Executive Memorandum

Published by The Heritage Foundation

No. 911
January 26, 2004

Job Creation and the Taxation of Foreign-Source Income

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The World Trade Organization (WTO) has ruled that portions of U.S. tax law—specifically, the Foreign Sales Corporation/Extraterritorial Income (FSC/ETI) Act—provide an impermissible "export subsidy." This creates a bad news/good news situation.

The bad news is that the WTO is interfering with America's fiscal sovereignty by insisting that Congress repeal the FSC/ETI legislation or run the risk of more than $4 billion of compensatory tariffs on U.S. exports to European Union nations. The good news, however, is that this creates an opportunity for lawmakers to enact much-needed tax reforms, especially reducing the tax on income earned by U.S. companies abroad so that they can compete on a level playing field with foreign-based firms.

- America's worldwide tax system places U.S.-based companies at a disadvantage in world markets, harming the U.S. economy and undermining job creation.
- Every dollar that a company invests overseas yields two dollars of additional exports for its home country.

Worldwide vs. Territorial Taxation. The U.S. tax code currently places American companies at a competitive disadvantage by taxing them on income earned abroad. This policy of "worldwide taxation" can subject U.S.-chartered companies operating overseas to tax burdens several times larger than those imposed on their foreign counterparts, most of which come from countries with "territorial taxation" (the common-sense policy of taxing only income earned inside national borders).

America's high corporate tax rate—the second highest in the developed world—exacerbates the anti-competitive impact of worldwide taxation, and American companies competing in low-tax jurisdictions like Ireland or Hong Kong are the most adversely affected. As the example in Table 1 indicates, U.S. companies can face an enormous additional burden because of America's worldwide tax regime.

Some lawmakers are concerned that moving toward territorial taxation would encourage companies to relocate jobs and factories from America to low-tax countries. The high U.S. corporate tax rate is an incentive for companies to create jobs and expand operations in jurisdictions with better tax law—or would be if they did not also have to pay the high U.S. corporate tax rate on overseas earnings.

Does this mean that worldwide taxation protects American jobs by making it more difficult for U.S. companies to produce overseas? Absolutely not. Worldwide taxation can—and does—limit the ability of American companies to compete abroad, but it does not affect the decisions of non-U.S. companies. In other words, bad U.S. tax law may prevent an

This paper, in its entirety, can be found at:
www.heritage.org/research/taxes/em911.cfm

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation,
214 Massachusetts Ave., NE, Washington, D.C. 20002–4999
(202) 546-4400 heritage.org

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American company from taking advantage of a profitable opportunity to build a factory in a low-tax jurisdiction, but this simply makes it easier for a company from another country to exploit that opening. And since a foreign-based company can ship goods into the U.S. market under the same rules as a U.S. company's foreign subsidiary, worldwide taxation does not insulate America from overseas competition. It simply means that foreign companies get the business and earn the profits.

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Impact of Worldwide Taxation on a U.S. Company Competing in Ireland

	Profit	Irish Tax	Additional Tax	Total Tax
U.S. Company	$100	$12.50	$22.50 to IRS	$35.00
Local Company	$100	$12.50	0	$12.50
Dutch Company	$100	$12.50	0	$12.50

Sources: Calculations based on U.S., Dutch, and Irish corporate tax laws.

How Worldwide Taxation Destroys Jobs. By placing U.S.-based companies at a disadvantage in world markets, America's worldwide tax system harms the U.S. economy and undermines job creation. This is because companies with foreign operations are more likely to purchase raw materials and intermediate goods from their home countries. The Organization for Economic Co-operation and Development estimates that every dollar that a company invests overseas yields two dollars of additional exports for its home country.

U.S. data strongly support the link between foreign operations and exports. An academic survey found that every dollar of overseas production by U.S. affiliates generates an average of $0.16 in exports from the United States. According to Commerce Department figures, U.S. companies sold $232 billion worth of American-produced goods to their overseas affiliates in 2000. This is impressive, but exports surely would be much higher if U.S. companies competing abroad were not hamstrung by worldwide taxation. Territorial taxation would allow American companies to win a larger share of foreign markets, and this would then translate into higher U.S. exports and more U.S. jobs.

Furthermore, companies generally build factories in other countries in order to serve foreign markets—not to produce goods for America. According to Commerce Department data, nearly 90 percent of the output from U.S.-controlled foreign companies is sold to foreign consumers. This explains why two experts found that shifting to a territorial tax system would not influence where U.S. firms locate their factories. The Council of Economic Advisers also reviewed the research and found no support for the notion that jobs and exports suffer when U.S. companies invest abroad.

Some politicians think that multinational companies hurt the U.S. economy. In reality, however, companies that produce at home and abroad generate more than 21 percent of U.S. economic output, produce 56 percent of U.S. exports, and employ three-fifths of all manufacturing employees—about 9 million workers. These numbers would be even higher if these companies were not hindered by an onerous tax code.

Conclusion. Worldwide taxation places U.S. companies at a competitive disadvantage reducing their share of the global market. This limits the degree to which U.S. companies can benefit by operating in low-tax jurisdictions, but it does not discourage foreign companies from building new factories in jurisdictions with good tax law or exporting products to the United States. In other words, worldwide taxation neither limits competition from factories in low-tax countries nor restricts imports. Instead, it impedes U.S. companies' ability to maintain profitable operations in foreign countries.

Territorial taxation is good tax policy, and reducing the tax burden on foreign-source income is a simple step in this direction that would help the U.S. economy, resulting in more jobs, better jobs, and improved competitiveness of U.S. companies.

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