Discussion of

Effective Labor Taxation and the International Location of Headquarters

by Peter Egger, Doina Radulescu, Nora Strecker (all ETH Zurich)

Discussant: Jost Heckemeyer (University of Mannheim)

ETPF/CEPS Conference on Financial Sector Taxation
Brussels, 13 May 2013

UNIVERSITÄT MANNHEIM

Brief Summary

- Paper investigates the role of **labor taxation** for the **location of headquarters (HQ)**
- Location choice is analyzed by estimating a conditional logit model
- Binary dependent variables reflect either the **HQ location as of 2009** or the **new locations** chosen in the course of HQ *re*-location or first location (through new incorporations)

- **Main findings**:
  - A one percentage point increase in a country's labor income tax leads to reduction in the probability of a country to attract HQs (re-located and new) by 6.1%
  - Social security contributions have an even larger impact on HQ location decisions
  - The **effect of labor taxation is twice as large as the effect from profit taxation** (i.e. the corporate income tax rate, CIT)

Comments I: Challenging findings and arguments

Question: Why is the impact of labor taxation on HQ location so high relative to the CIT effect?

The authors argue „that this result can be *ascribed to the possibility of corporate profit shifting to low tax locations. In comparison, the income tax base (wage bill) cannot be as easily manipulated* […]" (p. 18)

- Is this a plausible argument?
- What else could explain the empirical finding? What could challenge it?
- Could the empirical analysis better account for micro-level heteogeneity?

Comments I: Challenging findings and arguments

Question: Why is the impact of labor taxation on HQ location so high relative to the CIT effect?

Corporate profit shifting as explanation?

Comments I: Challenging findings and arguments

Comment: Relevance of CIT rate: The precise **function of the HQ** is essential!

- If the HQ‘s main function is to hold and manage shareholdings in its subsidiaries or affiliated companies, the low CIT effect is not surprising but quite plausible!
  - Dividends and capital gains from the sale of shareholdings are tax exempt in most countries, with the exception of IE and US.
  - The profit shifting argument is not required in this case to justify the result.
- If the HQ is itself actively engaged in production activity , the CIT rate should instead be more relevant (unless profits are effectively shifted abroad).
- Moreover, if the HQ is itself a tax planning vehicle, the CIT rate should also be relevant.
- Function could be assessed, e.g., by considering the share of dividend income in total HQ income, by trying to find out whether production takes place at the HQ. Does the HQ hold intangibles?

Comments I: Challenging findings and arguments

Comment: With regard to profit taxation, the focus of the paper is exclusively on the CIT rate.

- There are many **other aspects of profit taxation** which could affect HQ location choice
    - CFC rules
    - Tax exemption of dividend income and capital gains
    - Tax exemption of foreign PE income
    - Deductibility of
        - losses from foreign PE
        - refinancing expenses
    - No withholding taxes on outgoing dividends, royalties and interest payments
    - Favorable DTA network (no withholding taxes on incoming dividends, royalties and interest payments)
- The relevance of some of these aspects (CFC legislation, residual taxation) have been shown to affect HQ relocation (Voget, 2011; Desai and Hines, 2002)

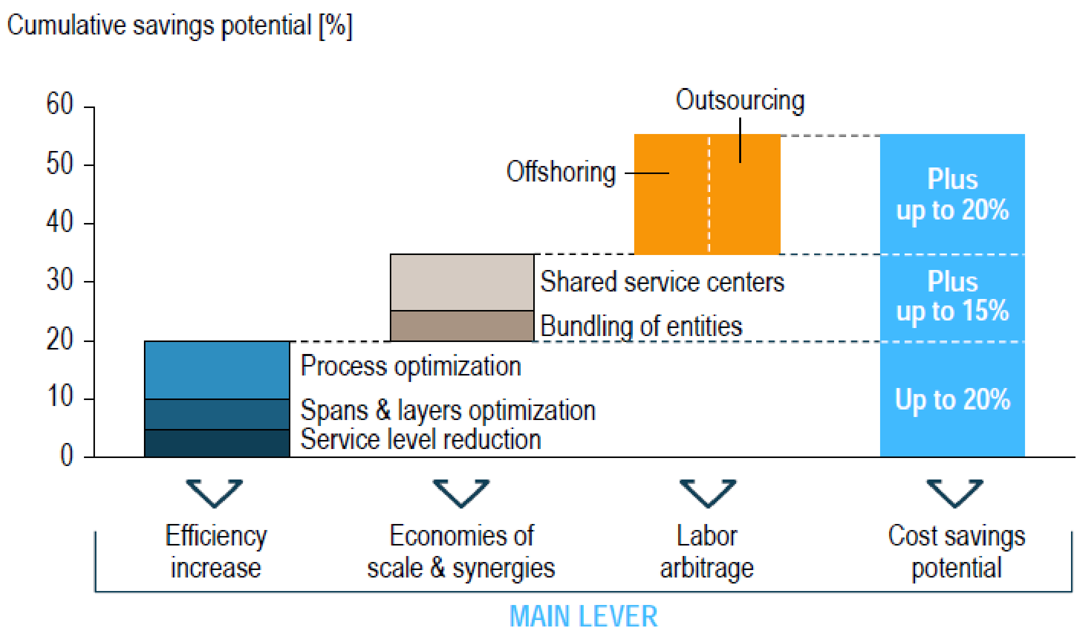
Comments I: Challenging findings and arguments

Question: Why is the impact of labor taxation on HQ location so high relative to the CIT effect?

Immobile (labor) income tax base as explanation?

Comments I: Challenging findings and arguments

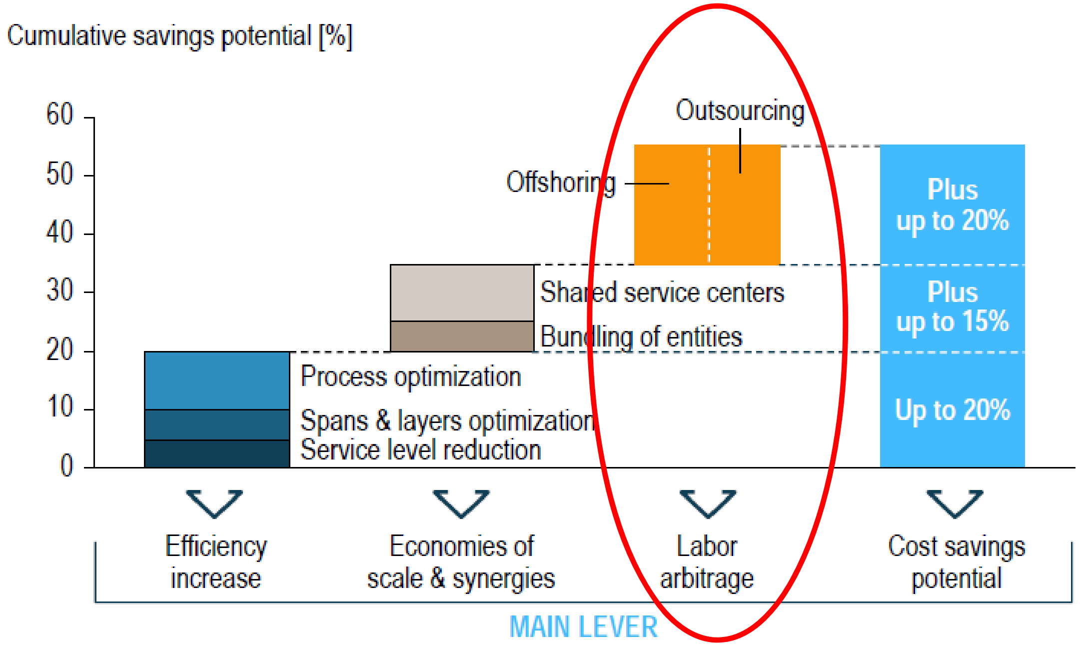
<u>Comment</u>: What about **labor arbitrage**? Labor costs (including employer-borne taxes and SSC) can be reduced by outsourcing and offshoring certain tasks.



Source: Roland Berger, 2013

Comments I: Challenging findings and arguments

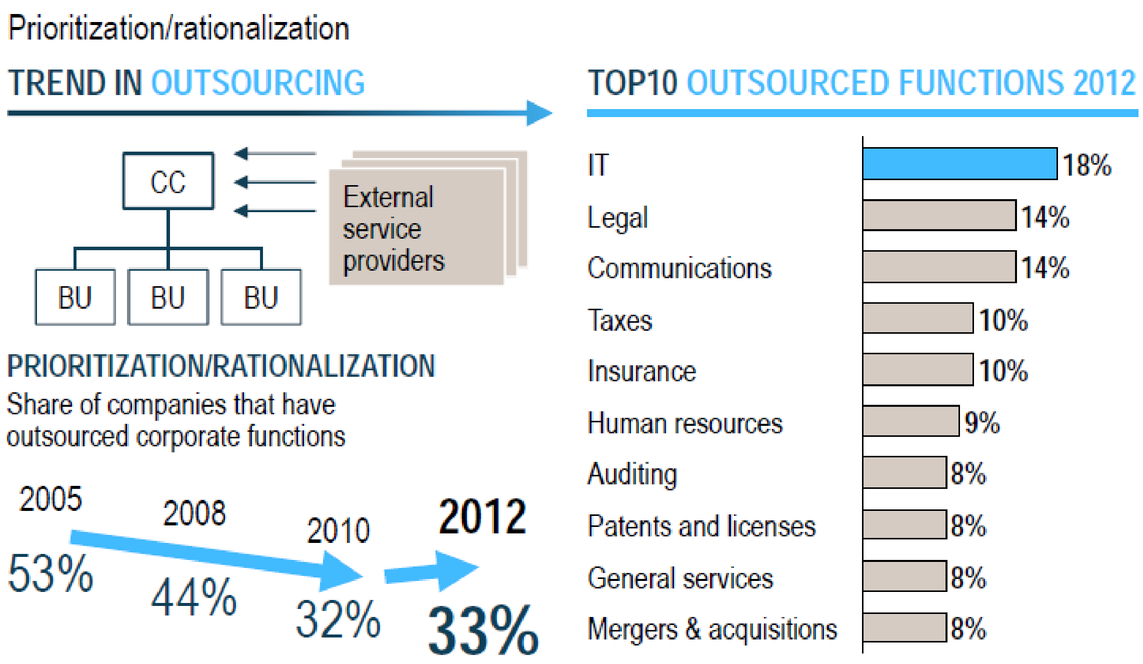
Comment: What about **labor arbitrage**? Labor costs (including employer-borne taxes and SSC) can be reduced by outsourcing and offshoring certain tasks.



Source: Roland Berger, 2013

Comments I: Challenging findings and arguments

Comment: What about **labor arbitrage**? Labor costs (including employer-borne taxes and SSC) can be reduced by outsourcing and offshoring certain tasks.



Source: Roland Berger, 2013

Comments I: Challenging findings and arguments

Comment: What about **labor arbitrage**? Labor costs (including employer-borne taxes and SSC) can be reduced by outsourcing and offshoring certain tasks.

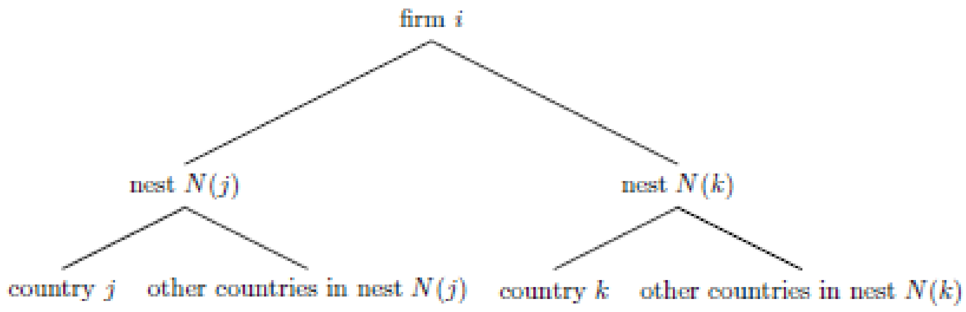
- Can the potential for labor arbitrage be controlled in the regressions (e.g. relative size of the HQ as measured by employee ratio (HQ staff/total staff) could capture attained degree of centralization/decentralization)

Comments II: Empirical analysis

Question related to the estimation and identification of tax effects:

- Nesting of locations :

Figure 3: Nested Logit Choice Structure



    - Nesting according to income, region, distance.

Comments II: Empirical analysis

Question related to the estimation and identification of tax effects:

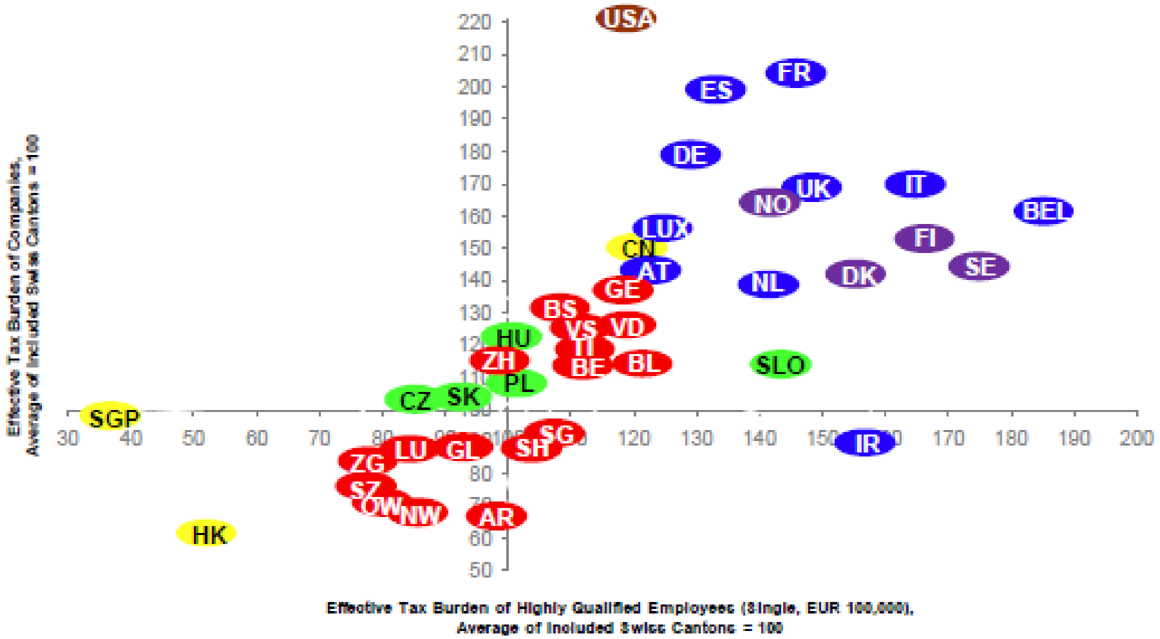
- Could nesting also refer to *top holding locations* which already have substantial clusters of holding companies, e.g. Ireland, Swiss cantons, Hong Kong, Singapore, as a separate nest?
- The underlying rationale could be derived from the following considerations in Yeung et al. (2001: 180):

  „Interurban competition for the location of RHQs through government incentives per se is unlikely to be highly effective […] among those cities with very different endowments of infrastructure and service qualities. In addition, it takes some time for individual cities to reach a threshold point of attractive total business environment […]. Existing centres of RHQs are thus likely to continue to enjoy their „first-mover“ advantage.“

Comments II: Empirical analysis

Question related to the estimation and identification of tax effects:

- Aren‘t personal income taxes and corporate income tax rates **highly correlated**, i.e. low-tax countries in terms of profit taxation tend to be low-tax countries in terms of labor taxes, and vice versa? Does this have negative implications for identification?



Source: BAK Basel Economics/ZEW Mannheim

Comments II: Empirical analysis

Considering HQ first locations:

- You also consider first HQ locations (through new incorporations) in your regressions. Aren‘t your results then reflecting location choices and, in addition, *legal form decisions*? Instead of locating corporate HQ in country A or B, a business might not incorporate at all to avoid CIT.
- Is it possible that HQ re-locations, e.g. within a US-MNE, and first locations are driven by very different considerations? MNEs are potentially highly profitable, while first locating HQ will belong to young and potentially loss-making firms. Considerations related to profit taxes might thus be of different importance?

Conclusions

- The paper is very interesting, sophisticated and deals with a very relevant topic.
- Significant effects of labor taxation on HQ location seem generally plausible.
- Some arguments put forward in the paper could be reconsidered.
- Are all relevant aspects of taxation accounted for in the regressions?
- Authors might want to think about further taking account of potential micro-level heterogeneity.