The Race Between Tax Enforcement and Tax Planning: Evidence from a Natural Experiment in Chile

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Abstract

Profit shifting by multinational corporations is thought to reduce tax revenue for governments around the world. What are the effects of tax enforcement policies aimed at limiting profit shifting? How is the tax advisory industry affected by these efforts and how does tax planning limit the efficacy of these policies? To answer these questions, we conduct a comprehensive analysis of the impacts of the introduction of regulations aimed at limiting profit shifting in Chile. Using transactions-level administrative data from taxes and customs in difference-in-differences event study designs, we find that the reform was ineffective in reducing multinationals' propensity to make transfers to affiliates in lower-tax countries and did not significantly raise tax payments.

In-depth interviews with tax advisors further reveal that the reform led to a strong increase in tax advisory services, with employment of transfer pricing experts at the leading consulting firms growing twelve-fold within three years. Confirming a mechanism for increased tax planning identified by our interviews, we find that multinationals concentrate their cost centers in fewer countries following the reform. These results illustrate that when enforcement can be circumvented by sophisticated tax planning, tax enforcement reforms can benefit the tax consulting industry at the expense of both tax authorities and taxpayers.