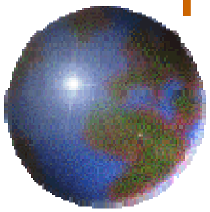

Taxing Multinational Firms: Securing Jobs or the New Protectionism?

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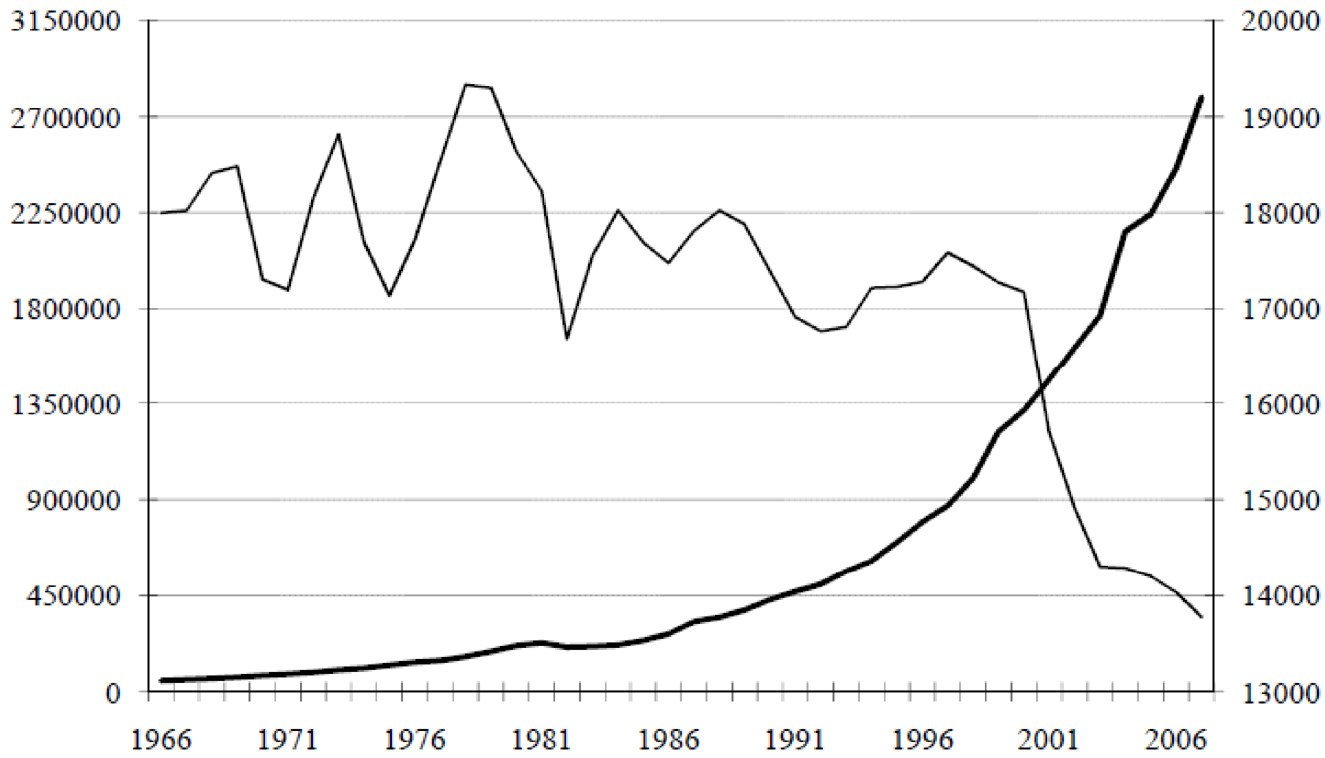
Motivation (1)

Two coincident trends have become coupled in the popular imagination – the growth of MNC foreign operations and the shrinking of domestic economic activity

Figure 1: Foreign Direct Investment Position & Domestic Manufacturing Employment, 1966-2007



Motivation (2)

Public sentiment is crystallizing on this presumed linkage and there is a belief that policymakers can and should fix this…

Scheve & Slaughter: “a consistent plurality to majority [of Americans] think that FDI in both directions eliminates jobs….with the prominent concern that outward FDI entails US firms ‘exporting’ jobs outside the country. Over two-thirds of Americans think that ‘companies sending jobs overseas’ is a ‘major reason’ for ‘why the economy is not doing better than it is.’”

Figure 2B – Previous policies unsatisfactory and desire for new policies to address this issue

Motivation (3)

Taxing MNC foreign activity increasingly a focus of these concerns

- Current system characterized as “subsidies for investing abroad”
- Changes abroad also heighten emphasis on these questions and wide-ranging proposals are surfacing
- Not unlike sentiments toward free trade

THIS PAPER asks three questions:

1) Any evaluation of policy must begin by asking: what motivates foreign investment?

2) Are these presumed linkages apparent in rigorous empirical analysis?

3) What can we learn from the recent dramatic U.S. experience?

What motivates foreign investment? (1)

Alternative theories lead to very different policy prescriptions…

Three alternative, successive theories:

1) Arbitraging rate of return differences

2) Exploiting firm-specific advantages

3) Systematically higher profitability that allows firms to absorb costs

=> Each theory leads to very different policy prescriptions

1. Arbitraging Return Differences

Basic Idea: Firms deploy capital to eliminate return differentials

Policy prescription: worldwide regimes with unlimited credits or deductions for foreign taxes (CEN, NN)

Underlying assumption: $'s go here or there

Policy implications: Not taxing foreign investment is a subsidy

Influence: Pervasive in U.S. policy

Difficulties: Firms are not sensitive to return differentials, recommended policies are not used, MNCs are no longer only arbitrage instrument out there any more…(Figure 3)

2. Exploiting Firm Specific Advantages

Basic Idea: Firms go abroad to exploit some advantage

Policy prescription: Self interested countries adopt exemption; world welfare can be max'ed with congruence (CON/NON)

Underlying assumption: Who owns what matters – that's why we have firms. FDI is about transferring ownership claims only

Policy implications: Not taxing foreign investment emerges as a norm

Influence: Pervasive in the academy and business; evident in policy, except for U.S.

Difficulties: Rests on degree to which FDI is about ownership claims or flows – what if FDI is lost investment?

3. Systematic Productivity Differences

Basic Idea: Productivity varies widely; and systematically with international exposure. A hierarchy is evident

i) Domestic firms

ii) Exporters [domestic +15% productivity]

iii) MNCs [exporters +15% productivity]

Only best firms can bear costs of exporting and overseas activities

Influence: Pervasive in international trade theory; little application to policy yet

Policy prescription: Home taxes will reallocate production away from most productive firms, reduce aggregate productivity, reduce competition (hurt consumers) and provide benefits to foreign firms

Motivations for FDI

Alternative policies – worldwide, exemption – map to alternative models of firm decision making

Current U.S. policy is really only consistent with the "arbitrage view" – unfortunately, that view of firm behavior would appear discredited

The arbitrage view is also the support for the intuition of "lost investment/employment" – the firm-specific advantages does not insist on that and allows for the possibility that the opposite is true

Regardless of the model, the facts suggest that MNCs are the most productive firms by a fair margin and worldwide systems should be understood as taxes on those types of firms

Evidence on the Linkages between Foreign Growth and Domestic Contraction

As with the theory, work began in a macroesque fashion – and yielded inconclusive results

Recently available data has allowed for firm-level analysis that promises to tell more…

But, thorny identification issues:

Domestic and MNC firms might differ in unobservable ways

Domestic and foreign operations of a MNC might respond to same shock

Evidence on the Linkages between Foreign Growth and Domestic Contraction

Solution 1: Aggregate to industry level

Arndt, Buch & Schnitzer (2007) using German data find complementarity

Even when outbound investment is "cost-motivated," there is no evidence of substitution

Solution 2: Carefully match domestic and MNC firms

Ando & Kimura (2007) on "kudoka" – Japanese MNCs shrink less than domestic firms domestically as they globalize - no evidence of substitutability

Several papers using French, German, Italian and Austrian firms finds that international expansions associated w/ domestic growth

Mechanism is intrafirm trade/R&D

No difference in expansions in developing vs. developed countries.

Evidence on the Linkages between Foreign Growth and Domestic Contraction

Solution 3: Instrument for foreign growth

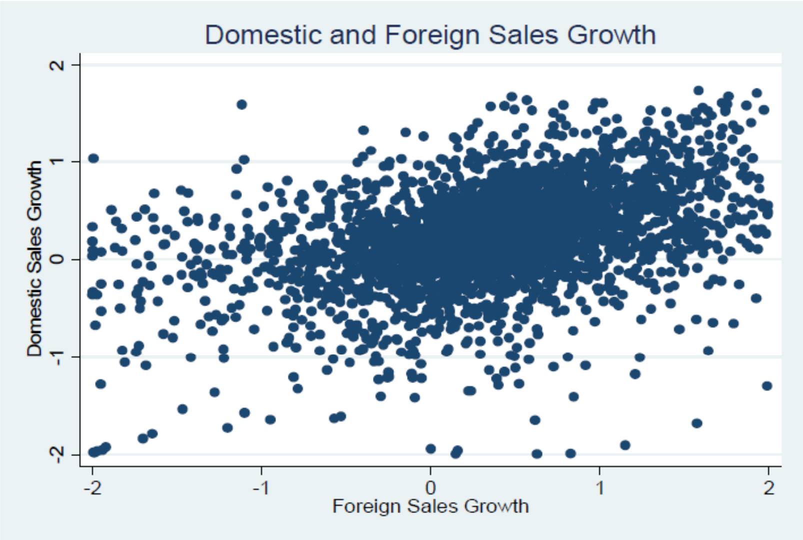
Desai, Foley and Hines (2009) use weighted average foreign economic growth rates to instrument for foreign growth

10% more investment abroad => 2.6% more domestic investment

10% more employee compensation abroad => 3.7% greater domestic employee compensation

Also evident in simple scatter…

=> Given the aggregate trends, it's surprising how difficult it's been to find any systematic evidence of substitutability



Evidence on the Linkages between Foreign Growth and Domestic Contraction

Some evidence on substitution

Brainard and Riker (1997, 2001), Muendler and Becker (2006), Simpson (2008) and Harrison and McMillan (2007) all report similar results - NB

1) Complementarity for vertical but substitutability for horizontal FDI

2) Effects are, as characterized by the authors, “very small” – substitutability effects can’t explain much of aggregate patterns

3) Vertical FDI may be much more prominent than previously measured (Alfaro and Charlton (2008))

The Recent U.S. Experience

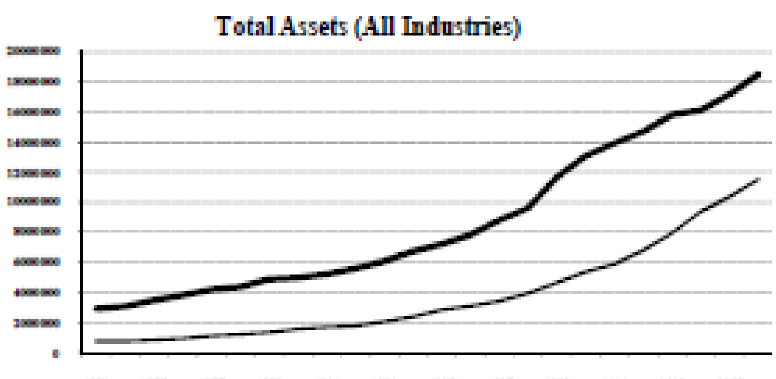
What happened in the US manufacturing shakeout of the late 1990s and early 2000s?

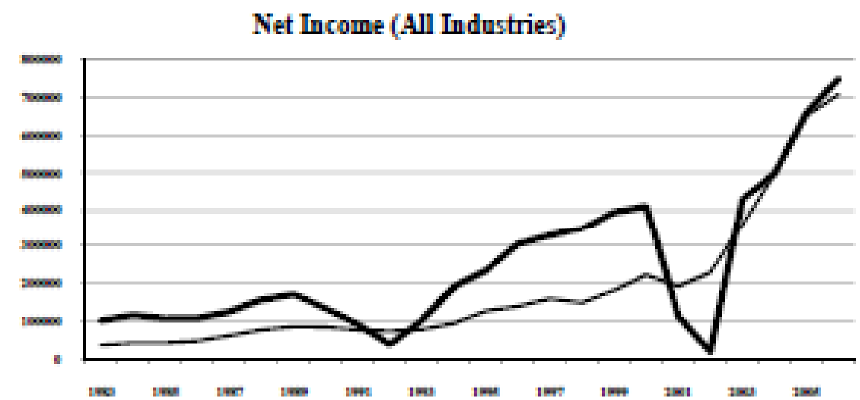
Can we learn anything from aggregate data on relative growth rates?

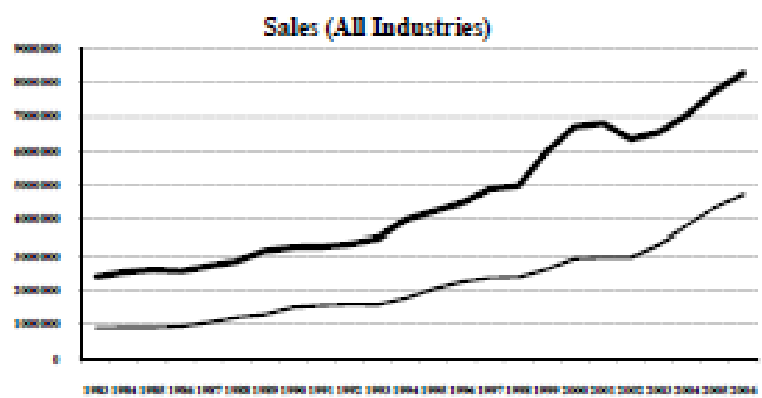
Can we learn anything about the relative skill composition of domestic and foreign operations?

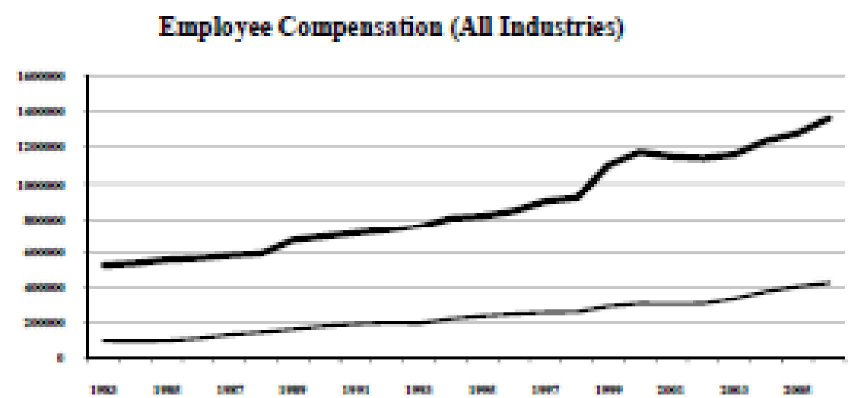
Relative growth rates of domestic and foreign operations

Sales and assets grow comparably domestically and abroad; profits have accelerated abroad but employee compensation has accelerated domestically





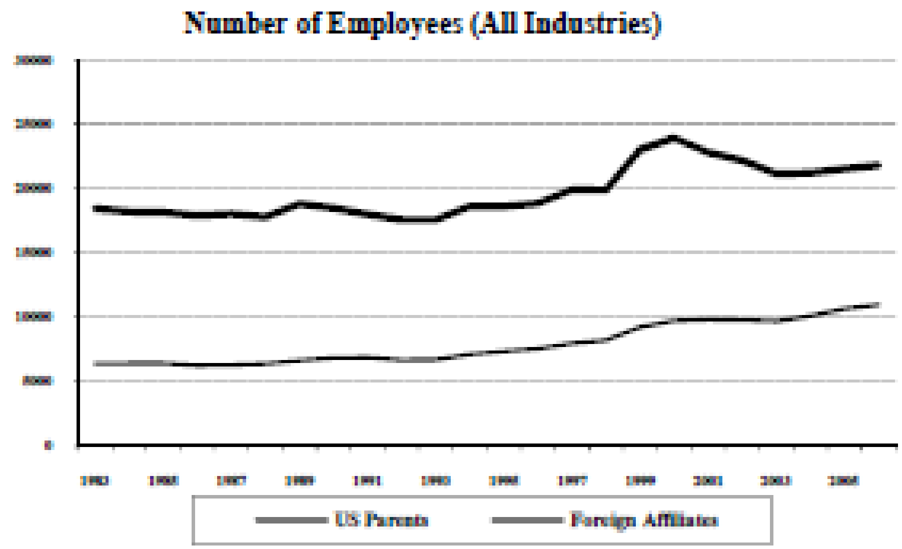


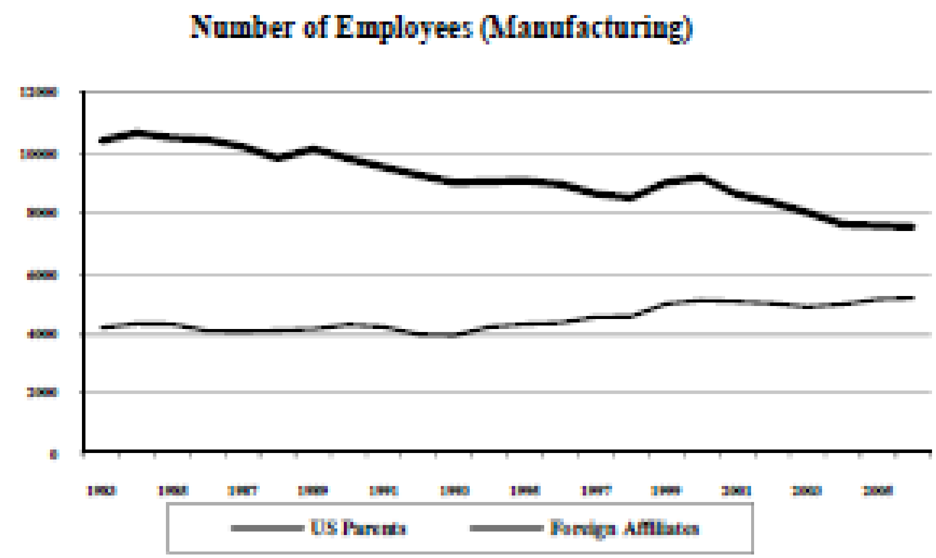


Relative growth rates of domestic and foreign operations

The employment trends are what really disturbs people – evident in all industries but really in manufacturing

But is this the right question?





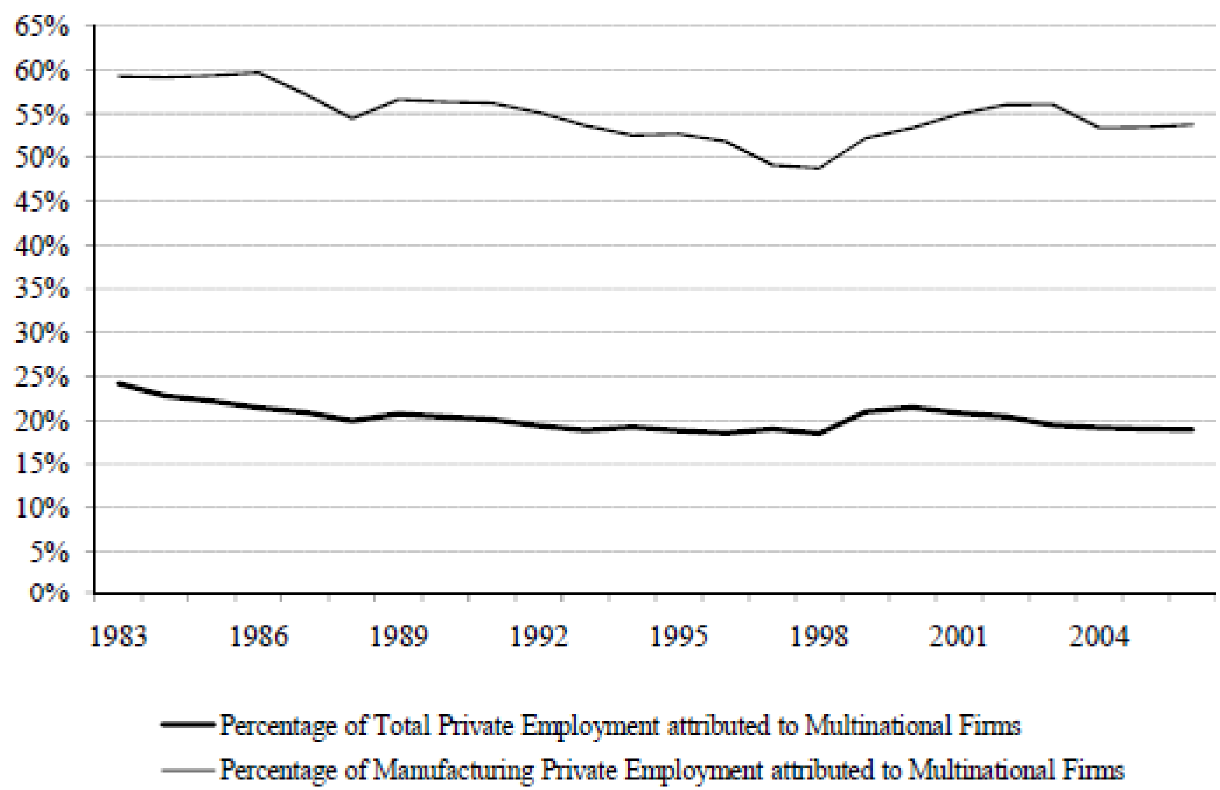
Relative growth rates of domestic and foreign operations

Relative share of multinational firms in domestic employment base:

- 1998: 49%
- 2003: 56%
- 2006: 54%

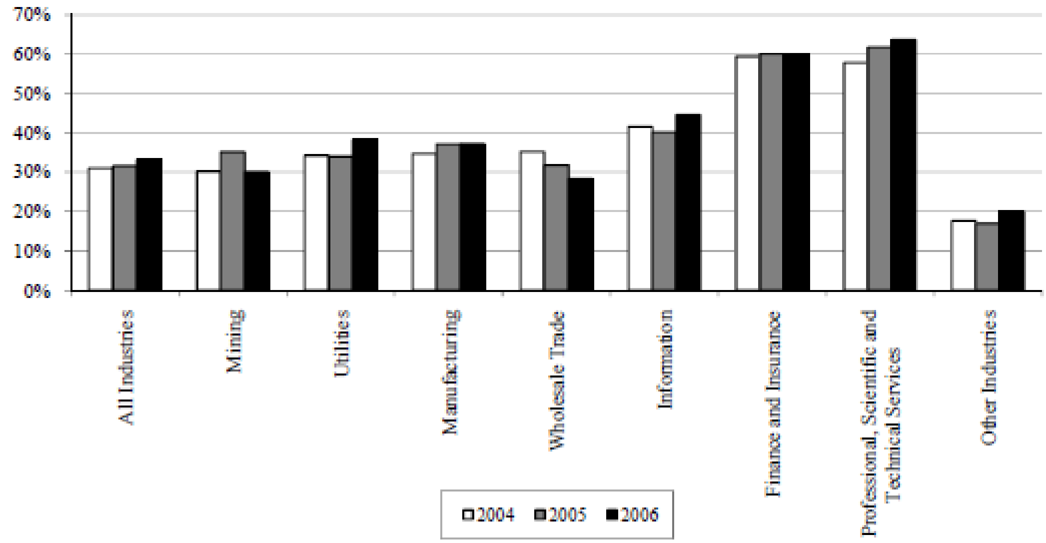
Manuf. shakeout as exit of domestic, low-productivity players rather than flight of MNCs

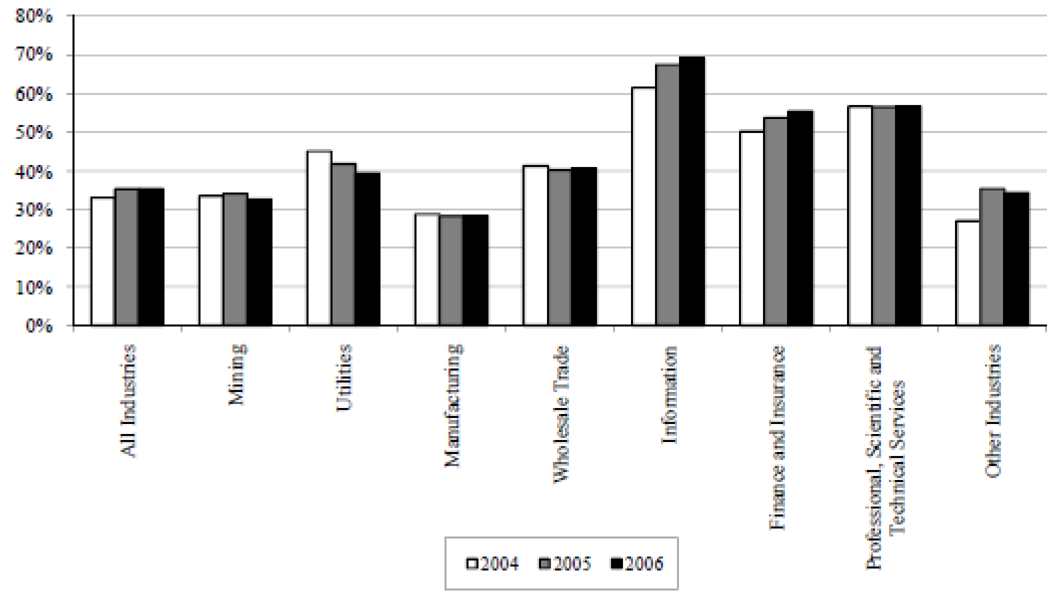
Figure 6: Multinational Employment: All Industries & Manufacturing, 1983-2006



Relative growth rates of domestic and foreign operations

Skill profile of employment domestically (top) and abroad (bottom) in Fig 7 is quite similar, in aggregate and the trend is not clearly toward moving one kind of labor or another abroad





Conclusion (1)

Theoretically, the arbitrage intuition that undergirds:

i) the substitutability intuition

ii) U.S. tax policy

is largely discredited

Alternative views emphasize productivity heterogeneity and the importance of ownership patterns – and allow for complementarity

Empirically, it is hard to find systematic evidence of substitutability – indeed, the opposite appears to hold across a variety of papers

The recent U.S. experience shows, if anything, the importance/resilience of U.S. MNCs in domestic employment

Conclusion (2)

The formulation of taxing multinational activity to further domestic economic interests is as valid, and alluring, as many protectionist sentiments

The required formulation is one that almost all other countries have adopted – the coupling of the success of firms abroad and at home