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"Shipping Jobs Overseas" or Reaching New Customers? Why Congress Should Not Tax Reinvested Earnings Abroad

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Trade and globalization have become more inviting targets during the current economic downturn. As output falls and unemployment rises, politicians in Washington are questioning not only imports but U.S. companies that invest in production abroad.

The incoming president, Barack Obama, pledged during his campaign that, "Unlike John McCain, I will stop giving tax breaks to corporations that ship jobs overseas and I will start giving them to companies that create good jobs right here in America."[1] That campaign refrain, echoed by a number of other successful candidates, raises three basic questions:

Why do U.S. multinational companies establish affiliates abroad and hire foreign workers? What kind of tax breaks are they receiving? And should the new Congress and new president change U.S. law to make it more difficult for U.S. multinational corporations to produce goods and services in foreign countries?

Reaching millions of new customers

To demonize U.S. multinationals operating production facilities abroad is to indict virtually every major American company. At latest count more than 2,500 U.S. corporations own and operate a total of 23,853 affiliates in other countries. In 2006, according to the U.S. Department of Commerce, majority-owned foreign affiliates of U.S. companies posted $4.1 trillion in sales, created just under $1 trillion in value added, employed 9.5 million foreign workers, and earned $644 billion in net income for their U.S.-based parent companies.[2]

The primary reason why U.S. companies invest in affiliates abroad is to sell more products to foreign customers. Certain services can only be delivered on the spot, where the provider must have a physical presence in the same location as its customers. Operating affiliates abroad allows U.S. companies to maintain control over their brand name and intellectual property such as trademarks, patents, and engineering expertise. U.S. companies also establish foreign affiliates because of certain advantages in the host country—lower-cost labor, ready access to raw materials and other inputs, reduced transportation costs and proximity to their ultimate customers. Yes, the motivations can include access to "cheap labor," but labor costs are not the principal motivation for most U.S. direct investment abroad.

Politicians focus most of their attention on comparing exports and imports, but the most common way American companies sell their goods and services in the global market today is through overseas affiliates. In 2006, U.S. multinational companies sold $3,301 billion in goods through their majority-owned affiliates abroad and $677 billion in services. For every $1 billion in goods that U.S. multinational companies exported from the United States in 2006, those same companies sold $6.2 billion through their overseas operations. For every $1 billion in service exports, U.S.-owned affiliates abroad sold $1.6 billion.[3]

Contrary to popular myth, U.S. multinational companies do not use their foreign operations as an "export platform" back to the United States. Close to 90 percent of the goods and services produced by U.S.-owned affiliates abroad are sold to customers either in the host country or exported to consumers in third countries outside the United States. Even in Mexico and China, where low-wage workers are supposedly too poor to buy American products, more than half of the products of new and existing U.S. affiliates are sold in their domestic markets, whereas customers in the United States account for only 17 percent of sales.[4]

More Jobs Abroad, More Jobs at Home

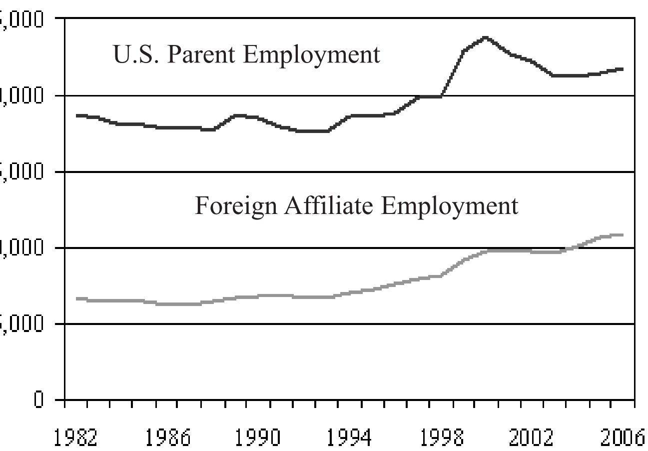
Investing abroad is not about "shipping jobs overseas." There is no evidence that expanding employment at U.S.-owned affiliates comes at the expense of overall employment by parent companies back home in the United States. In fact, the evidence and experience of U.S. multinational companies points in the opposite direction: foreign and domestic operations tend to compliment each other and expand together. A successful company operating in a favorable business climate will tend to expand employment at both its domestic and overseas operations. More activity and sales abroad often require the hiring of more managers, accountants, lawyers, engineers, and production workers at the parent company.

Consider Caterpillar Inc., the Peoria, Illinois-based company known for making giant earth-moving equipment. From 2005 through 2007, the company enjoyed booming global sales because of strong growth in overseas markets, especially those with resources extracted from the ground. According to the company's 2007 annual report, Caterpillar earned 63 percent of its sales revenue abroad, including $1 billion in sales in China alone. As a result, Caterpillar ramped up employment at its overseas affiliates during that time from 41,238 to 50,788, an increase of almost 10,000 workers. During that same three-year period, the company expanded its domestic employment from 43,878 to 50,545, a healthy increase of 6,667.[5]

Caterpillar's experience is not unusual for U.S. multinational companies. A 2005 study from the National Bureau of Economic Research found that, during the 1980s and 1990s, there was "a strong positive correlation between domestic and foreign growth rates of multinational firms." After analyzing the operations of U.S. multinational companies at home and abroad, economists Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr. found that a 10 percent increase in capital investment in existing foreign affiliates was associated with a 2.2 percent increase in domestic investment by the same company and a 4 percent increase in compensation for its domestic workforce. They also found a positive connection between foreign and domestic sales, assets, and numbers of employees.[6] "Foreign production requires inputs of tangible or intellectual property produced in the home country," the authors explained. "Greater foreign activity spurs higher exports from American parent companies to foreign affiliates and greater domestic R&D spending."[7]

The positive connection between foreign and domestic employment of U.S. multinational companies has continued into the current decade. As Figure 1 shows, parent and affiliate employment have tracked each other since the early 1980s. More recently, employment rose briskly for parents and affiliates alike in the boom of the late 1990s, fell for both during the downturn and slow recovery of 2001 through 2003, and then rose again from 2003 through 2006.[8] Although the numbers have not been reported yet for 2007 and 2008, it's likely that the loss of net jobs in the domestic U.S. economy will be mirrored by much slower growth or outright decline in foreign affiliate employment.

Figure 1
Employment (thousands)



Source: Raymond J. Mataloni Jr., "U.S. Multinational Companies: Operations in 2006," Bureau of Economic Analysis, U.S. Commerce Department, Survey of Current Business, November 2008, Table 1.

Modest Investment in China and Mexico

Investment in China and Mexico drew the most fire on the campaign trail. In a primary debate in Texas in February 2008, then-senator Obama said, "In Youngstown, Ohio, I've talked to workers who have seen their plants shipped overseas as a consequence of bad trade deals like NAFTA, literally seeing equipment unbolted from the floors of factories and shipped to China."[9] That makes for a good sound-bite in the heat of a campaign, but it does not accurately reflect the broader reality of outward foreign investment by U.S. manufacturers.

Outflows of U.S. manufacturing investment to Mexico and China have been modest by any measure. Between 2003 and 2007, U.S. manufacturing companies sent an average of $2 billion a year in direct investment to China and $1.9 billion to Mexico. That pales in comparison to the average $22 billion a year in direct manufacturing investment "shipped" to Europe during that same period, but talking about equipment being unbolted from the floors of U.S. factories and shipped to England just doesn't have the same bite.[10] The modest annual outflow in investment to China and Mexico is positively dwarfed by the annual $59 billion *inflow* of manufacturing investment to the United States from abroad during those same years[11] and the average of $165 billion per year that U.S. manufacturers invested domestically in plant and equipment.[12]

The fear of manufacturing jobs being shipped to China and Mexico is not supported by the evidence. While U.S. factories were famously shedding those 3 million net jobs between 2000 and 2006, U.S.-owned manufacturing affiliates abroad increased their employment by a modest 128,000 jobs. An increase in 172,000 jobs at U.S.-owned affiliates in China was partially offset by an actual decline of almost 100,000 jobs at affiliates in Mexico.[13] The large majority of factory jobs lost in the United States since 2000 were not "shipped to China" or anywhere else, but were lost to automation and other sources of increased efficiency in U.S. manufacturing.

U.S. manufacturing investment in China remains modest compared to the huge political investment that candidates and pundits have made in making it an issue. U.S. direct investment in China remains a relatively small part of China's overall economy, and a small part of America's total investments abroad. Of the nearly 10 million workers that U.S. affiliates employ abroad, fewer than 5 percent are Chinese; American-owned affiliates employed just as many manufacturing workers in high-wage Germany in 2006 as they did in low-wage China.[14]

"Tax breaks" Keep U.S. Companies Competitive

Politicians are not usually specific about exactly what "tax breaks" they want to repeal. The biggest tax exemption for U.S. companies that invest abroad is the deferral of tax payments for "active" income. U.S. corporations are generally liable for tax on their worldwide income, whether it is earned in the United States or abroad. But the relatively high U.S. corporate tax rate is not applied to income earned abroad that is reinvested abroad in productive operations. U.S. multinationals are taxed on foreign income only when they repatriate the earnings to the United States. Not surprisingly, the deferral of active income gives U.S. companies a powerful incentive to reinvest abroad what they earn abroad, but this is hardly an incentive to "ship jobs overseas."

Such deferral may sound like an unjustified tax break to some, but every major industrial country offers at least as favorable treatment of foreign income to their multinational corporations. Indeed, numerous major countries exempt their companies from paying any tax on their foreign business operations. Foreign governments seem to more readily grasp the fact that when corporations have healthy and expanding foreign operations it is good for the parent company and its workers back home.[15]

If President Obama and other leaders in Washington want to encourage more investment in the United States, they should lower the U.S. corporate tax rate, not seek to extend the high U.S. rate to the overseas activities of U.S. companies. Extending high U.S. tax rates to U.S.-owned affiliates abroad would put U.S. companies at a competitive disadvantage as they try to compete to sell their goods and services abroad. Their French and German competitors in third-country markets would continue to pay the lower corporate tax rates applied by the host country, while U.S. companies would be burdened with paying the higher U.S. rate. The result of repealing tax breaks on foreign earnings would be less investment in foreign markets, lost sales, lower profits, and fewer employment and export opportunities for parent companies back on American soil.

Politicians who disparage investment in foreign operations are wedded to an outdated and misguided economic model that glorifies domestic production for export above all other ways for Americans to engage in the global economy. They would deny Americans access to hundreds of millions of foreign customers and access to lower-cost inputs through global supply chains. In short, they would cripple American companies and their American workers as they try to compete in global markets.

Notes

1. Transcript, "Barack Obama's Acceptance Speech," *New York Times*, August 28, 2008, www.nytimes.com/2008/08/28/us/politics/28text-obama.html?_r=1&pagewanted=print.
2. Raymond J. Mataloni Jr., "U.S. Multinational Companies: Operations in 2006," Bureau of Economic Analysis, U.S. Commerce Department, *Survey of Current Business*, November 2008, Table 17.2, p. 43.
3. Mataloni, Tables 3 and 17.2; and Council of Economic Advisers, *Economic Report of the President 2008*, Table B-106.
4. Mataloni, p. 36.
5. Caterpillar Inc., *Annual Report 2007*, p. 37.
6. Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Foreign Direct Investment and Domestic Economic Activity," National Bureau of Economic Research, Working Paper no. 11717, October 2005, p. 1.
7. Ibid., p. 3.
8. Mataloni, Table 1, p. 27.
9. Quoted in Steve Chapman, "Why Are These People So Ashamed of NAFTA?" Reason Online, February 28, 2008, http://www.reason.com/news/show/125218.html.
10. U.S. Bureau of Economic Analysis, International Economic Accounts, "U.S. Direct Investment Abroad: Balance of Payments and Direct Investment Position Data," http://www.bea.gov/international/di1usdbal.htm.
11. U.S. Bureau of Economic Analysis, International Economic Accounts, "Foreign Direct Investment in the U.S.: Balance of Payments and Direct Investment Position Data," http://www.bea.gov/international/di1fdibal.htm.
12. U.S. Census Bureau, "U.S. Capital Spending Patterns: 1999–2006," U.S. Department of Commerce, October 7, 2008, http://www.census.gov/csd/ace/.
13. U.S. Bureau of Economic Analysis, International Economic Accounts, "U.S. Direct Investment Abroad: Financial and Operating Data, Employment by Country and Industry 1999–2006," http://www.bea.gov/International/Index.htm.
14. Mataloni, Table 18.2, p. 45.
15. For a more detailed discussion of the impact of U.S. corporate taxation on the activities of U.S. multinationals, see Chris Edwards and Daniel J. Mitchell, *Global Tax Revolution: The Rise of Tax Competition and the Battle to Defend It* (Washington: Cato Institute, 2008), esp. Chapter 6.

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