Romney’s New Tax Incentive for Outsourcing U.S. Jobs

Seth Hanlon  July 16, 2012

Introduction

The Washington Post recently reported that some of the companies Mitt Romney’s firm Bain Capital invested in were “pioneers in the practice of shipping work from the United States to overseas call centers and factories.” Even more troubling than his business record is his platform as Republican presidential candidate, which includes a policy that would encourage and further accelerate the outsourcing of American jobs to foreign countries.

The former Massachusetts governor would make U.S. corporations’ overseas profits exempt from U.S. taxes. These profits are already treated favorably under the tax code compared to corporate profits that are earned and reported domestically, creating an inefficient bias toward investment offshore. The favorable treatment of profits that are reported offshore also creates rewards for corporations that shift profits (on paper) out of the United States to foreign countries, including tax havens such as Bermuda and the Cayman Islands.

Romney’s proposed exemption for foreign profits would exacerbate the worst features of our current tax system. It would:

• Enhance the tax code’s rewards for moving jobs and investments overseas
• Provide a gratuitous windfall to some of the very companies that have already shifted jobs and profits overseas
• Further invite the offshore tax haven abuse that deprives the U.S. Treasury of tens of billions of dollars in revenue every year

Romney argues that we must exempt the overseas profits of American companies from U.S. taxes to make them more competitive in a global economy. But the evidence for this claim is lacking, as this issue brief will demonstrate. More fundamentally, Romney confuses the interests of multinational corporations based in the United States with the competitiveness of the U.S. economy overall. His plan would not make the U.S. economy—or U.S. workers—more competitive. Instead, it would reward foreign outsourcing, putting American workers at a disadvantage.
The current tax code’s incentives for moving jobs and investment overseas

One of the many ways that our tax system is broken is that it actually encourages and rewards U.S. corporations to make job-creating investments overseas even if similar investments in the United States—absent tax considerations—would be more profitable.

This perverse incentive stems from a feature of our tax system known as “deferral.” Under deferral, U.S. corporations pay taxes on their domestic profits in the year they are earned, but can delay paying taxes on their foreign profits for many years, or even indefinitely. Deferral is a valuable benefit because foreign profits can compound free of U.S. tax until they are “repatriated,” or brought back to the United States (at which point the corporation is allowed a credit for foreign taxes paid).  

The disparate treatment between domestic and foreign profits means that the U.S. tax code makes moving investment abroad more attractive. Economist Martin Sullivan of Tax Analysts explains:

*Under current law, if an American corporation opens a factory in Indiana, the profits of that factory are subject to the 35 percent U.S. corporate tax rate. If the same corporation instead opens a similar factory in Ireland, the profits from that factory are subject to a 12.5 percent tax rate [Ireland’s corporate tax rate]. If that factory generates a profit of $100, the choice is between an after-tax profit of $65 in the United States and $87.50 in Ireland. Obviously, U.S. tax law provides a large tax advantage for building and moving factories to low-tax countries.*  

In reality, most U.S. corporations don’t pay the full 35 percent on income earned in the United States because they take advantage of many available tax deductions and credits. But they’re also unlikely to pay the full foreign rate on overseas profits. In fact, major U.S. corporations investing in Ireland pay a small fraction of the 12.5 percent Irish rate. Indeed, many major U.S. corporations pay extremely low foreign taxes, while indefinitely deferring the U.S. taxes on their foreign profits. The bottom line is that overall, the effective tax rate that U.S. corporations pay on their foreign profits is about a third lower than the tax rate on their domestic profits, according to a 2008 study by the Government Accountability Office. (see figure)

The unfortunate consequence is that our tax system’s skewed incentives “encourage firms to locate physical assets, production, and jobs in [low-tax foreign] countries[,]” according to the nonpartisan Tax Policy Center. Worse, our existing system even encourages companies to
invest in high-tax foreign countries, rather than the United States, because once assets are offshore, the resulting profits can be moved fairly easily on paper to tax havens.7

Loopholes in the existing tax code also encourage and reward large corporations to game the rules to treat their profits as having been earned abroad even if they were actually earned in the United States. Profit shifting by multinational corporations costs the United States tens of billions of dollars in revenue.8 This system is badly in need of reform to reverse the bias toward offshore investment and prevent profit shifting.

Romney’s new and expanded subsidy for offshore investment

Romney’s economic platform would exacerbate these harmful features of the international tax system. He pledges to move the United States toward a “territorial” tax system.9 What this means is that instead of paying a deferred tax on their foreign profits, U.S. corporations would pay no U.S. tax.10 Exempting overseas profits from tax would be a tax cut for multinational corporations of $130 billion over 10 years.11 When combined with Romney’s proposal to slash the top corporate rate from 35 percent to 25 percent, which would cost more than $900 billion,12 it pushes the total corporate tax cuts in the Romney plan to over $1 trillion.

A bigger reward for shipping U.S. jobs abroad

Exempting U.S. corporations’ foreign profits would sweeten the tax code’s already-rich inducements to move investments and jobs overseas. A U.S. company deciding whether to build a factory in the United States or elsewhere would know that the returns from its investment, if made abroad, would be permanently free of U.S. tax—not merely tax-deferred, as under our current system. That would result in a large tax cut for some U.S. multinationals, but it would run counter to the interests of U.S. workers. In recent testimony, Congressional Research Service economist Jane Gravelle explained that a territorial system:

... would make foreign investment more attractive. That would cause investment to flow abroad, and that would reduce the capital with which workers in the United States have, so it should reduce wages. [A territorial system] will increase the after-tax rate of return that firms see abroad, so they will want to move their investments—they would want to make investments abroad, instead of the United States.13

Gravelle concludes that because a territorial tax system distorts investment decisions, pushing investment offshore, it is “not neutral or efficient.”

An analysis by Reed College economist Kimberly Clausing similarly finds that “the tax incentive to locate jobs in low-tax countries would increase significantly.” Clausing
estimates that investment and profits would migrate to low-tax countries, resulting in 800,000 jobs in low-tax countries and potentially displacing U.S. jobs.14

A windfall to companies that have already shifted jobs, investments, and profits overseas

Romney wants to exempt from U.S. taxes not just future foreign profits, but also profits that corporations are already storing overseas.15 That would provide a pure windfall to the very companies that have been most successful in avoiding U.S. tax by shifting jobs, investments, and profits overseas. U.S. corporations claim that they have more than $1.4 trillion in earnings “permanently reinvested” overseas (though a congressional survey found that a large portion of these earnings are actually deposited in U.S. banks).16 Much of these earnings have not been subject to any appreciable tax in the foreign countries where they were reported, which means that the U.S. taxes that these companies would eventually pay under current rules would not be offset by foreign tax credits.17

Consequently, the companies that have been most aggressive and most successful in avoiding foreign taxes by shifting profits to tax-haven countries such as Bermuda and the Caymans stand to receive the biggest windfall under Romney’s plan.

An invitation to greater abuse of tax havens

Romney’s proposal would also invite increased corporate tax haven abuse in the future. In 2008, U.S. multinationals artificially shifted as much as $250 billion in profits overseas, largely to tax-haven countries, reducing their taxes by as much as $90 billion, according to one study.18 The reward for such legal and accounting gamesmanship under our current system is that U.S. taxes are deferred. In a territorial system, the taxes on profits shifted overseas “would not simply be deferred; they would be completely erased,” explains economist Kimberly Clausing. “This would eliminate existing constraints on shifting income abroad.”

Clausing estimates that under a territorial tax system, even more profits of U.S.-based companies would shift to tax haven countries such as Bermuda, Luxembourg, Switzerland, and the U.K. Islands (including the Caymans).19

Romney’s economic plan briefly alludes to the need for anti-abuse rules but provides no hint of details.20 And on the campaign trail the all but certain Republican presidential candidate has rejected a sound proposal for addressing tax haven abuse: a minimum tax on corporate profits. A minimum tax would ensure that corporate profits that are subject to unusually low levels of tax—for example when booked in no-tax countries such as Bermuda—are subject to at least some U.S. tax in the year they are earned.21
President Obama called for such a minimum tax in his framework for business tax reform. And the president is not alone in proposing such a mechanism. The Republican Chairman of the Ways and Means Committee, Dave Camp (R-MI), put forward a somewhat similar proposal as one of three potential options to prevent the “erosion” of the tax base from a shift to a territorial system. Many foreign countries already have similar mechanisms to prevent abuse.\textsuperscript{22}

A shift to “territorial” without strong anti-abuse mechanisms is a dangerous invitation to greater corporate tax haven abuse.

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**Whose competitiveness?**

Romney claims that a territorial system would make the U.S. economy more competitive. But this line of thinking mistakes the interests of U.S.-based multinational corporations with the interests of U.S. workers and the broader U.S. economy, which are not always aligned. The evidence is that U.S.-based multinationals are not disadvantaged, in general, under our existing tax code. In fact, a recent study of the 100 largest companies based in the United States with their European Union counterparts found that the European companies pay higher taxes, on average.\textsuperscript{23}

There might be an argument for subsidizing overseas investment if such investment leads to greater domestic investment and job creation. But there is little evidence that this “complementary” effect outweighs the “substitution” effect that occurs when foreign investment takes the place of domestic investment and American jobs go overseas.\textsuperscript{24} Under the tax code’s existing incentives for foreign investment, U.S. multinationals have created jobs abroad while shedding them at home. Between 1999 and 2010, U.S. multinationals decreased U.S. employment by 1 million jobs while increasing foreign employment by 3 million.\textsuperscript{25}

Romney’s tax and budget plan would harm the U.S. economy in other ways, too. A massive $1 trillion corporate tax cut would require deeper cuts in public investments such as education, infrastructure, research and development, and other areas.\textsuperscript{26} Large and unnecessary cuts in public investments would kill jobs and hamper future economic growth and competitiveness.

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**The flawed “lock-out” theory**

Romney’s proposal to adopt a territorial system ignores the incentives that U.S. corporations would have to invest abroad, and focuses solely on the so-called lockout effect. In his view, our current system “penalizes” U.S. companies that bring back profits from abroad because they must pay the U.S. corporate tax (less a credit for foreign taxes)
when the funds are returned to the United States. Romney’s theory is that exempting foreign profits would unlock the earnings that U.S. corporations are keeping abroad to avoid U.S. tax, thereby increasing investment and jobs in the United States.27

This theory is based on the flawed belief that some of the world’s largest corporations would invest more in the United States if only they had more cash at their disposal. Yet large corporations already are holding onto near-record levels of cash—$1.7 trillion at the end of 2011—and are also able to borrow at historically low rates.28 Given a windfall tax cut on their foreign earnings, they are likely simply to buy back shares or pay dividends to investors.

That’s exactly what happened when Congress enacted a one-time “tax holiday” for foreign profits in 2004: Corporations used the tax-amnestied profits for share buybacks and dividend payouts rather than investment or job creation in the United States. Many corporations claiming the tax break actually shed jobs.29 Romney is undisturbed by this history. He acknowledges and even welcomes the prospect that U.S. corporations would once again use the funds from a tax holiday to pay out dividends to shareholders rather than investing in their businesses.30

Romney’s lock-out theory also ignores the fact that if a corporation is allowed to bring its profits back to the United States tax-free, its decision on how to reinvest those profits is still distorted by the tax code’s pro-offshore bias—a distortion that would be made worse under Romney’s territorial system. “[T]here would remain an incentive to reinvest foreign subsidiary earnings in lower-taxed offshore jurisdictions,” according to international tax expert Stephen Shay.31

A stark contrast

Romney’s proposal to move the United States to a territorial tax system, without identifying any potential safeguards to deter the outflow of American jobs or profit shifting abroad, contrasts sharply with President Obama’s agenda on corporate taxes. In advancing a framework for comprehensive business tax reform, President Obama rejected a “pure territorial” system. The president’s framework explained:

*If foreign earnings of U.S. multinational corporations are not taxed at all, these firms would have even greater incentives to locate operations abroad or use accounting mechanisms to shift profits out of the United States.*32

Instead, President Obama proposes to reduce these existing perverse incentives and crack down on profit shifting. He proposes:

• A minimum tax on corporate profits to ensure that multinational corporations cannot avoid taxes by exploiting tax havens. The minimum tax is aimed at ensuring that
corporations cannot exploit weaknesses in the U.S. tax system and overseas tax havens to avoid taxes. By ensuring that corporations pay some tax abroad it will reduce the rewards for shipping jobs overseas and shifting income to foreign tax havens, making investments in the U.S. more competitive. The president also proposes more specific anti-abuse measures to address areas of rampant profit shifting.

- **Curtailing tax deductions that subsidize foreign investment.** One of the most illogical aspects of our current tax system is that companies can take immediate deductions against U.S. taxes for expenses that support tax-deferred overseas profits. In other words, if they borrow funds in the U.S. which support offshore investment, they can take the interest deduction now but pay taxes on the resulting income later, if at all. This is a clear subsidy for foreign investment, and President Obama proposes to eliminate it.

- **Denying deductions for expenses associated with outsourcing jobs abroad while providing a credit for “insourcing.”** The “Bring Jobs Home Act,” which would do just that, has been introduced in the Senate by Sen. Debbie Stabenow (D-MI) (S. 2884) and in the House by Rep. Bill Pascrell (D-NJ) (H.R. 5542). Companies that return jobs and business activity to the United State would qualify for a 20 percent tax credit for their “insourcing” costs.

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**Conclusion**

President Obama’s international tax plan and that of his presidential rival Romney offer a clear contrast. By exempting the foreign profits of U.S. corporations from U.S. tax, Romney’s plan would reward and potentially accelerate the shift of jobs and profits overseas. President Obama’s plan, by contrast, helps level the playing field for job creation here at home.

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Endnotes


10 In a territorial system, “passive” income such as interest or dividends from portfolio investments is typically not exempt, but income from active businesses is exempt or subject to a nominal level of tax.


17 See Kimberly A. Clausing, “The Revenue Effects of Multinational Firm Income Shifting,” Tax Notes, March 28, 2011 (finding that six of the seven countries where U.S. multinationals reported their largest profits in 2008 imposed effective tax rates of 4 percent or lower, including the Netherlands, Luxembourg, Ireland, Bermuda, Switzerland, and Singapore).

18 Clausing, “The Revenue Effects of Multinational Firm Income Shifting.”


20 “Complex technical issues will arise during the transition [to territorial]: amendments to the tax code need to be crafted in a way that does not encourage corporations to game the system and export jobs or to move their headquarters abroad. With proper draftsmanship, these potential hazards can be overcome.” Mitt Romney for President, “Believe in America,” p. 46.


25 Department of Commerce, Bureau of Economic Analysis.


33 See Hanlon, Why We Need a Minimum Tax on U.S. Corporations’ Foreign Profits.”