Tax Threat and Disruptive Market Power of Foreign Portfolio Investors

Marshall, Neupane, Neupane, and Thapa

Discussion

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Do tax subsidies work (reliance on revealed preference)?
- Do foreign portfolio investors (FPI) respond to a host-country policy shock in a predictable manner?
- Relation between change in tax policy “interpretation/implementation” and portfolio choice by FPIs

Motivation: My reading: The bright (more focus) and dark sides of FPI
Question, Motivation, and Overview

- **Set-up: Why India?**
  - Stated: Reliance of emerging economies on FPI etc.
  - My reading: plausible exogeneous shock and quasi-natural experiment

- **Hypothesis: Ability to influence policy with their feet (flight of capital)**

- **Method: Difference-in-difference estimation using “treatment” and “control”**

- **Key Result 1:** When favorable tax-treatment is eliminated FPIs withdraw capital

- **Key Result 2:** Reversal of policy did not reverse the capital flow (magnitude)
Measures the size of the capital withdrawal ~2 billion USD per month

Relative size of the effect:
- USD 5 billion withdrawal in November 2016 from demonetisation (Economic Times, Nov 28, 2016)
- USD 3.5 billion in December 2016 (Financial Express, Dec 25, 2016)
- USD 1.7 billion in September 2017 (LiveMint, Dec 17, 2017)

Measurement of inflow on subsequent tax policy reversal – smaller effect
- Potential explanation 1: Risk/uncertainty originating in unpredictable institutional behavior regarding policy enforcement – real option to delay until a resolution of uncertainty
- Explanation 2: No news is good news effect (Campbell and Hentschel (1992))?
- Potential explanation 3: Why are there more escalators out of a subway station than going in?
General Comments

• Motivation: Try to expand the scope of the work

• Where does this work fit within a broader discussion on whether tax subsidies:
  • Are beneficial for the offering economies
  • Pay for themselves
  • Are subsidy driven investors net consumers of (priced?) liquidity
General Comments

- Internal inconsistency: Can FPIs be uninformed noise traders and simultaneous liquidity providers
  - Argument for need for tax-subsidy (potential lobbying) – incentives to offset information disadvantage
  - Minor results on liquidity, volatility post-event seem to argue the opposite

- Can we analyze all the different channels of a tax minimization strategy in a comprehensive way?

- For inspiration see Lewellen and Lewellen (2016) on investment cash flow sensitivity

- Lack of systematic elimination of alternative hypotheses
Methodological Issues

- Your controls (firms in the bottom tercile of FPI holding) are also subject to the same shock as treated firms
  - You could use your results to argue that in a “hypothetical true control” your results will be stronger
  - Such an argument leaves you vulnerable to omitted variable bias driving your results

- Establish parallel trend between your treatment and control in a “pre-event” window

- Systematic investor preference not addressed
  - Diagnostics: Create $5 \times 5$ portfolios based on size and M/B quintile
  - Check for average FPI total cumulative holding (TCH) in these 25 portfolios
Main Results and Concerns

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<tr>
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<th>Addressing Systematic Shocks</th>
<th>Balanced Panel</th>
<th>False Experiment</th>
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<tbody>
<tr>
<td><strong>MAT effect _i \times TRMT</strong></td>
<td>$-0.283^{***}$</td>
<td>$-0.495^{**}$</td>
<td>$-0.200$</td>
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<td></td>
<td>$(-3.91)$</td>
<td>$(-2.38)$</td>
<td>$(-1.59)$</td>
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<tr>
<td>USD Volatility</td>
<td>$-7.298^{***}$</td>
<td>$-19.24^{***}$</td>
<td>$-0.646$</td>
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<tr>
<td></td>
<td>$(-2.78)$</td>
<td>$(-2.96)$</td>
<td>$(-1.03)$</td>
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<tr>
<td>US TB Rate</td>
<td>$-2.897^{***}$</td>
<td>$-9.601^{***}$</td>
<td>$1.135$</td>
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<tr>
<td></td>
<td>$(-3.69)$</td>
<td>$(-4.21)$</td>
<td>$(0.27)$</td>
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To eliminate some of the alternative hypotheses/explanations
- Measure $NET_{it}$ over event period for FPI and domestic funds
- In the core D-i-D specification (Table 6, model 4) volatility of USD and treasury rate dominate
- In the test of False Experiment (Table 7, model 7) these two factor also disappear along with the treatment effect
- Diagnostic Test – regress these two factors on $NET_{it}$ first and extract residuals and use those in the second stage for the main specification
Volatility measurement – assumption violation (high sampling frequency and serially uncorrelated return)

Calculating abnormal return using a three- or four-factor model instead of controlling for size and M/B

Your long(treatment)-short(control) portfolio generates 16 basis points over a 22-day window
  Is that enough to cover transaction cost?

Your citation practice makes it appear Vig (2013) invented D-i-D method
  The method is owed to labor economists (see Ashenfelter (1978)) – please cite appropriately