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Ohio Employment and International Economic Policy

William Melick
Kenyon College

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Executive Summary

There is no issue more important than high-paying jobs for Ohio's workers. Unfortunately, the public debate regarding policies to support this goal has been confused or even misleading, especially with regard to international aspects of economic policies. This paper seeks to clarify the discussion regarding issues such as "offshoring" of jobs.

The key findings are that U.S. competitiveness and jobs are significantly harmed by the fact that the U.S. corporation income tax is the highest among developed countries. In addition, the U.S. clings to an outdated tax strategy ("worldwide taxation") that places its companies at a competitive disadvantage in world markets, hurts jobs, and encourages foreign purchase of vital U.S. companies.

As a complement to pro-competitive tax reforms, U.S. policy should seek agreements to open global markets to the products of U.S. workers. This is especially important for Ohio workers who are already engaged in substantial global market activities and who face both a tax disadvantage and export barriers. Finally, an improved, permanent tax credit for research and development will support productivity growth, global competitiveness, and high-wage service and manufacturing employment in Ohio.

Introduction

There is no policy issue more important than high-wage jobs for Ohio's workers. Unfortunately, the public debate regarding policies to support this goal has been confused or even misleading, especially with regard to international aspects of economic policies. This paper seeks to clarify the discussion regarding issues such as "offshoring" of jobs.

I discuss some of the key aspects of economic policy that have global dimensions and hinder job growth in Ohio: (a) the high U.S. corporation income tax rate, (b) the outdated strategy of worldwide income taxation, (c) access to foreign markets, and (d) research and development that aids productivity growth and competitiveness. The final section is a summary with conclusions.

U.S. Corporation Taxation versus Its Competitors

To see the damage that poor international economic policies can render to Ohio's workers one need look no further than the U.S. corporate tax code, which stands as the biggest barrier to employment in our economy. The U.S. has the second highest corporate tax rate in the developed world, and will soon move into the top spot once Japan's government follows through on its pledge to reduce its corporate tax rate[i]. In the last twenty years every single country in the developed world reduced its corporate tax rate save for the United States – which actually *increased* its tax rate. The effective U.S. corporate tax rate is just below 40 percent while the average of the other developed countries is now well below 30 percent[ii] – see Table 1.

Table 1
Corporation Tax Rates

Country	2010 Tax Rate	1990 Tax Rate
Australia	30.0	39.0
Austria	25.0	30.0
Belgium	34.0	41.0
Canada	29.5	41.5
Denmark	25.0	40.0
Finland	26.0	44.5
France	34.4	42.0
Germany	30.2	54.5
Greece	24.0	46.0
Hungary	19.0	40.0
Ireland	12.5	43.0
Italy	27.5	46.4
Japan	39.5	50.0
Mexico	30.0	36.0
Netherlands	25.5	35.0
New Zealand	30.0	33.0
Norway	28.0	50.8
Portugal	26.5	40.2
Spain	30.0	35.0
Sweden	26.3	53.0
Switzerland	21.2	30.6
United Kingdom	28.0	34.0
United States	39.2	38.7

It is not difficult to see that an onerous tax burden hurts the ability of U.S. firms on global markets. After all, higher costs from any source hurt competitiveness. In this regard, an uncompetitively high corporation income tax is simply a self-inflicted wound. What is less appreciated is who effectively *pays* this tax. Higher corporate taxes can force firms to compensate by cutting back wages, reducing fringe benefits, or even hiring fewer workers. In each case, the burden of the tax is effectively borne by U.S. workers who make less, have fewer perks, or even see their jobs disappear. The non-partisan Congressional Budget Office concluded that it was reasonable to expect that workers bore the burden of 70 cents out of each dollar of corporation income tax.[iii]

One might think that this high rate of tax is driven by budgetary considerations. But what makes our high corporate tax rate so frustrating is that it isn't entirely clear that it actually generates any more money than a lower tax rate. Capital is mobile, and countries that have lowered their tax rates typically experience a surge of investment and profits as well, and in turn increasing tax revenues[iv]. Japan's Prime Minister declared that their high tax rate was costing them revenue when he announced his government's plan to reduce their corporate tax rate in 2011[v].

Clinging to an Outdated Tax Strategy

The high rate of U.S. taxation is a problem for Ohio workers and employers. But just as important is that the U.S. clings to an outdated corporate tax strategy known as worldwide taxation. Under this system, U.S. corporations pay tax in the United States on income earned anywhere on the globe. That means that every U.S. global manufacturer has to pay taxes to foreign governments *and* the United States – a double tax. Until recently, only the U.S., Japan, and the United Kingdom persisted in this approach. The remainder of our developed-country competitors use a system in which taxes are only owed to the country where the income is earned – a single tax. Japan and the U.K. saw the advantages of the latter system, so the U.S. is the only country clinging to the past.

What does this mean for Ohio? Thanks to the U.S. tax code, when Goodyear, based in Akron, Ohio, sells tires in South Korea, Goodyear pays taxes to South Korea and *then* additional taxes to the U.S. government. Goodyear's foreign competitors pay taxes *only* to the South Korean government at South Korea's rate of 20 percent and do not have to pay taxes to their home country.

Table 2 outlines the basics for two identical companies, a U.S. based company and its overseas competitor, each of which operates in the same markets and makes the same profits ($200). The U.S. corporation pays U.S. taxes on all income – $40 on overseas earnings and $40 on domestic earnings – and overseas taxes of $20 on overseas earnings. The overseas competitor pays U.S. taxes ($40) only on U.S. earnings and overseas taxes ($20) only on overseas earnings.

The U.S. system does allow our corporations a credit for taxes paid to foreign jurisdictions ($20 in this example), but the bottom line remains plain: the U.S. corporation faces an effective tax rate of 40 percent – fully one-third higher than its competitor. The outdated U.S. system is a severe competitive handicap.

Table 2 The Tax Disadvantage for U.S. Companies		
	U.S. Company	Overseas Competitor
Global Operations		
Income	$100	$100
Overseas Tax Rate	20%	20%
Overseas Taxes	$20	$20
U.S. Tax Rate	40%	-
Gross U.S. Taxes	$40	-
Credit for Taxes Paid Abroad	-$20	-
Net U.S. Taxes	$20	-
US. Operations		
Income	$100	$100
Overseas Tax Rate	-	-
Overseas Taxes	-	-
U.S. Tax Rate	40%	40%
U.S. Taxes	$40	$40
Combined Operations		
Combined Income	$200	$200
Combined Taxes	$80	$60
Effective Tax Rate	40%	30%

Tax Deferral and "Offshoring" Jobs

The anti-competitive effects of the U.S. tax system have traditionally been mitigated somewhat by the practice of "deferral". Specifically, the U.S. tax on foreign earnings is deferred until the earnings are brought back to the United States. Thus, in the example above, both the U.S. tax of $40 and the $20 credit for foreign taxes are not realized until earnings are returned to the United States. During the deferral period, the U.S. firm is able to compete on a level playing field with competitors in overseas markets.

Unfortunately, some politicians have drawn the wrong conclusions from these facts. Their first choice is to convince other countries to increase their tax rates, thereby "solving" the competitiveness problem. The fact that all other countries have been lowering their corporation taxes suggests this approach is futile.

The next errant conclusion is that the fact that the U.S. firm is temporarily on a level playing field will cause firms to "ship" jobs offshore. The "solution" in this thinking is to eliminate deferral and raise immediately taxes overseas to the U.S. level. Thus, the Democratic Congress recently passed such legislation under the guise of protecting U.S. jobs and preventing the "off shoring" of jobs. While politicians and their union backers may want to claim that this will deter

US businesses from shipping jobs abroad, the claim flies in the face of the facts and the reality of the need to compete abroad.

The facts speak for themselves. The latest data available from the Commerce Department[vi] show that employment in foreign affiliates of U.S. multinationals increased by 3.8 million from 1997 to 2007. Under the mistaken "off shoring" view, we would expect a 3.8 million loss of jobs in the U.S. parents of these foreign affiliates. Rather, we see a 2.1 million increase in employment at the U.S. parents. Workers in the foreign affiliate and the U.S. parent company are complements, not substitutes. As global operations expand, firms need more workers both at home and abroad. Goodyear operating more than 57 plants in 23 countries can increase Ohio employment as it increases employment overseas.

This aggregate data is consistent with a more detailed company-level study covering the period 1982 through 2004.[vii] For almost two-thirds of U.S. based multinationals, employment in foreign affiliates and the U.S. parent move together. Only one-fifth of these companies saw an increase in foreign employment and a decrease in U.S. employment. Of course, the media usually focuses on the "off shoring" in this minority of cases, missing completely the critical point that overall U.S. and foreign employment are moving together. What's more, the U.S. jobs created by these multinationals are high paying, with wages 50 percent above the average wage.

Implications for Ohio Employers. How important is deferral to Ohio employers? To get a feel for the implications, I build on the work of Shapiro and Mathur [2009] who estimate that elimination of deferral would cost 159,000 jobs in U.S. multinational corporations.[viii] Using publicly available data, I estimate that this translates into an impact of deferral in Ohio that would lower direct employment by multinationals by 6,582 directly and 11,051 indirectly, for a total of 17,633.[ix] (To give the reader some perspective, private sector job growth in Ohio was 2,100 between June and July this year.)

Finally, if one assumes the same ratio of direct/indirect jobs for specific Ohio firms as for the overall MNC sector, it is possible to roughly estimate the impact on particular Ohio employers. Using data from the Ohio Department of Development yields[x]:

Firm	Jobs in Ohio – April 2009		Impact of Eliminating Deferral		
	Direct Jobs	Indirect Jobs	Direct Lost	Indirect Lost	Total Lost
P&G	14,000	23,504	101	169	270
The Limited	9,700	16,285	70	117	187
Parker Hannifin	4,100	6,883	30	50	80

The lesson in Ohio and elsewhere is to remember that corporations create jobs, and that the more we tax them the less we should expect them to produce – whether it be goods, services or jobs. Nobel-prize-winning Economist Robert Lucas remarked that reducing the corporate income tax is the closest thing to a free lunch that he has ever seen in terms of the economic output it would create[xi]. Other developed countries recognize this and have reacted accordingly, slashing tax rates on corporate profits and investment. The U.S. remains the lone holdout, apparently hoping that the other countries will reverse course and push their corporate tax rates up again before too long.

Repatriation Policy

The U.S. has experimented with more competitive tax policies. The American Jobs Creation Act of 2004 included a provision that allowed corporations to deduct 85 percent of earnings brought back from overseas operations – a policy referred to as repatriation. Although only temporary, this provision had two advantages. First, it reduced the competitive disadvantage imposed by the U.S. tax code by eliminating taxes on 85 percent of overseas earnings. Second, it eliminates the tax-based barrier to bringing funds back to the U.S.. In simple terms, this means investment and jobs.

A two-year reduction in taxes on repatriated profits was proposed by Dr. Laura Tyson, former Chair of the US Council of Economic Advisers during the Clinton administration, whose research indicated that the repatriated funds would mean as many as 425,000 additional jobs created during that period.[xii]

Foreign Takeovers and the Loss of Jobs

The final perverse incentive of proposals to eliminate deferral is to put the best American firms on sale to foreign buyers. To see this, return to the example in Table 2. By construction, the two firms are equally productive and competitive. However, the firm based in a foreign country faces a much lower effective tax rate. Put differently, if the U.S. firm was bought by a foreign corporation, the effective tax rate would fall immediately. Thus, there is a tremendous incentive for foreign corporations to buy their U.S. competitors and for every merger to have its headquarters located abroad. The long-run consequences of losing major Ohio companies will not be good for Ohio workers.

Exports and Jobs

Encouraging Ohio companies to export and expand their global presence should be a priority for our leaders. Ohio currently stands seventh among the fifty states in exporting[xiii], and a corporate tax code that does not seek to punish firms with operations abroad would definitely boost the Ohio economy. Recent work by the Brookings Institution[xiv] highlights the importance of exports in stimulating U.S. economic growth and shows that this is especially true for Ohio, which is home to seven of the top 100 metropolitan exporting areas in the country. For example, in the Youngstown area, exports account for almost 20 percent of economic activity. The Brookings study also found a link between innovation and exports, noting that the Cleveland area’s high rate of patenting is consistent with its large export share. Obviously, the key to Ohio’s future development, even in areas hit hardest by the recession, is global engagement. This engagement will not happen with tax and trade policies that punish global expansion.

The current recession is the most severe since the Great Depression, and it's not clear that we've come out of it yet. We can all agree that we need to do more to get the economy going again, although the administration's policies to that end have missed the point. Using the recession as an excuse to funnel billions of dollars in subsidies and tax breaks to favored companies and industries is the height of folly, and stimulating the economy has been the excuse for such misguided industrial policy.

Congress has a simple way to help our manufacturing sector, and that is to pass the trade agreements with Panama, South Korea, and Columbia. Ohio companies such as Timken, Parker Hannifin, and Owens Corning are poised to increase their sales by billions of dollars once they obtains unfettered access to these three markets. Moreover, Ohio farmers stand to see their exports increase as U.S. farm exports surge as well. The American Meat Institute estimates that meat and poultry imports would go up by over $2.3 billion[xv] and the American Farm Bureau Federation estimates that grain and commodity sales would increase by $1.8 billion[xvi].

Research, Productivity, Competitiveness and Jobs
Congress should extend the Research and Experimentation Tax Credit that is in danger of expiring this year.[xvii] This credit gives companies that ramp up spending on future production methods a significant tax break if they significantly increase their expenditures above the levels of the preceding years. Research has shown this to be a very effective way to encourage manufacturing companies to modernize their plant and equipment and keep pace with their competition around the world: After the United States first created such a tax incentive in the 1980s, countries around the world imitated us, and today our credit is among the least generous out there. And unless Congress acts soon it may expire.

Instead, the Congress has offered a response narrowly targeted to manufacturing jobs that is tepid at best. The Democratic Congress just passed a bill demanding that the Administration conduct a study that would make recommendations on how to combat the loss of manufacturing jobs. There's no mystery what an administration-guided study is going to suggest: More "managed" trade, more industrial policy and subsidies for favored industries, and in general a greater role for government in the economy. And anyone with their eyes open will realize that this is the height of folly. Spending a few million dollars so that the administration can make another political statement under the guise of "economic policy" will not create jobs.

Incentives matter, and right now the incentives in place for U.S. corporations make little sense. We need to fix our corporate tax code as soon as possible, and encourage our companies to invest here, to invest abroad, and to sell their wares across the globe.

Summary and Conclusions
Ohio competitiveness and jobs are significantly harmed by the fact that the U.S. corporation income tax is the highest among developed countries. In addition, the U.S. clings to an outdated tax strategy ("worldwide taxation") that places its companies at a competitive disadvantage in world markets, hurts jobs, and encourages foreign purchase of vital U.S. companies.

As a complement to pro-competitive tax reforms, U.S. policy should seek agreements to open global markets to the products of U.S. workers. This is especially important for Ohio workers who are already engaged in substantial global market activities and who face both a tax disadvantage and export barriers. Finally, an improved, permanent tax credit for research and development will support productivity growth, global competitiveness, and high-wage manufacturing in Ohio.

Endnotes

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[i] http://www.japantoday.com/category/business/view/kan-eager-to-lower-corporate-taxes-as-early-as-next-year
[ii] *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, U.S. Treasury, 2007, p. 10.
[iii] http://www.cbo.gov/ftpdocs/75xx/doc7503/2006-09.pdf
[iv] http://www.aei.org/paper/24629
[v] http://www.businessweek.com/news/2010-07-22/japan-says-corporate-tax-cuts-don-t-always-reduce-revenues.html
[vi] http://bea.gov/international/index.htm#omc
[vii] http://www.businessroundtable.org/sites/default/files/Slaughter%20Paper-Color.pdf
[viii] See Robert Shapiro and Aparna Mathur, "The Economic Benefits of Provisions Allowing U.S. Multinational Companies to Defer U.S. Corporate Tax on their Foreign Earnings and the Costs to the U.S. Economy of Repealing Deferral." http://www.techceocouncil.org/storage/documents/Shapiro-Mathur_June_8_2009_Report.pdf
[ix] The computation uses BEA data (http://www.bea.gov/newsreleases/international/mnc/2010/mnc2008.htm) that indicates total jobs in the U.S. by multinational corporations (MNCs) in 2008 was 22.9 million. I translate this to 2009 employment, by assuming MNC employment fell as much as total private employment. According to the BLS total private employment (in thousands) in December 2008 was 111,767, while in December 2009 it was 107,107. This is a drop of -4.2 percent, suggesting MNC employment of 21.9 million in 2009. Thus, if eliminating deferral leads to a decline of 159,000 jobs, this is 0.72 percent of MNC employment.

To translate to Ohio, I use Business Roundtable data for 2007 that showed that MNCs in Ohio employed 988,400 people and supported an additional 1,659,400 jobs through their supply chains and spending by the people they employed directly or indirectly. (http://www.pace4jobs.org/pdf/statefacts/Ohio%20Fact%20Sheet%2007-14-2009.pdf). Finally, I translate to 2009 data using BLS reports that total private employment (thousands) in Ohio in 2007 was 4,630.9 compared with 4,283.2 in 2009. If MNC employment fell at the same rate (-7.5 percent) then MNC employment was 914,188 directly and 1,534808 indirectly.
[x] http://www.development.ohio.gov/research/files/B100000002.pdf
[xi] http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3727
[xii] "A Temporary Reduction in Taxes on Repatriated Profits for the Purpose of Economic Stimulus and Investment in National Priorities." Dr. George Schink and Dr. Laura Tyson. January 30, 2009.
[xiii] http://development.ohio.gov/research/FILES/B000000000.pdf
[xiv] http://www.brookings.edu/reports/2010/0726_exports_istrate_rothwell_katz.aspx
[xv] http://www.meatami.com/ht/a/GetDocumentAction/i/60268
[xvi] www.qconline.com/archives/qco/display.php?id=504140
[xvii] The Administration's budget proposes to make the credit permanent. As this paper was being finalized, this proposal was being given increased attention and priority. Unfortunately, the proposal was linked to a detrimental restriction in international tax deferral.