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Higher Taxes on US-Based Multinationals Would Hurt US Workers and Exports

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As presidential candidate, Barack Obama repeatedly advocated tax "reforms" aimed squarely at US-based multinational enterprises (MNEs). As president, he again declared—in the same State of the Union address that laid out an ambitious goal for export expansion—that "it is time to finally slash the tax breaks for companies that ship our jobs overseas, and give those tax breaks to companies that create jobs right here in the United States of America."[1]

Do US multinationals deserve tax punishment because they "ship jobs overseas"? Studies comparing US firms that engage in outward investment with similar firms that stay at home show that outward bound firms consistently *export more* from the United States than the homebodies.[2] If US tax policy were changed so as to hinder outward investment by US firms, evidence indicates, US export performance would be weaker, not stronger, as a consequence.

Somewhat surprisingly, the positive relationship between outward investment and exports holds for US low-tech (low R&D) industries just as for US high-tech industries and for heavily unionized US industries just as for nonunionized US industries. Outward investment creates more export-related jobs in the US economy for low-tech workers and unionized workers just as it does for US workers overall. Since export-related jobs pay wages around 10 percent higher than average jobs requiring similar skills, fewer exports would spell fewer "good jobs" in the domestic economy.[3]

Changing US tax policy to retard outward investment by US multinationals would not lead to more investment at home either. Mihir Desai, Fritz Foley, and James Hines show that the years in which American MNEs make greater capital expenditures abroad coincide with the years of greater capital spending at home by the same firms.[4] They find that 10 percent greater foreign direct investment (FDI) by the multinational triggers 2.2 percent additional domestic investment. They show that there are similar positive relationships between FDI and R&D spending, numbers of employees, and employee compensation, as well as home-country exports.

The best bottom line for American workers—and the American economy as a whole—is to keep the United States a favorable location for American MNEs to do business. The plants of US multinationals are the most productive in the United States, both in terms of total factor productivity and labor productivity. They are also the most technology-intensive and pay the highest wages. In 2007 the parents of US MNEs accounted for 29 percent of all US private-sector investment and 74 percent of all US private-sector R&D. Labor productivity at American plants of US

1. Remarks by the President in State of the Union Address, US Capitol, January 27, 2010, available at www.whitehouse.gov (accessed on May 4, 2010).

2. The evidence is summarized in Theodore H. Moran, *American Multinationals and American Economic Interests: New Dimensions to an Old Debate,* Working Paper 09-3 (Washington: Peterson Institute for International Economics, 2009).

3. J. David Richardson, "Uneven Gains and Unbalanced Burdens? Three Decades of American Globalization," in *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, ed. C. Fred Bergsten (Washington: Institute for International Economics, 2005).

4. Mihir A. Desai, C. Fritz Foley, and James R. Hines, Jr., "Foreign Direct Investment and the Domestic Capital Stock," *American Economic Review* 95, no. 2 (May 2005), 33–38.

MNEs is 16.6 percent higher than at large homebody firms and 44.6 percent higher than at small US firms. US multinationals pay wages that are 7 to 15 percent more than wages at comparable domestic plants.

Given these facts, it makes little sense to slap US-based MNEs with higher taxes. Other countries are doing just the opposite—attracting foreign investment and enhancing the export performance of their firms by adopting competitive tax policies. But not the United States. According to the Tax Foundation, as of 2009, the combined US federal and state statutory corporate tax rate was about 39 percent, about 13 percentage points higher than the average OECD combined corporate tax rate. Among 30 OECD members, the United States has the second highest combined statutory corporate income tax rate after Japan (40 percent).

In contrast to most countries that maintain simple territorial tax systems, either de jure or de facto, the United States subjects its MNEs to worldwide taxation. Consequently they face heavier burdens of tax planning, reporting, and accounting than their foreign competitors, as well as higher tax burdens. Only a tax collector could appreciate this style of "tough love."

Nor does it make sense to deny US oil companies the tax benefits enjoyed by their European, Japanese, Chinese, and other state-owned competitors when those firms lift oil from countries in the Middle East, Africa, and Asia. Yet, in a complex way, one of the administration's proposals would do just that and give foreign oil companies a leg up on US companies.[5] Whatever one thinks about US reliance on imported oil, and the larger question of climate change, it hardly makes sense to favor private and state-owned oil companies based abroad in this critical industry.

Professor Reuven S. Avi-Yonah of New York University argues that "the Obama proposals represent a very cautious first step toward making US multinationals pay their fair share of the tax burden" and urges Congress to enact them as soon as possible.[6]

In our view, this is bad advice—bad for American workers, bad for US exports, and bad for the competitive position of American multinationals. "Tax fairness" is in the eyes of the beholder, but as far as we can see, MNEs already pay their "fair share of the tax burden." Contrary to critics, US MNEs pay about the same overall tax rate as homebody US firms—in 2005 an average effective rate of about 33 percent.[7] Apart from the elusive question of "tax fairness," there are important issues of providing good jobs for American workers and promoting US exports. Higher taxes on MNEs run counter to both goals.

The United States should say farewell to tirades against US-based MNEs. Instead, US leaders should reform the US tax system to create a more business-friendly environment. A worthy short-term goal for the Obama administration, commended by Senate Finance Committee Chairman Max Baucus, is to cut the statutory tax rate to 25 percent. This makes far more sense than singling out US MNEs for tax punishment.

In fact, when the Obama team lifts its sights to the challenge of curbing the runaway fiscal deficit—driven by escalating entitlement expenditures—it should embrace even bolder corporate tax reforms. Curbing the deficit will require an iron-clad pact between Republicans and Democrats that caps federal spending as a percent of GDP while, at the same time and in the same breath, boosts federal revenue beyond the historic norm of 18 percent of GDP. The revenue side of this pact cannot come from corporate taxes—that would drive the best and brightest firms abroad and cripple the American economic engine. Instead, new revenue must come from a broad-based consumption tax, as spelled out by Yale Professor Michael Graetz.[8] Simultaneously, the corporate tax rate should be cut to at least 20 percent, as urged by Graetz and other commentators.[9]

The road to expenditure and tax reform is bound to be long and rocky. In the meantime, the United States should align its taxation of MNEs to the territorial norms of foreign competitors—from France and Germany to Brazil, India, and China.[10] These home-base countries for powerful MNEs either exempt entirely or tax very lightly the income earned by their MNE subsidiaries doing business abroad. The United States should adopt its own version of territorial taxation and allow US-based MNEs to repatriate dividends from their foreign subsidiaries at a flat rate of 5 percent, with no foreign tax credit. This was successfully tried for the year 2005 in the American Jobs Creation Act of 2004 (the AJCA). The result was a gush of repatriated income, around $300 billion, and revenue that the US Treasury would never have seen.

In 2010, the Congress should lay aside the administration's proposals for punishing US MNEs with higher taxes and instead make the AJCA tax of 5 percent on repatriated dividends a permanent part of the tax code.

5. The proposal would automatically deem a portion of the US oil company tax paid, for example, to Nigeria or Qatar, as a royalty and deny the US foreign tax credit for that portion of the tax. Current law, in place for more than 30 years, instead relies on a facts and circumstances approach for distinguishing between taxes and royalties collected by foreign governments that own subsurface minerals.

6. Reuven S. Avi-Yonah, "President Obama's International Tax Proposals Could Go Further," *Columbia FDI Perspective*, February 11, 2010.

7. See Matthew Adler and Gary Clyde Hufbauer, "The Outward Migration of US Firms: Are We Losing Our Best and Are We Forcing Them Out?" (unpublished paper, Peterson Institute for International Economics, June 2009).

8. See Michael J. Graetz, *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States* (Yale University Press, 2008). Graetz advocates a value added tax (VAT) modeled after the credit-invoice system, now used by more than 150 countries. With a rate of 15 percent, a VAT could deliver enough revenue to drop around 100 million households from the federal income tax system and reduce the corporate tax rate to the range of 15 to 20 percent.

9. In *Reforming the US Corporate Tax* (Institute for International Economics, 2005), Gary Clyde Hufbauer and Paul L. E. Grieco argued for substituting a subtraction method VAT, called the "corporate activity tax," for the corporate tax as a way of reducing the steep US tax on capital formation.

10. See Gary Clyde Hufbauer and Ariel Assa, *US Taxation of Foreign Income* (Washington: Peterson Institute for International Economics, October 2007).