

Tax Threat and Disruptive Market Power of Foreign Portfolio Investors

Marshall, Neupane, Neupane, and Thapa

Discussion

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Question, Motivation, and Overview

- 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)

Innovation in the Paper and Contributions

- 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 5×5 portfolios based on size and M/B quintile
 - Check for average FPI total cumulative holding (TCH) in these 25 portfolios

Main Results and Concerns

	Addressing Systematic Shocks	Balanced Panel	False Experiment
$MAT\ effect_t \times TRMT$	-0.283*** (-3.91)	-0.495** (-2.38)	-0.200 (-1.59)
USD Volatility	-7.298*** (-2.78)	-19.24*** (-2.96)	-0.646 (-1.03)
US TB Rate	-2.897*** (-3.69)	-9.601*** (-4.21)	1.135 (0.27)

Alternative Methodology/Measurement and Additional Robustness Checks

- 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

Other Comments

- 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