein and Stein, 2000, and Inderst and Laux, 2005). In the paper, we provide a welfare analysis of how the efficiency effects of internal capital markets intertwine with corporate tax policy in a two country setting.

[1] See, for instance, Auerbach (1979), Sinn (1991) and, for a review of the literature, Auerbach (2002) and Auerbach et al. (2008).

The timing of the model is as follows: At stage zero, the two jurisdiction engage in fiscal competition and set their tax rates non-cooperatively. At stage one, each division manager makes his/her effort choice which determines the amount of profits, i.e. cash-flows available in the next period. At stage two, the headquarter reallocates resources, i.e. cash-flows, in order to enhance the overall profitability of the MNE.

Fiscal competition between the two jurisdictions influences (i) the capital allocation in the internal capital market and (ii) the effort provision by each division manager. The latter effect exists because the division manager is aware that any increase in the local tax rate causes the headquarter to reallocate resources towards the other jurisdiction. The amount of resources available, however, influences the division manager's marginal return to effort and thereby determines the level of effort provision by each division manager. Both effects may have opposite implications for the tax rate choice. While the reallocation effect implies that taxes are inefficiently low, the effect which works through effort provision may result in inefficiently high profit taxes. Therefore, agency problems are in general not neutral for profit taxation.

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