Insight

Tax Reform and The Value of Foreign Direct Investment

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EXECUTIVE SUMMARY

- FDI is essential to the U.S. economy – with $3.7 trillion invested in the United States
- FDI supports almost 7 million jobs
- The U.S. tax code is unfriendly to foreign investment, and should be improved to support higher wages, R&D, and productivity for U.S. workers and firms

INTRODUCTION

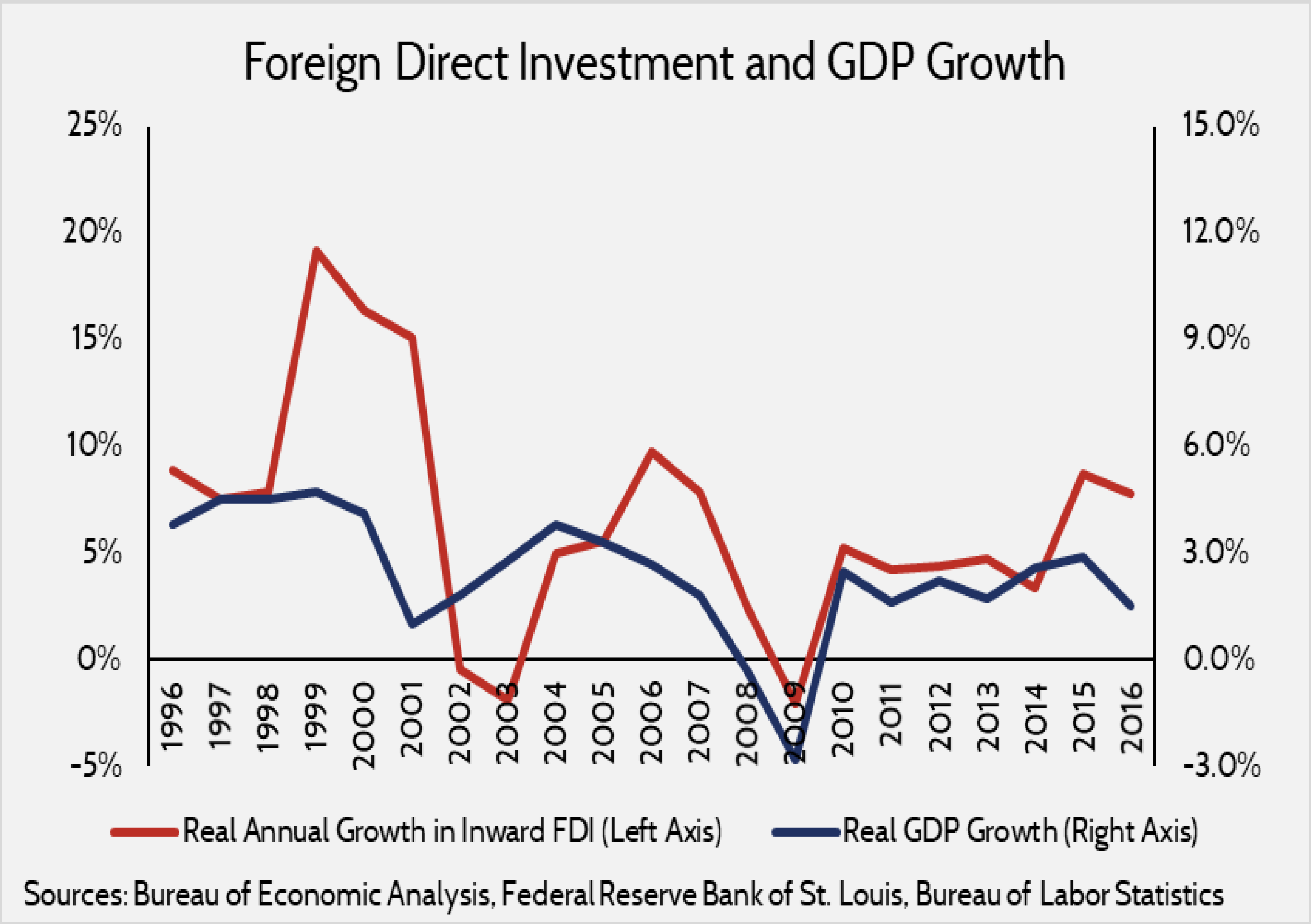
The U.S. economy has grown at an average annual rate of a little over 2 percent since the recovery from the Great Recession began. The Congressional Budget Office recently projected that U.S. economic growth would remain intractably stuck at just *below* 2 percent annually for the next 10 years. At that tepid rate of growth, it takes about 70 years for the living standard of the average American to double, an achievement that used to happen over about 35 years or the span of a working career. Without fundamental policy changes, this basic proposition will remain out of reach for American workers. Improving the climate for investment and resultant improved productivity is essential to this goal. Tax reform is the most conspicuous policy reform effort needed to enhance the U.S. investment climate. As policymakers consider a fundamental overhaul of the nation's tax code, tax reforms should reflect and enhance the critical role of foreign direct investment (FDI) in spurring domestic economic growth

FDI IN THE UNITED STATES

The United States boasts the largest economy in the world. U.S. GDP makes up almost 25 percent of the entire global economy, while U.S. citizens only represent 4.3 percent of the global population. It is no surprise that this economic strength attracts the attention of foreign investors: in 2016, the United States had a larger stock of FDI than any other nation.

FDI occurs when foreign individuals or companies establish business interests in the United States, often by taking positions in U.S.-based firms or by building new manufacturing facilities. This results in an inflow of foreign capital, which in turn stimulates the economy. It also enables U.S. investment projects to be financed by foreign savings, which expands the number of investment opportunities that can be realized in the United States.

To date, foreign companies have invested $3.7 trillion in FDI in the United States. This comprises 24 percent of worldwide FDI, and is more than foreign companies have invested in any other country in the world. It is also a direct reflection of the vitality of the U.S. economy. The following chart compares growth in FDI with growth in the economy over the past 20 years. It shows that inflows of FDI are directly related to the performance of the U.S. economy. Increased foreign investment in the United States is simply a result of investors capitalizing on a prosperous U.S. economy.



In addition to infusing funds and other capital into the U.S. economy, FDI also creates jobs for U.S. workers. In 2014, majority foreign-owned businesses employed 6.8 million Americans, which is over 5 percent of total private-sector employment. An additional 5.9 million jobs can be attributed to the economic activity of foreign-owned businesses and their suppliers as well as productivity gains in the manufacturing sector. Furthermore, U.S. affiliates of foreign companies employ more than one fifth of total manufacturing workers in the United States.

For example, Moran and Oldesnki found that U.S. workers at foreign-owned firms were actually better paid than their counterparts at U.S.-owned multinational firms, earning $77,597 compared to $69,208 for workers at U.S.-owned multinationals. The authors also found that U.S. firms spend about 4.8 percent of value added on research and development, while foreign-owned firms spend more than 7 percent. In addition to these direct benefits of inward FDI, the authors also noted strong spillover effects, finding that "a one percentage point increase in the share of total employees in an industry who work at foreign-owned firms in the US increases the productivity of all firms in the industry by an average of 0.81 percent after one year and by 2.75 percent in the second year, or a total of more than 3.5 percent."

The value of FDI is evident. The investments made by foreign enterprises in the United States stimulate economic activity, contribute to competition and innovation, and create jobs for U.S. workers.

TAX CONSIDERATIONS AND FDI

A large body of research has coalesced around the finding that a high corporate tax rate increases the user cost of capital, which slows investment, productivity growth, and economic growth. Among the more telling examples is a study by the Organisation for Economic Co-operation and Development (OECD) that notes that "corporate income taxes have the most negative effect on GDP per capita."

A more recent paper by Djankov et al assessed this broad literature and observes that "this research finds adverse effects of corporate income taxes on investment." Based on a unique database of corporate income tax rates for 85 countries, the paper finds that "effective corporate tax rates have a large and significant adverse effect on corporate investment and entrepreneurship."

Another sweeping literature review concluded that: "A vast analysis of the corporate income tax in countries around the world — both industrialized and developing countries — finds that the corporate income tax reduces gross domestic product (GDP) growth, reduces worker productivity, reduces domestic investment by domestic and foreign companies, and reduces entrepreneurship."

While the need to improve the tax climate for investment in the United States is strongly reported in the tax literature, there is also corresponding research that specifically reflects the importance of tax policy to enhance the attractiveness of inward FDI. Oldenski and Moran note that "the U.S. tax system is particularly business-unfriendly for foreign companies." Based on work by Hufbauer and Wong, the authors state that cutting the U.S. corporate rate by 1 percent would improve the output of U.S. foreign-owned firms by 2 percent. Scaled up, this would pose a significant benefit for U.S. workers and the economy in general.

CONCLUSION

As policymakers consider reforms to the tax code, they should focus on improving the investment climate in the United States. This approach should embrace the importance of inbound FDI to U.S. employment and economic growth. FDI supports millions of U.S. jobs, while providing opportunity for improved wages. FDI supports robust R&D in the United States, and provides spillover effects that enhance the U.S. economy beyond the direct benefit arising from the investment. A successful pro-growth tax reform should reflect these benefits.