

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is centered in the narrow neck of the hourglass. The top bulb has a dark blue cap, and the bottom bulb has a light blue cap.

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*Taxes and Offshore Outsourcing*

Donald J. Marples, Government and Finance Division

March 11, 2008

**Abstract.** The impact of taxes on international trade and investment has been debated for decades. Most recently, a variety of bills addressing international taxation have been introduced in the 110th Congress - some would cut taxes for U.S. firms overseas, while others would increase taxes on foreign investment. The debate over taxes and foreign outsourcing has tended to grow more heated during times of domestic economic weakness and high unemployment; questions arise over whether taxes contribute to such weakness by discouraging exports (or encouraging imports) or by encouraging U.S. firms to move abroad. The debate over international taxation has again become prominent as a part of the wider debate over "outsourcing." With taxes, the debate asks how the current system affects outsourcing, and whether policies designed to limit the phenomenon might be desirable. This report applies economic analysis to both questions.

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# Taxes and Offshore Outsourcing

**Donald J. Marples**  
Specialist in Public Finance

March 11, 2008

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## Summary

The impact of taxes on international trade and investment has been debated for decades. Most recently, a variety of bills addressing international taxation have been introduced in the 110<sup>th</sup> Congress—some would cut taxes for U.S. firms overseas, while others would increase taxes on foreign investment. The debate over taxes and foreign outsourcing has tended to grow more heated during times of domestic economic weakness and high unemployment; questions arise over whether taxes contribute to such weakness by discouraging exports (or encouraging imports) or by encouraging U.S. firms to move abroad. The debate over international taxation has again become prominent as a part of the wider debate over “outsourcing.” With taxes, the debate asks how the current system affects outsourcing, and whether policies designed to limit the phenomenon might be desirable.

The precise meaning of the term “outsourcing” varies, depending on the context. In one usage, outsourcing simply refers to the use by domestic firms of inputs produced by other firms. Other usages, however, refer exclusively to the international sector, and the analysis in this report focuses on two types of such “offshore” outsourcing: the use by domestic firms of imported foreign inputs, including both the use of foreign technical services and the use of foreign-made goods; and the shifting by U.S. firms of domestic operations abroad. The analysis of the first of these types of outsourcing focuses primarily on how taxes affect trade while investment is held constant. The assessment of the second type looks at how taxes affect investment.

Taxes probably have little impact on the balance of trade (what might be termed “net” outsourcing), apart from indirect effects that may result from their impact on investment flows. In the language of the outsourcing debate, taxes likely do not change the extent to which the economy as a whole engages in the use of foreign, rather than domestic, inputs (compared to the extent the economy exports). In contrast, taxes can affect the flow of direct investment abroad—that is, the establishment of overseas production facilities by U.S. firms. Thus, if outsourcing is taken to mean the use by U.S. firms of foreign rather than domestic labor, taxes can have an impact. The current U.S. system, however, produces a variety of incentives, disincentives, and neutrality towards overseas investment, and the net impact of the system on the flow of investment is not clear. Similarly, the likely impact of recently enacted legislation is not clear.

Economic theory provides frameworks for evaluating the efficiency effect of taxes on international trade and investment, and their subsequent impact on economic welfare. According to theory, taxes best promote economic efficiency—and thus best promote economic welfare—when they do not distort the level or composition of trade or alter the allocation of investment between foreign and domestic uses. In short, taxes best promote economic efficiency and aggregate economic welfare when they do not distort the level of outsourcing, in the sense it is used in this report. With respect to employment, outsourcing may cause sector-specific and near-term job losses but likely does not have a substantial long-run impact on overall employment. This report will be updated only when major legislative developments occur.

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## What is Outsourcing?<sup>1</sup>

The term “outsourcing” has recently assumed a prominent place in the public debate over economic policy. In general, the debate concerns the impact various federal policies are thought to have on outsourcing, including the policy that is the focus of this report, taxes. But “outsourcing” is not a formally-defined term of economic theory, and has no specific meaning in economics. And its usage in the popular debate varies. Thus, the first step in applying economic analysis to the outsourcing debate is to clarify the term’s meaning—to define it, using terms that do have a precise meaning in economic theory.<sup>2</sup>

In one common usage, outsourcing simply means the use by a firm of inputs produced outside the firm, either by foreigners or unrelated domestic firms—the important fact is simply that someone else performs the function. Here, a firm’s manager might speak of “outsourcing” a task, meaning that another firm does that particular job. Similarly, outsourcing sometimes refers to the use by government agencies of services provided by the private sector—for example, legislation has recently been introduced in Congress that would “outsource” certain debt-collection functions of the Internal Revenue Service. The focus of this report, however, is the international economy; its analysis is confined to what might be termed “offshore” outsourcing.

But here, too, the term’s usage varies. For example, one focus of the recent public debate has been the use by U.S. firms of skilled foreign technological workers who reside and work abroad, but who provide services to customers in the United States. A prominent example of this usage is in the 2004 *Economic Report of the President*, which cited “the increased use of offshore outsourcing in which a company relocates labor-intensive service industry functions to another country.”<sup>3</sup> The Report, along with a subsequent statement by the President’s chief economic advisor that such outsourcing “is just a new way of doing international trade” sparked a heated debate in Congress and elsewhere.<sup>4</sup> In economic terms, this particular usage of outsourcing refers to international trade, specifically the importation of services.

A second use of “outsourcing” has also referred to international trade, but to flows of goods rather than services. This use may have been more frequent in past years than in the current debate. For example, a 1983 *Fortune* magazine article that was among the first sources to use the term described an increasing tendency for U.S. automakers to “buy more and more parts abroad” and further stated that “to a large extent the products to be out-sourced are low-technology items such as window cranks, seat fabrics, and plastic knobs.”<sup>5</sup>

Another use of the term in the current debate refers to foreign investment rather than trade. Here, the term refers to a U.S. firm that shifts its domestic production of an item to a foreign location or

<sup>1</sup> This report was originally written by David L. Brumbaugh, Specialist in Public Finance.

<sup>2</sup> For its part, the Oxford English Dictionary defines “outsourcing” as follows: “to obtain (goods, etc., esp. component parts) by contract from a source outside an organization or area; to contract (work) out.” *Oxford English Dictionary Online*, at <http://dictionary.oed.com/>, visited Aug. 18, 2004.

<sup>3</sup> U.S. President (Bush), *Economic Report of the President Transmitted to the Congress February 2004* (Washington: GPO, 2004), p. 229.

<sup>4</sup> Jonathan Weisman and Paul Blustein, “Trade Deficit Hits \$489 Billion; Widening Gap Triggers Further Debate on Job Losses Overseas,” *The Washington Post*, Feb. 14, 2004, p. A8. The quotation is from Chairman of the President’s Council of Economic Advisors N. Gregory Mankiw.

<sup>5</sup> Steven Flax, “A Hard Road for Auto Parts Makers,” *Fortune*, vol. 107, March 7, 1983, p. 110.

to a U.S. firm that establishes a new production facility abroad rather than in the United States. One example of this type of outsourcing that has recently been prominently featured by the media is the closing of a Chicago plant by Radio Flyer, Inc.—maker of a popular children’s wagon—and the moving of production to China.<sup>6</sup> In a usage that directly applies to taxes, Presidential candidate John Kerry called for the closing of “loopholes in international tax law that encourage outsourcing.” (The question of whether the U.S. tax system does, in fact, encourage this type of outsourcing is one focus of this report, and is addressed below.)

In economic terms the three popular usages of outsourcing that are mentioned here can be described respectively as, the import of services from abroad, the import of goods from abroad, and the use of domestic capital in foreign locations. Given this economic view of outsourcing, the analysis in the following sections of the report looks at the impact of taxes on two key economic variables: trade and investment. The basic analysis of taxes and trade is the same whether the trade is in services or goods; thus, it is important to look at the first two examples of outsourcing together, combining our assessment of the direct use of foreign labor with that of the importation of goods. The analysis continues by assessing the impact of taxes on foreign investment, the third type of outsourcing.

The results of the following analysis are summarized briefly in advance. First, according to economic theory, tax policy does not alter the country’s balance of trade, as long as it does not also produce a change in foreign investment flows. In terms of the outsourcing debate, taxes do not affect the net amount of the first type of outsourcing identified above, the use of foreign labor services or inputs made by foreign firms. Taxes can, however, alter both the composition and level of trade and reduce economic efficiency and economic welfare if they distort either how much a country trades or what it trades. Second, tax policy can affect the extent to which firms invest abroad; in terms of outsourcing, it can affect the extent to which firms use overseas production facilities to produce inputs for their domestic operations. Current U.S. tax law poses a mix of incentives and disincentives towards overseas investment; its net result is uncertain. However, in a manner similar to trade, economic theory suggests that taxes best promote world economic efficiency when they are neutral towards investment location. In a divergence from trade theory, investment theory suggests taxes can promote national economic welfare (though not world welfare) if they pose a small impediment to overseas investment.

An underlying concern of the outsourcing debate is employment. The debate is sometimes conducted in terms of the export of jobs, yet the economic analysis just summarized does not mention employment effects of outsourcing. In part, this is because the focus of this report is on how taxes affect outsourcing, not how outsourcing, in turn, affects variables such as employment.<sup>7</sup> The last section of the report does, however, briefly turn to employment questions and summarizes how economic theory applies to outsourcing and employment. Economic theory indicates that outsourcing does not play an important role in determining the aggregate level of employment in the economy, although it can affect the division of income in broad terms between labor on the one hand, and owners of investment capital, on the other.

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<sup>6</sup> Charles Murdock, “Your Jobs: A Leading U.S. Export?” *Chicago Tribune*, Aug. 22, 2004, p. 1.

<sup>7</sup> These more general assessments of outsourcing are analyzed in CRS Report RL32484, *Foreign Outsourcing: Economic Implications and Policy Responses*, by Craig K. Elwell. For an analysis of data on outsourcing, see CRS Report RL32461, *Outsourcing and Insourcing Jobs in the U.S. Economy: Evidence Based on Foreign Investment Data*, by James K. Jackson.

## Taxes and Outsourcing Through Trade

In its discussion of outsourcing through trade in services, the 2004 Economic Report of the President used the example of a U.S. firm that might use a call-center in India to answer customer service-related questions. For goods, an example might be a U.S. firm that uses foreign-made components as part of an overall product made in the United States. Importantly, in this usage of the term “outsourcing” we rule out items produced by the U.S. firm’s own foreign facilities. In economic terms, we are thus assessing the impact of taxes on trade, while at least initially holding investment flows constant.

In this setting, economic theory indicates that taxes have little impact on the country’s balance of trade—the excess of imports over exports. As applied to the outsourcing debate, theory thus indicates that taxes have little impact on the extent to which the economy as a whole engages in this type of outsourcing, at least as compared to the country’s level of exports. (In the context of the outsourcing debate, we might term a country’s trade balance its “net” outsourcing.) This result is an important one, and since it may counter the reader’s intuition, it is worth examining more closely.

First, economics points out that a country’s trade deficit is the excess of what a country uses over what it produces. And just as an individual who spends more than he earns must necessarily borrow to finance the difference, a country that uses more than it produces and that runs a trade deficit must borrow from other countries to finance the deficit. In terms of the international economy, the borrowing consists of imports or inflows of investment capital from abroad. It follows from this fact of economic life that a country’s trade balance mirrors its balance on capital account. Countries normally both import and export investment capital. But if a country runs a trade deficit, it must likewise import more capital than it exports, with the difference making the trade deficit possible.

The trade deficit (or surplus) thus moves in parallel with the balance on the capital account and net imports can increase only if net capital inflows also increase; identically, net exports can only increase if net capital outflows increase. In effect, if an economy does not increase its own production, it can increase its use of goods and services only if it borrows to do so. The mechanism by which this identity is enforced in the current international economy is exchange rate adjustments. If there is no change in capital flows and some factor, such as taxes, changes so as to increase imports or exports, exchange rates will eventually adjust so as to offset any impact the factor might otherwise have on the trade balance.

An example using outsourcing is useful here; we use the case of a hypothetical domestic industry (we’ll call it Industry A) whose firms typically employ staffs of technical support personnel who are on call to answer customer questions. Suppose the home country implements a tax policy that inadvertently encourages firms to shift from using domestic service employees to using foreign ones. For example, the home country might implement more stringent depreciation rules for a certain type of equipment the home-country technical services personnel use. Since foreign operations of foreign firms are generally beyond the U.S. tax jurisdiction, imported services would not be directly affected by such a change. For illustration’s purposes, we shall say that the new depreciation rules increase the cost of using domestic personnel to such an extent that Industry A finds it advantageous to begin importing the services it previously obtained domestically. Industry A, in other words, increases its outsourcing, which may initially be reflected in an increase in the home country’s trade deficit (its net outsourcing).

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But this is where exchange rate adjustments occur, neutralizing any changes in the balance of trade. In order to pay the foreign service providers, the firms in the home country's Industry A must increase their purchases of foreign currency. The increase in demand for foreign currency, in turn, will normally drive up the price of the foreign currency, which, in turn, makes all the home country's imports more expensive while at the same time making the home country's exports cheaper for foreign buyers. In the aggregate, the home country's exports increase while its imports recede from their initial expansion, and when the adjustment is complete, the initial increase in the trade deficit is completely offset by increases in aggregate exports and reductions in aggregate imports induced by the exchange rate movements. Because the exchange rate adjustments apply to all the home country's traded goods and services, not just to Industry A's imports, and because we assumed that only one home-country industry was subject to increased taxes, only part of Industry A's initial increase in outsourcing would likely be offset by exchange rate movements before the adjustments run their course. A part of Industry A's initial increase in outsourcing is, in other words, likely to remain. But the crucial point is this: if there is an increase in outsourcing in one sector, it will be offset by reduced outsourcing, reduced imports of other products, and increased exports in other sectors.

While taxes do not alter the trade balance, they can affect other aspects of trade, including its composition, its level, and what economists call the "terms of trade." First, composition: even from the simple example here, it is clear that a tax that causes uneven changes in price across industries can alter what is traded—the exact mix of goods and services that a country imports and exports. In our example, we assumed that because of a tax change, a particular industry in the home country increased its service imports but other home-country imports fell and exports increased because of exchange rate adjustments. In general terms, the composition of trade depends on the particular pattern of relative costs within the domestic economy; when tax burdens within the economy are uneven, they distort relative costs and change what is traded.

Taxes can likewise alter the overall level of trade even where the balance of trade does not change. To illustrate, in our example the increase in imports triggered by the tax change was partly offset by exchange rate adjustments, but because part of the adjustment necessary to maintain the trade balance was absorbed by increased exports, the overall level of imports remained higher than before. Again in general terms, the changed tax policy did encourage a higher reliance on imports by industry A, but to pay for the imports (again assuming no capital flows or added borrowing) the home country also increased its exports; the overall level of trade increased.

The "terms of trade" is an economic term denoting the price of home-country exports compared to the price of its own imports; it measures the amount of exports a country must provide foreigners in order to obtain a given amount of foreign products. Taxes can alter the terms of trade by reducing the price foreigners pay for exports or by increasing the price of imports. A prominent example in current tax policy is the impact of the U.S. extraterritorial tax exclusion (ETI) tax benefit for exports that is at the heart of an ongoing controversy between the United States and the European Union. The ETI benefit is designed to boost U.S. exports by cutting taxes on export income. In order to sell more exports, however, U.S. producers necessarily pass on part of their own tax savings to foreign consumers in the form of reduced prices, thus registering what economists term a "worsening" of the terms of trade. (The terms of trade effect of our earlier outsourcing examples are ambiguous, and would depend on market conditions.)

We have thus far looked at a type of outsourcing where the U.S. firm that imports its inputs does not itself produce the imported items in an overseas production facility. Our specific examples

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have consisted of trade in services, although the same general analysis applies to trade in goods. In terms of economic variables, we have also assumed there is no outflow of capital that accompanies the outsourcing; we have focused exclusively on trade rather than investment. But as described at the report's outset, a part of the outsourcing debate has concerned overseas production by U.S. firms, and so the next section shifts the focus from trade to capital flows.

## **Taxes and Overseas Production by U.S. Companies**

We have seen that economic theory indicates that if taxes do not alter capital flows, they have no impact on the balance of trade, although they may affect the level and composition of trade. Absent changes in foreign investment, in other words, taxes do not affect what might be called net outsourcing. Theory also indicates, however, that taxes can affect investment: they can alter the relative attractiveness of foreign and domestic locations for multinationals, leading them to change their allocation of capital between the domestic and foreign economies. Thus, if we define a second type of outsourcing as the use of overseas rather than domestic production facilities, taxes can have an impact. An example of this second type of outsourcing might consist of a U.S.-owned factory in a foreign country that produces tangible goods shipped back to the United States.

Taxes enter the investment equation as follows: according to economic theory, firms allocate their investment resources between foreign and domestic locations by comparing the rate of return investment produces in either location. In general, they invest in each location up to the point where the rate of return on an additional increment of investment is the same at home and abroad. Since firms are concerned with their aftertax profits, they equate the return of foreign and domestic investment after taxes, rather than before them. The basic impact of taxes results: other factors remaining constant, taxes will induce firms to shift more investment than they otherwise would from the domestic economy to foreign locations if the tax burden on foreign investment is lower than that on domestic investment. Taxes will shift investment from foreign locations to the domestic economy if taxes are relatively lower on domestic investment, and taxes will have no impact on (will be "neutral" towards) the location of investment if their burden is the same in each location.

We can make this general result more concrete by constructing another example. Here, we shall say that a domestic manufacturing industry (Industry B) uses a particular part—say, a door handle—as a component of its final product. We will also say that the home-country government again introduces more stringent depreciation rules, in this case for the equipment used to manufacture the door handle, thus effectively increasing the cost of the part for Industry B. We return below to some possible trade effects of the tax policy change, but here focus on the investment impact. Since the new depreciation rules do not apply to investment abroad, the policy change will have the effect of increasing the tax burden on domestic investment compared to investment abroad. Rather than importing the door handle in this case, we will say that Industry B establishes its own foreign operations, conducted by foreign subsidiary corporations unaffected by the tax change. Here, then, the outsourcing consists of production overseas by U.S. firms, using investment funds flowing from the domestic economy to foreign locations.

Before looking at how specific features of the existing U.S. tax system affect investment, we return briefly to trade. As noted in the first section, taxes do not affect the trade balance unless they alter capital flows, and our analysis there held capital flows constant. In the present section, however, we have seen how taxes can, in fact, alter capital flows. Since the trade balance moves

in parallel with the balance on capital account, taxes can therefore temporarily alter the balance of trade indirectly through their impact on capital flows. The direction of the impact is perhaps counter to intuition; an increase in capital outflows reduces the trade deficit, since capital outflows are, in effect, exports. In terms of the outsourcing debate, in other words, an increase of our second type of outsourcing—the type that consists of overseas investment—actually reduces the net amount of the first type of outsourcing—the type consisting of imports.

As before, this result occurs because of exchange rate adjustments. When U.S. firms increase their overseas investments, they supply additional dollars as they increase their purchases of foreign assets. The price of the dollar accordingly declines; U.S. exports become less expensive for foreigners and U.S. imports become more expensive. Imports shrink, exports increase, and the trade deficit—net outsourcing through trade—diminishes. While this is an attention-getting result because of its irony (outsourcing through investment reducing outsourcing through trade), it should not be emphasized because it is temporary: the increased flow of capital abroad lasts only until U.S. firms achieve their new desired level of capital stock abroad.<sup>8</sup>

A more persistent impact of tax policy on the trade balance may occur if tax policy affects the federal budget deficit and thus alters federal borrowing requirements—a development that would likely change net capital flows. For example, repeal of the ETI export tax subsidy would, in isolation, increase federal tax receipts and thus reduce the budget deficit. The resulting decline in federal borrowing requirements would (again, in isolation) reduce capital inflows, which would reduce the trade deficit. The importance one attaches to this effect depends on whether one assumes that a given change in tax policy is matched by another change that offsets its revenue effect—for example, whether repeal of a provision such as ETI is matched by revenue-losing changes occurring elsewhere. We do not offer a conclusion on this subject here. Further, it can be argued that federal budget deficits must ultimately be offset by a surplus at some point in the future, so this effect, too, may be temporary.

## **The Impact of the Current System and Recent Legislation**

In the preceding section we saw how taxes can have an impact on the overall level and composition of trade, though not the trade balance; they can also alter the type of outsourcing that consists of overseas production by U.S. firms. We do not provide a detailed assessment here of the impact of the current tax system on the level and composition of trade (again, the system does not have a direct impact on the balance of trade). We can note, however, that the existing system may well reduce the level of trade by virtue of its use of a “classical” system for taxing corporate income. Under such a system, income from corporate investment is taxed twice, once at the corporate level and once when it is received by stockholders as capital gains or dividends. In contrast, the principal types of non-corporate investment, owner-occupied housing and non-corporate business, are taxed only once, if at all. Given that goods and services in the “tradables” sector consist more frequently of corporate rather than non-corporate products, the double-

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<sup>8</sup> We should also note that in the long run there may be a slight, permanent increase in the demand for domestic currency as firms increase their repatriations of foreign earnings. This would drive up the exchange rate, reducing exports, increasing imports, and increasing net outsourcing.

taxation of corporate investment may shift resources from tradables to non-tradables, thus reducing the level of trade.

Other features of the federal tax system (in isolation) likely increase the level of trade from what would otherwise occur. Specifically, the Internal Revenue Code contains two separate export tax benefits: the extraterritorial income exclusion (ETI), and the so-called “inventory source rule,” which permits firms, in effect, to exempt part of their export income from taxes by characterizing part of export income as having a foreign source for purposes of the foreign tax credit rules. (As described below, the ETI provision is the focus of legislation being actively considered in the current Congress.) While both provisions induce U.S. firms to increase their exports, exchange rate adjustments (in a manner similar to the adjustments described above) increase imports and do not completely offset the expansion of exports. The provisions thus increase the overall level of trade. We do not assess whether the two export benefits have an impact large enough to offset the possible trade-reducing impact of the corporate income tax and the trade reducing impact that occurs where tariffs are imposed.

We look at the impact of the existing U.S. system on investment flows in more detail. Again, the key factor for taxes’ impact on investment is how the tax burden on foreign investment compares with that on domestic projects. Other CRS products provide more detailed descriptions of the U.S. international tax system and how it affects the relative tax burden on foreign and domestic investment.<sup>9</sup> Here, however, we note only its essential features. In general, the U.S. system produces no single, overall impact on investment flows that is readily discernable; different parts of the system, viewed in isolation, produce different results. The so-called “deferral” principle, for example, permits an indefinite postponement of U.S. tax for overseas operations conducted through foreign subsidiary corporations rather than branches of U.S. parent firms. Deferral poses a tax incentive for investment in countries with low tax rates, resulting in more U.S. investment in those locations than would otherwise occur. The U.S. tax system also permits its investors to claim a foreign tax credit for foreign taxes they pay, a feature that reduces double-taxation of overseas income; in some cases the foreign tax credit can result in even tax treatment of foreign and domestic investment, producing tax neutrality. The foreign tax credit, however, is limited to U.S. tax on foreign and not domestic income, a feature that poses a disincentive for investment in countries with high tax rates, resulting in less U.S. investment in those locations than would otherwise occur.

## **The Tax Increase Prevention and Reconciliation Act of 2006 (TIPRA; P.L. 109-222)**

The principal features of TIPRA—extension of reduced rates for capital gains and minimum tax relief—were not directly related to international taxation. Early versions of the legislation also contained extension of a large number of temporary tax benefits (“extenders”) that expired at the end of 2005. Most extenders were not included in the final act, but were addressed in Congress’s December 2006 session. However, two extenders that were not excised from TIPRA were international tax provisions. One provision extended through 2008 the exclusion of active financing income (income from banking, insurance, and similar activities) from Subpart F’s anti-deferral regime. A second provision excludes from Subpart F through 2008 income of a type that

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<sup>9</sup> See CRS Report RL32429, *Foreign Investment and Tax Incentives: Analysis of Current Law and Legislative Proposals*, by David L. Brumbaugh.

would ordinarily be included in the regime—dividends, interest, and similar income—but that is paid by a related foreign corporation out of active business income.

## **American Jobs Creation Act of 2004 (AJCA; P.L. 108-357)**

For a variety of reasons, congressional interest in tax provisions related to the types of outsourcing outlined in this report was particularly high in 2004, and resulted in legislation much broader in scope than that included in TIPRA. In 2004, both the House and Senate passed major tax bills with a variety of provisions that were relevant to offshore outsourcing. In part, the bills—H.R. 4520 and S. 1637—addressed a trade controversy between the United States and the European Union by repealing the extraterritorial income (ETI) tax benefit the United States provides to its exporters. Beyond this, however, the bills each contained a variety of provisions with the potential to affect the relative tax treatment of domestic and overseas investment, and that therefore might affect the volume of outsourcing through foreign investment. In October, both chambers approved a conference committee version of the legislation that became P.L. 108-357, the American Jobs Creation Act of 2004 (AJCA). As with the overall impact of the current tax system, the likely combined impact of the act's various provisions is uncertain. However, the impact several of the measure's most prominent features are likely to have, in isolation, is more clear.<sup>10</sup>

### **Deduction for Domestic Production**

For domestic investment, the act contains a 9% tax deduction from income from domestic (and not foreign) production activities. The deduction applies to corporations and non-corporate businesses alike. To illustrate its effect, for a firm in the top corporate tax bracket of 35%, the deduction has an effect similar to a reduction in the tax rate to 31.85% (i.e.,  $35\% \times [100\% - 9\%]$ ).

Because the deduction is restricted to domestic investment, the deduction (in isolation) poses an incentive for firms to invest in the United States rather than abroad. In this respect, the deduction's impact on investment is similar to the extraterritorial income (ETI) tax benefit for exporting that was repealed by the AJCA in order to solve a trade dispute with the European Union. Export tax benefits necessarily favor domestic over foreign investment, since export production—by definition—requires domestic rather than foreign production. The domestic production deduction, in fact, was partly intended to compensate for the economic impact of ETI's repeal. In contrast to the repealed ETI benefit, however, the incentive is not confined to investment in the export sector.

### **Less Restrictive Foreign Tax Credit Rules**

The act makes a variety of changes in rules relating to the foreign tax credit. The general thrust of the provisions is to relax foreign tax credit rules, principally in areas related to the credit's limitation. By far the most important of the changes is a change in the rules for allocating interest expense between foreign and domestic sources—an allocation firms must make in calculating their foreign tax credit limitation. While the act reduces taxes only for firms with foreign tax credits and will thus be confined to firms with foreign investment, the reduction nonetheless

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<sup>10</sup> Note that the analysis does not consider the indirect effect of the proposals' investment provisions on trade due to the temporary nature of those effects.

applies more to multinationals' domestic than to foreign investment.<sup>11</sup> The provision will thus probably reduce the tax burden on domestic investment relative to foreign investment and will reduce net outsourcing through foreign investment. The remaining foreign tax credit provisions, while likely smaller in impact than the interest allocation rules, will reduce the relative tax burden on foreign investment, thus likely increasing the flow of investment abroad.

## Changes Related to Deferral

As with the foreign tax credit, the act contains several provisions related to the ability of U.S. firms to defer U.S. tax on foreign income. The general thrust of the provisions is to expand the scope of deferral, in most cases by restricting the applicability of subpart F's denial of deferral. The impact of these provisions, in isolation, will likely be to reduce the relative tax burden on foreign investment, thus likely increasing the flow of foreign investment abroad.

## Tax Cut for Repatriated Foreign Earnings

An additional international provision is a temporary tax cut for earnings that repatriate from foreign subsidiaries. As described above, the deferral of U.S. tax lasts only as long as foreign earnings are reinvested abroad; U.S. taxes ultimately apply when the earnings are repatriated to the United States as dividends. The act provides a temporary reduction in the U.S. tax that applies upon repatriation; the provision will have the effect of reducing the tax rate to 5.25% (the normally applicable corporate rate is 35%). The temporary period is one year.

While an intuitive analysis of the provision might conclude that it would persuade firms to repatriate additional funds and would thus increase domestic investment, economic theory suggests there is reason to be skeptical of intuition in this case. Theory indicates that firms' investment decisions are dependent on the likely return to prospective investment rather than cash flow, and the provision will not alter the return on domestic investment even if it were to increase repatriations. Thus, the proposal may not alter net outsourcing through investment. Further, it might be argued that the provision will actually increase overseas investment if firms believe that the temporary measure will ultimately be made permanent.

## Policy Perspectives

Economic theory has developed frameworks for evaluating tax policy towards both international trade and international investment in terms of economic efficiency and economic welfare. These frameworks can be applied to tax policy towards both types of outsourcing assessed in this report.

### Tax Policy and Trade

As described above, taxes affect the trade balance (what we have termed "net outsourcing") only if they also alter capital flows. Thus, for example, economic theory holds that tax policies designed to curtail imports (e.g., tariffs) or encourage exports (e.g., export subsidies) do not change the trade balance, although they can alter the level and composition of trade. For example,

<sup>11</sup> For an explanation, see CRS Report RL32429, *Foreign Investment and Tax Incentives: Analysis of Current Law and Legislative Proposals*, by David L. Brumbaugh.

tariffs may shrink the overall level of trade or outsourcing, but because of exchange rate adjustments, declines in imports are accompanied by reduced exports so that the trade balance is not altered. Similarly, export subsidies cannot increase an economy's trade surplus but do expand the overall level of trade. Thus, economic theory indicates that taxes are powerless to alter the net level of outsourcing that occurs through importing.

This is not necessarily a bad result: economic theory points out that imports are not inherently "bad" and exports are not inherently "good," and so policies that restrict imports or promote exports may miss the point. International trade is indeed "trade" in the most literal sense—the exchange of some items for others to enhance mutual well-being. Exports are thus not a key to the economy's wellbeing, but rather the goods that are given to foreigners in exchange for the imported foreign goods the economy uses.

Classic economic theory says that such exchange occurs, and makes an economy better off, because it enables economies to specialize in the production of goods they produce most efficiently. For example, an economy might be able to produce wheat more efficiently than watches. If its consumers nonetheless desire a certain amount of watches, it might behoove the country to shift resources out of watch production into wheat, and trade wheat for watches made by a foreign country that produces watches more efficiently than wheat.<sup>12</sup> The important point is that it is not the exports that make the economy better off, but the ability to specialize by trading exports for imports.

From the point of view of the economy's efficiency, and thus, general economic welfare, there is an optimal level of international specialization. There is, in other words, a level of trade (imports plus exports) at which an economy is specializing enough in what it does efficiently to improve its welfare, but not specializing so much that it exports goods it produces inefficiently and imports items that it could produce domestically at little resource cost. It is here that economic theory provides an insight about the results of taxes' impact on trade. To the extent that taxes distort trade by either changing the mix of what an economy trades or the level at which it trades, taxes are believed to impair economic efficiency and reduce the overall economic welfare of the economy's participants.

The application of this principle to tax policies designed to alter trade—policies designed to shrink imports or expand exports—is straightforward. As previously noted, economists believe that neither tariffs nor export subsidies alter the balance of trade, but rather can change the composition and/or level of trade, with tariffs shrinking trade and export subsidies expanding it. To the extent any of these tax policies shift the economy away from its optimal level of trade, they make the economy's participants as a whole worse off in terms of economic welfare.<sup>13</sup>

Such arguments, however, focus on the economy as a whole and are sometimes difficult to see when only a particular sector of the economy is the focus. The idea that a tariff probably makes the economy as a whole worse off would likely be hard to explain to an employee who has just been laid off because his firm has started relying on imported inputs. (The employment effects of

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<sup>12</sup> Note that the country may be better off in making this trade even if it produces both watches and wheat more efficiently than the foreign country in an absolute sense; the key is for both countries to produce one good more efficiently than the other good and for the margin of this efficiency to differ.

<sup>13</sup> For a detailed economic analysis of the effect of an export subsidy on trade, efficiency, and economic welfare, see CRS Report RL30684, *The Foreign Sales Corporation (FSC) Tax Benefit for Exporting: WTO Issues and an Economic Analysis*, by David L. Brumbaugh.

outsourcing are discussed in the following section.) Trade theory does not deny that increases in imports (or reductions in exports) can cause economic dislocation in particular sectors of the economy. But because of the efficiency gains an economy realizes from trade, the welfare gain to the economy as a whole are held to outweigh the sum of sector-specific losses. In principle, the “winners” from a country’s international trade can compensate those made worse off by providing transition relief or other transfers to those made worse off by trade. Such relief could, in principle, be provided through the tax code, although mechanisms such as unemployment insurance or subsidized job-training might be more effective. The message of economic theory on the basic relation of taxes and trade, however, is clear: tax policies that distort trade make the economy worse off. In terms of the outsourcing debate, economic theory asserts that tax policies designed to curtail the type of outsourcing that occurs through trade probably make an economy as a whole worse off.

### Tax Policy and Foreign Investment

Economic theory also provides a framework for interpreting taxes’ impact on foreign investment from the perspective of economic efficiency and economic welfare. Here, the results are slightly more ambiguous than those for trade because the framework distinguishes between policies that promote world economic welfare and those that promote national economic welfare but that are not optimal for world welfare.

We first ignore taxes and note that a central tenet of economics holds that as capital investment in an economy increases, the product added by each additional increment of capital declines—in terms of economic theory, there is a declining marginal product of capital. Given this physical property of capital, firms will generally allocate investment between foreign and domestic locations until the return on an additional unit of overseas investment (the marginal product of capital employed abroad) is equal to that of an additional domestic investment—an outcome seen above in the discussion of how taxes affect investment decisions. Here, we also note that where capital is allocated so that the marginal product of foreign and domestic capital is equal, every unit of capital is necessarily being used in its most productive location. Given the declining marginal product of capital in both locations, if an increment of capital were shifted away from this point, the shifted capital would necessarily earn a lower return in its new location than its old one. At this point, therefore, the firm’s entire capital stock is employed in its most productive location. More generally, again ignoring taxes, when firms equate the marginal product of domestic and foreign capital, the world economy’s capital resources are employed in their most productive location and world economic welfare is maximized.

But taxes can change things. Profit maximizing firms focus on the *aftertax* return to capital and invest so that the *aftertax* return to additional investment is the same in each location. If taxes on investment are the same in every location, this point will be no different from the allocation of investment without taxes. But if taxes are different at home and abroad, the allocation of investment will be distorted. Capital will therefore not be employed in its most productive location and world economic welfare is not maximized.<sup>14</sup> In short, theory indicates that tax policy best promotes world economic welfare when it applies at the same rate at home and abroad, and

<sup>14</sup> Put another way, governments use tax revenue to finance services that (in principle) enhance economic welfare. Thus, the social benefit from capital investment consists of an investment’s pretax return: the investment’s *aftertax* return plus the tax revenue it generates. Thus, economic welfare is maximized where the pretax rather than *aftertax* return of marginal investment is equal.

is therefore neutral towards firms' investment decisions. In economic parlance, such a tax policy possesses "capital export neutrality"—it is neutral towards the export of capital.

A tax policy that maximizes world economic welfare is not necessarily that which maximizes a nation's own welfare. When an increment of capital is employed in the domestic economy, it is the home country that collects and uses the tax revenue produced by the investment. Thus, the home country's residents benefit from the investment's entire pre-tax return, not just the aftertax return. In contrast, when capital is employed abroad, foreign governments normally are normally entitled to taxes on the investment they host and the home country benefits only from the aftertax return to the investment. Accordingly, the home country's economic welfare is maximized when firms equate the pretax return of marginal domestic investment with the aftertax return of foreign investment. This outcome suggests that the home country (but not the world economy) is better off when it allows only a deduction for foreign taxes rather than a credit. Allowing only a deduction for foreign taxes would result in higher taxes on foreign investment than domestic investment.<sup>15</sup> Importantly, however, the benefit from such a policy may be offset if foreign countries retaliate.

A third type of tax policy termed "capital import neutrality" is sometimes promoted by business leaders and others. It recommends a policy that enables U.S. firms to compete in foreign markets on an even footing with firms from foreign countries. This policy would consist of an exemption for foreign investment from home-country taxes, but is not neutral in its effect on investment and does not promote economic efficiency.

As described above, the U.S. tax system in some cases poses incentives towards overseas investment, and in other cases is either neutral or poses a disincentive. The average impact of the system is, however, uncertain, and so whether the system as a whole comes closest to capital export neutrality, national neutrality, or competitive neutrality is likewise uncertain. Likewise, whether the legislation Congress is considering in 2004 would nudge the system in the direction of a particular standard is uncertain.

The impact of certain features of the system, considered in isolation, is, however, more clear. For example, the foreign tax credit generally promotes capital export neutrality because it alleviates double taxation. While the credit's limitation is likely necessary to protect the U.S. tax base,<sup>16</sup> it permits the overall tax rate on investment in high-tax countries to exceed the U.S. tax rate, thus permitting a tax disincentive towards foreign investment to exist. In a sense, then, the limitation is consistent with national neutrality, although as a general matter, permitting firms only to deduct rather than credit foreign taxes would closely approach national neutrality. The deferral principle is consistent with capital import neutrality, since it can reduce the tax burden on foreign investment to a level lower than the domestic tax rate. In contrast, the current taxation that applies

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<sup>15</sup> Trade theory suggests that, tax revenue considerations aside, a capital exporting country could benefit (at the expense of the world economy) by taxing foreign investment more heavily than domestic investment. The situation exists where the capital-exporting country faces a high foreign demand for its investment funds. In a manner analogous to that of a monopolist who restricts output, the exporting country can extract economic rents by taxing investment outflows relatively heavily.

<sup>16</sup> Without the limitation, foreign governments could, in principle, deprive the United States of tax revenue by raising their tax rates on U.S. firms whose investment they host to extremely high rates. Without the limitation, the foreign governments would not need to fear that the high tax rates would drive off desirable investment because the firms could simply credit the high foreign taxes against the firms' U.S. tax on U.S. source income.

to branch operations or under subpart F is consistent with capital export neutrality as long as foreign tax credits are also permitted.

## Outsourcing and Domestic Employment

The preceding economic analysis concluded that taxes best promote economic efficiency and economic welfare when they neither encourage nor discourage outsourcing, whether that outsourcing consists of imports of goods or services or exports of capital investment. But much of the debate over outsourcing has concerned its perceived impact of jobs, with some participants expressing fears that outsourced jobs destroy domestic jobs and reduce domestic employment.<sup>17</sup> The absence of employment from a prominent role in the preceding discussion indirectly suggests what economic theory indicates about outsourcing and employment: outsourcing has no profound effect on long-term aggregate employment in the domestic economy, although it can trigger short-term sector-specific job losses. Nonetheless, given the prominence of employment considerations in the outsourcing debate, we provide a brief summary of economic theory in this area.

First, mainstream contemporary economic theory holds that economies generally tend toward “full employment” or are moving in that direction. The labor market is thought to ordinarily be at equilibrium, where the supply of labor is equal to demand. Monetary policy set by the Federal Reserve is generally set so as to keep the economy at full employment and to avoid shocks to the system that might temporarily jar the economy from equilibrium. This is not to say there is never unemployment—in fact, unemployment is always present due in part to transitions within the economy (some of which may result from outsourcing). This persistent, minimum level of unemployment is termed the “natural” rate of unemployment by economists and is viewed as an unavoidable consequence of maintaining an efficient, flexible, and adaptable economy. Nonetheless, given appropriate monetary policy, an economy is thought to generally absorb displaced workers and tend towards full employment.

Against this backdrop, we return to the foregoing analysis of trade, which indicated that, absent changes in capital flows, the balance of trade cannot change; economists believe that an exogenous increase in imports (i.e., outsourcing) will ultimately be matched by an increase in exports and a mitigation of the initial increase in imports. Here, the mix of what the economy produces has indeed been changed, and an increase in unemployment in the import-competing sector may occur. Nonetheless, with the economy tending towards full employment, new jobs will be created in other sectors of the economy that will, in time, offset those lost in the sector where outsourcing occurred. In short, when we view outsourcing as a trade phenomenon, its employment effects will be confined to the near-term.

The employment analysis of outsourcing that occurs through investment—that is, where capital outflows occur—is somewhat different. As with trade, there may be near-term and sector specific unemployment as a result, for example, a factory that shuts down in a particular U.S. city and that moves to a foreign location can certainly cause increased unemployment in the original U.S. location.<sup>18</sup> Again, however, the economy as a whole is seen as tending towards full employment and the absorption of dislocated labor. There may also, however, be a shift in the shares of

<sup>17</sup> For more information, see CRS Report RL32292, *Offshoring (a.k.a. Offshore Outsourcing) and Job Insecurity Among U.S. Workers*, by Linda Levine.

<sup>18</sup> CRS Report RL30799, *Unemployment Through Layoffs and Offshore Outsourcing*, by Linda Levine.

national income accruing to labor and capital respectively. This outcome is based on the basic economic precept that labor's earnings depend on its productivity, which in turn depends on the amount of capital it has to work with. The larger the economy's stock of capital for a given supply of labor, the higher will be labor productivity and the higher will be labor earnings. It follows, then, that when capital shifts abroad, domestic labor earnings fall from the level they otherwise would attain.

As noted in the discussion above on efficiency, in principle those that gain from outsourcing can, in principle, compensate those that lose and, because of the efficiency gains embedded in outsourcing, still be better off than before. In principle, the economic harm to workers from outsourcing can be mitigated by appropriate redistributive and retraining policies. Theory maintains, however, that these policies are most efficiently effected as general transitional relief than as policies designed to limit outsourcing.

## Summary and Conclusions

A recent focus of tax policy debate has been the impact of taxes on the extent to which firms use imported inputs rather than domestic goods and services and whether taxes encourage U.S. firms to establish operations abroad rather than in the United States. In the current debate, the phenomena are frequently referred to as offshore or foreign "outsourcing." In economic terms, the debate concerns the impact of taxes on two aspects of the international economy: trade and foreign investment.

Economic theory maintains that taxes can alter the composition and level of trade, but do not alter the balance of trade (the excess of imports over exports). In contrast, taxes can alter the extent to which firms invest abroad rather than in the United States. The current U.S. tax system produces a patchwork of effects on investment so that its net impact, whether it encourages or discourages overseas investment, is uncertain.

Economic theory also provides frameworks for evaluating the impact of tax policy on trade and investment from the perspective of economic efficiency and economic welfare. Theory suggests, in general, that tax policy best promotes efficiency and national economic welfare when it neither encourages nor discourages imports or exports. In terms of the outsourcing debate, theory holds that taxes best promote economic welfare when they do not distort the level or composition of outsourcing. With outsourcing that occurs through investment, theory similarly indicates taxes best promote world economic efficiency and economic welfare when they do not distort investment flows. A policy that poses a small impediment to overseas investment may, in contrast, best promote national welfare, although such a policy may make foreign economic actors worse off and may be offset by retaliation.

## Author Contact Information

Donald J. Marples  
Specialist in Public Finance  
dmarples@crs.loc.gov, 7-3739