

# Endogenous Product Differentiation and Profit Shifting\*

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## Abstract

High product differentiation enhances consumers' utility and firms' profits but at the same time makes it difficult for tax authorities to audit MNEs' tax avoidance strategies, as the arm's length principle is difficult to apply. This paper combines these two aspects of product differentiation and studies the interrelation between profit shifting and product differentiation. The model shows that MNEs engage in more investment in product differentiation in the presence of profit shifting opportunities and financial economic integration accelerates the investment.

**Keywords:** Tax avoidance; Product differentiation; Financial economic integration

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