

Profit Shifting and Firm Dynamics: Explaining the Selection into Tax Havens*

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Abstract

I develop a firm-dynamics model where heterogeneous firms pay a sunk cost to adopt tax-haven status and choose shifting intensity subject to a convex cost. The sunk cost generates a two-threshold band of inaction in adoption, and the convex cost yields a closed-form shifting schedule increasing in firm size. Aggregate revenue losses depend on the size composition of haven users, not only their number. Calibrated to 2019 U.S. data, the model implies that raising the adoption barrier (the BEPS margin) triggers an offsetting composition effect and leaves aggregate shifted profits nearly unchanged, whereas compressing the statutory tax differential works through the intensive margin and generates substantial fiscal effects. In a Stackelberg tax-competition game between a large home and a small haven, uncoordinated rate setting produces a welfare loss of approximately 7%, whereas a Pillar Two floor at 21% eliminates strategic undercutting and raises welfare by approximately 10%.

Keywords: Profit Shifting, Tax Havens, Corporate Taxation, Firm Dynamics, Hysteresis

JEL classification: D21, L25, H26, H87

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