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Article

Comment on "Hosting multinationals: Economic and fiscal implications"

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Comment on “Hosting multinationals: Economic and Fiscal Implications” by Peter Egger and Marko Koethenburger

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This paper is clearly written by experts in the field who have themselves contributed importantly to the literature. Hence, this commentary can only offer some additional reflections.

Regarding the economic impact of multinational enterprises (MNEs), it would be interesting to add more information on how MNEs are created and how they shrink and disappear again. Firm growth is driven by R&D and innovation. Because firms innovate, they grow large. If they sustain their innovation potential, they become large MNEs. The firm's life-cycle is linked to the cross-section. MNEs are the most productive, the most skill-intensive and the largest; exporters are in between; and purely local firms are smallest and least productive. Due to potential technology spillovers via imitation, R&D cooperation and worker flows, MNEs could have positive effects on the rest of the economy. Is this really particular to MNEs? Technology spillovers would also happen in a closed economy, from the most innovative and productive firms to others. International spillovers would also happen via export- and import-competing firms, and not only due to MNEs. Maybe competition is more important for innovation than mechanical technology spillovers. Innovation is the key strategy to beat rival firms. Because MNEs and export firms operate on international markets, they face fiercer, worldwide competition compared to national firms, which forces them to innovate more systematically.

It is often claimed that MNEs pay higher wages. But maybe they don't really. Because they operate subject to fierce international competition, they are more technology intensive and innovative and, therefore, more skill-intensive than other firms. My intuition is that they probably pay the same wage per skill type, but employ a larger share of high-skilled workers so that the average wage paid by MNEs is higher. The paper also argues that MNEs might be a channel for international shock transmission, but is not very precise on this matter. I wonder whether MNEs really transmit international fluctuations to a larger or smaller extent to the home economy than exporting or importing firms. In fact, my intuition is that MNEs with many establishments in different countries operate an internal capital market that also potentially operates as a cross-national insurance device, which keeps operations in each location more stable and less exposed to the local business cycle.

The paper documents nicely the impact of taxes on extensive and intensive investment decisions and international profit-shifting by MNEs. What is underemphasized in the debate on tax competition is the question of how these effects compare to other determinants of investment and profit-shifting. Arguably, institutional quality may be even more important for investment location and profit-shifting than taxes. Insights on this matter would be important for governments to set policy priorities in making the country more attractive as a location for business activity. It might also be the case that an MNE would like to shift profits to a country despite of high taxes, in order to internally finance discrete investments in the face of a dysfunctional local capital market. In this case, profit-shifting would be a means to overcome local market frictions and institutional failures and would serve a positive economic purpose, rather than merely saving taxes. In consequence, fighting profit-shifting to protect the local tax base might sometimes have a counterproductive effect.

Finally, the paper discusses the use of patent boxes to strengthen Switzerland's position in international tax competition. The challenge is to replace a discriminatory tax regime with a non-discriminatory one. Patent boxes are open to all firms, but are particularly attractive for internationally mobile MNEs since they are the most R&D-intensive firms. The key idea is to give a tax privilege to the most innovative and mobile firms, thereby strengthening Switzerland's tax attractiveness to such firms. The Swiss proposal of a patent box is to tax royalty income on patents at a reduced rate. Since it is not linked to the underlying R&D activity that created the patents, it ends up again being a rather aggressive form of tax base competition. In particular, it does not address the key economic question of how to strengthen incentives for innovation in Switzerland and attract real R&D activity to the country. It is only about the location of income on patents that may have been invented elsewhere. This surely invites permanent discord with other governments, and could be cured only if the proposal were amended to establish a clear link between royalty income and the underlying R&D activity.

In any case, my personal preference would be a tax deduction of R&D expenditures in excess of 100%, as a number of other countries are already doing. Not all R&D-intensive firms, in particular smaller ones, create patents, but their R&D activity might be equally valuable in creating external social returns, and they may be equally mobile. So there would be a good reason to treat all R&D activity the same, irrespective of whether it is done in small or large firms and whether it is patented or not. Nevertheless, my preferred proposal follows the same idea: give a non-discriminatory tax privilege on R&D spending to all firms. Since a nation's R&D spending is concentrated among the most innovative, and therefore internationally mobile, firms, it strengthens the country's attractiveness as a location for real R&D activity, which is often connected with R&D-intensive

production and investment. It serves a real economic function to strengthen innovation and growth in Switzerland, rather than trying to merely snatch a larger share of the internationally mobile tax base.