JOINT ECONOMIC COMMITTEE

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OBAMA'S TAX POLICY TO OUTSOURCE INVESTMENT AND JOBS

Summary

President Obama proposed to raise $210 billion over the next ten fiscal years by limiting the ability of U.S. multinational corporations to (1) use foreign tax credits, and (2) defer the repatriation of profits earned by their foreign subsidiaries. The U.S. corporate income tax system with its high top rate and worldwide reach already places U.S. multinational corporations at a severe competitive disadvantage with their foreign rivals. By exacerbating this disadvantage, Obama's proposals would reduce U.S. exports as well as business investment and jobs in the United States.

Introduction. In the *Budget for Fiscal Year 2010*, President Obama proposed to raise $210 billion over the next ten fiscal years by "reforming" federal taxes regarding foreign income. Among other things, Obama would severely limit the ability of U.S. multinational corporations (MNCs) to (1) use foreign tax credits, and (2) defer the repatriation of profits earned by their foreign subsidiaries. The U.S. corporate income tax system already places U.S. MNCs at a severe competitive disadvantage with their foreign rivals. Obama's proposal would intensify this disadvantage, reducing U.S. exports as well as business investment and jobs in the United States.

Basics of international taxation. The United States and other countries recognize that foreign-source income may be taxed by the country in which it was earned. However, the United States differs from most other countries on the taxation of the income earned by foreign subsidiaries of resident MNCs.

To prevent the double taxation of the income earned by the foreign subsidiaries in both the home and host countries, most countries tax resident

Key Points:

- In 2008, the top combined U.S. federal and average state corporate income tax rate was 39.3 percent compared with an unweighted average for the other OECD member-countries of 26.2 percent.
- Worldwide taxation with foreign tax credits places U.S. MNCs at a competitive disadvantage with their foreign rivals in any country with lower corporate income tax rates.
- U.S. MNCs do not generally invest in foreign subsidies to "off-shore" production in low-wage countries. Actually, 79 percent of all value-added at foreign subsidiaries of U.S. MNCs was in other high-wage countries.
- FDI by U.S. MNCs is not generally a substitute for domestic production for export. U.S. MNCs need local production facilities to sell most services and certain goods that require frequent deliveries.
- Outward U.S. FDI is generally a complement to, rather than a substitute for, investment within the United States by U.S. MNCs.
- Employment and employee compensation have increased simultaneously at both U.S. parents and their majority-owned foreign subsidiaries.

MNCs on a territorial basis. Thus, resident MNCs pay home country corporate income taxes only on income earned within their home country, but not on income earned by their foreign subsidiaries in other countries.

However, the United States taxes U.S. MNCs on a worldwide basis. Thus, U.S. MNCs pay U.S. corporate income taxes on all income earned anywhere. The United States tries to alleviate this obvious competitive disadvantage through a system of foreign tax credits and deferrals.

If the U.S. corporate income tax rate is equal to or lower than corporate income tax rates in other countries, then worldwide taxation with foreign tax credits and deferrals does not disadvantage U.S. MNCs. However, U.S. MNCs that operate foreign subsidiaries in host countries with lower corporate income tax rates than the United States are at competitive disadvantage with other MNCs whose home countries have territorial taxation.

Globally uncompetitive U.S. corporate income tax rate. As late as 1990, the United States had a globally competitive corporate income tax system. In 1990, the top U.S. corporate rate was 38.7 percent, a combination of the 34 percent federal rate and the average state rate after taking into account the deductibility of the state income taxes against federal income taxes. In the same year, the average top corporate income tax rate for the other member-countries of the Organization for Economic Cooperation and Development (OECD) was 39.5 percent on an unweighted basis and 38.5 percent on a GDP-weighted basis.

Over the fifteen years since the *Omnibus Budget Reconciliation Act of 1993* increased the top federal corporate income tax rate from 34 percent to 35 percent, many countries have slashed their top corporate income tax rates. In 2008, the top U.S. corporate rate remained nearly unchanged at 39.3 percent. Among other OECD member-countries, however, only Japan had a higher top corporate income tax rate of 39.5 percent. Indeed, the average top corporate income tax for the other OECD member-countries fell to 26.2 percent on an unweighted basis and 30.4 percent on a GDP-weighted basis. In other words, the top U.S. corporate income tax rate of 39.3 percent was 13.1 percentage points higher than the non-U.S. OECD unweighted average and 8.9 percentage points higher than the non-U.S. OECD GDP-weighted average.[1]

From a competitiveness perspective, the United States fares no better when comparing effective corporate tax rates, which take account of such factors depreciation schedules and investment tax credits, instead of statutory rates. According to the World Bank's *Doing Business 2009*, the U.S. effective corporate tax rate in 2008 ranked 50th of all 181 countries (top 28th percentile) and 7th of the 30 OECD countries (top 23rd percentile).[2] For an equity-financed investment of new equipment and facilities, the Institute for Fiscal Studies found that the U.S. had the 5th highest marginal effective corporate income tax among 19 OECD countries.[3]

Foreign tax credits. President Obama proposed to raise $43.0 billion over ten fiscal years by preventing U.S. MNCs from using "loopholes to artificially inflate or accelerate these [foreign tax] credits." However, the current system of foreign tax credits is a not a loophole.

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[1] Peter R. Merrill, "Competitive Tax Rates for U.S. Companies: How Low to Go?," *Tax Notes* (February 23, 2009), 1009-1010.
[2] Ibid., 1011.
[3] Institute for Fiscal Studies, corporate tax rate data found at: http://www.ifs.org.uk/publications/3210. Only Australia, Canada, Germany, and Japan were higher.

Rather it attempts to reduce competitive inequality between U.S. MNCs and foreign MNCs whose home countries have territorial taxation.

Nevertheless, the current system of foreign tax credits puts U.S. MNCs at a competitive disadvantage with foreign MNCs when both have foreign subsidiaries in host countries with lower corporate income tax rates than the United States. Obama's proposal on restricting foreign tax credits would exacerbate rather than reduce this competitive disadvantage.

For example, consider two MNCs one based in the Netherlands and the other based in the United States. Each MNC has a Hungarian subsidiary that earned $100 million and paid $20 million in Hungarian corporate income taxes at a 20 percent rate, leaving $80 million in after-Hungarian-corporate-tax profits in each subsidiary. The Dutch MNC can repatriate this $80 million free of any Hungarian non-EU withholding tax or any Dutch income taxes. However, if the U.S. multinational corporation were to seek to repatriate its profits, the U.S. MNC must first pay a Hungarian non-EU withholding tax of $4 million (5 percent times $80 million, in addition to the $20 million of Hungarian corporate income taxes already paid) and then pay federal corporate income taxes of $11 million ($100 million times the 35 percent top federal corporate income rate less a foreign tax credit of $24 million). Thus, the U.S. MNC would pay a total of $35 million in federal and foreign corporate income and withholding taxes, while its Dutch rival would pay only $20 million.

Thus, the relevant comparison for global MNCs is not between the U.S. and home country corporate income tax rates, but between the U.S. and host country corporate income tax rates. According to IRS data, the average combined corporate income and withholding tax rate for foreign subsidiaries of U.S. MNCs was 19.1 percent in 2004 (the last year in which data is publicly available). This is much higher than both the unweighted and GDP-weight non-U.S. OECD averages.

Deferral. President Obama proposed to raise $60.1 billion over ten years by restricting deferrals through the disallowance of deductions for foreign subsidiaries except for research and development expenses that are not paired with repatriated income.

Deferral allows U.S. MNCs to delay paying U.S. corporate income taxes on certain profits earned by their foreign subsidiaries so long as this income is reinvested abroad. U.S. MNCs are liable for U.S. corporate income taxes only when these profits are repatriated. Generally, most active income from foreign subsidies may be deferred, but passive investment income such as dividends, interest, rent, royalties and certain active income from foreign subsidies may not be deferred. For example, a U.S. MNC may not defer the income earned in a foreign distribution facility from sales to bordering countries if the goods were imported from other subsidiaries of the MNC.

Deferral moves the taxation of U.S. MNCs away from strict worldwide taxation and gives some, but not all, of the benefits of territorial taxation. Obama's proposal on restricting deferrals would once again worsen the competitive disadvantage that the U.S. government imposes on U.S. MNCs relative to their foreign rivals.

Economic consequences. Many Americans mistakenly believe the main reason that U.S. MNCs make outward foreign direct investment (FDI) is to reduce labor costs by replacing domestic production for the U.S. market with imports from foreign subsidiaries in low-wage

countries. Outward U.S. FDI is widely viewed as outsourcing American jobs, but the reality is quite different.

- Most outward U.S. FDI occurs in other high-income, high-wage countries. In 2006 (the last year for which complete data is available), 79 percent of the value-added by all foreign subsidiaries of U.S. MNCs and 90 percent of the value-added by newly acquired foreign subsidiaries of U.S. MNCs was in high-income, high-wage countries. Most of the remainder occurs in middle-income, middle-wage countries with rapidly growing economies.[4]
- FDI by U.S. MNCs is not generally a substitute for domestic production for export. Some goods in which U.S. firms excel such as detergents and soft drinks are impractical to export because they are cheap, heavy, and frequently delivered and thus exporting such goods would entail prohibitive transportation costs. Many services in which U.S. firms excel such as hotels and fast food restaurants require a physical presence to serve foreign markets. In other cases, foreign subsidiaries provide necessary sales and after-sale services for goods such as heavy construction equipment manufactured in and exported from the United States. Without FDI, U.S. MNCs could not sell these goods and services to foreign customers.
- Today many goods are manufactured in cross-border networks in which inputs may move from one country to another many times before a product is ready for sale. In such cases, U.S. MNCs locate most of their highly paid, high-skilled jobs in research and development, design, marketing, and general management in the United States, while lower-paid, less-skilled assembly jobs may be located abroad. Cross-border production networks help to keep goods produced by U.S. MNCs price competitive in international markets with goods produced by foreign rivals. In 2006, U.S. MNCs accounted for 51.3 percent of U.S. goods exports and 36.6 percent of U.S. goods imports. Reflecting these cross-border production networks, 38.2 percent of the goods exported by U.S. MNCs went to their foreign subsidiaries, while 37.2 of the goods imported by U.S. MNCs went to their U.S. parents.[5]
- In contrast to Obama's assertion, economists have found that outward U.S. FDI is generally a complement to, rather than a substitute for, investment within the United States by U.S. MNCs. Desai, Foley, and Hines (2009) found a 10 percent increase in outward U.S. FDI was associated with a 2.6 percent increase in U.S. investment by U.S. MNCs from 1982 to 2004.[6]
- Likewise, employment and employee compensation increased simultaneously at both U.S. parents and their majority-owned foreign subsidiaries. From 1997 to 2006, employment grew by 9.4 percent in U.S. parents and 46.6 percent in their majority-owned foreign subsidiaries, while compensation per employee expanded

[4] Raymond J. Mataloni, Jr., "U.S. Multinational Companies: Operations in 2006, *Survey of Current Business* (November 2008), 29.
[5] Ibid., 30.
[6] Mihir A. Desai, C. Fritz Foley, and James R. Hines, Jr., "Domestic Effects of the Foreign Activities of U.S. Multinationals," *American Economic Journal: Economic Policy*, 1 no. 1 (February 2009): 181-203.

> by 38.8 percent in U.S. parents and 19.7 percent in their majority-owned foreign subsidiaries.[7]

Obama's tax proposals on foreign tax credits and deferrals are based upon the false premise that "our tax code provides a competitive advantage to companies that invest and create jobs overseas compared to those who invest and create those same jobs in the U.S." Actually, the United States (1) penalizes U.S. MNCs relative to their foreign rivals regarding FDI through worldwide taxation, and (2) discourages job-creating business investment in the United States by both U.S. MNCs and inward FDI by foreign MNCs through a punitively high, uncompetitive U.S. corporate income tax rate.

Conclusion. To increase both the competitiveness of U.S. MNCs and inward FDI by foreign MNCs, policymakers should consider (1) slashing the U.S. top corporate income tax rate and (2) replacing worldwide taxation with foreign tax credits and deferrals with territorial taxation. Policymakers should reject Obama's proposals to restrict foreign tax credits and deferrals, which would only intensify the competitive disadvantage confronting U.S. MNCs.

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[7] U.S. Department of Commerce, Bureau of Economic Analysis data with author's calculations. Found at: http://www.bea.gov/international/index.htm#omc.