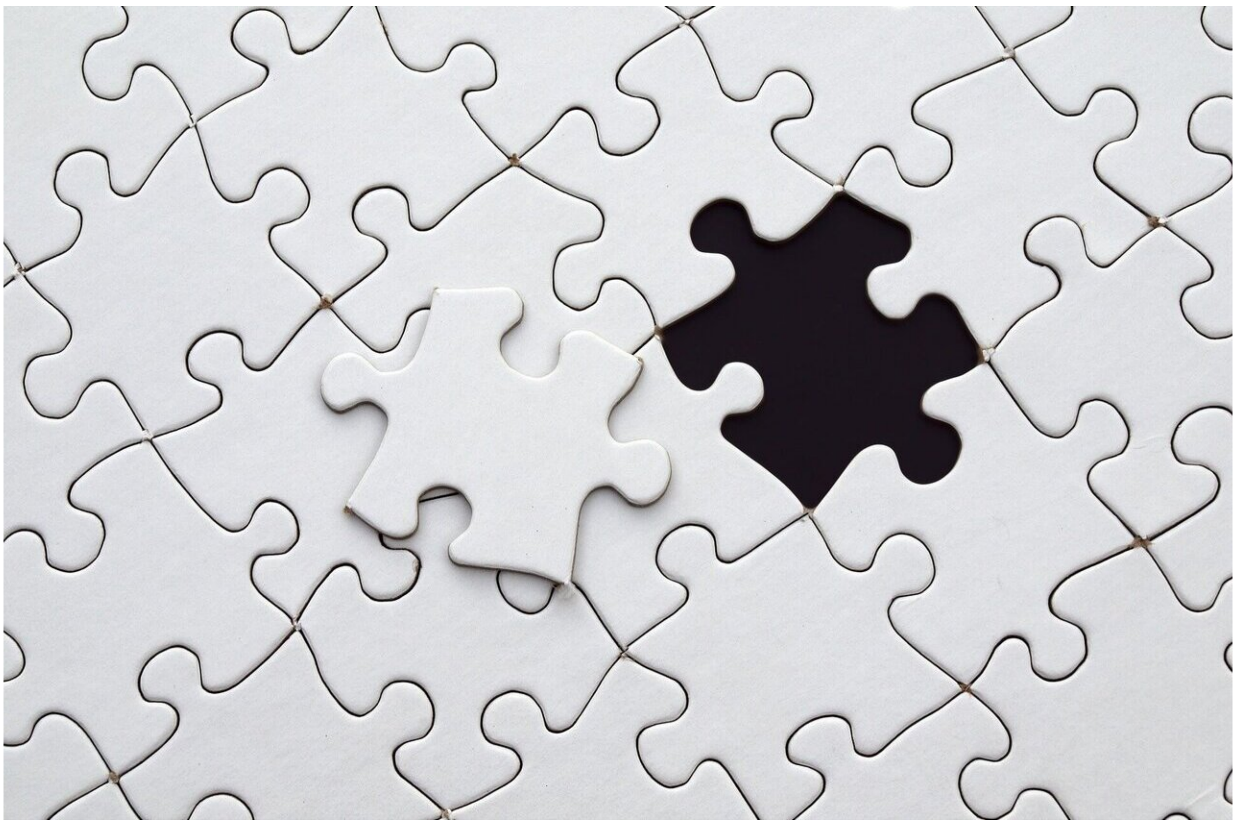
Study analyzed tax treaties to assess effect of offshoring on domestic employment

October 31 2019



Credit: CC0 Public Domain

The practice of offshoring—moving some of a company's manufacturing or services overseas to take advantage of lower costs—is on the rise and is a source of ongoing debate. A new study identified a way to determine how U.S. multinational firms' decisions about offshoring affect domestic employment. The study found that, on average, when U.S. multinationals increase employment in their foreign affiliates, they also modestly increase employment in the United States—albeit with substantial dislocation and reallocation of workers.

The study was conducted by researchers at Carnegie Mellon University, Georgetown University, and the Federal Reserve Bank of Kansas City. It is published in The *Review of Economics and Statistics*.

"In recent years, the question of how offshoring affects domestic employment has been at the forefront of political and popular discussions of international economic policy," notes Brian K. Kovak, assistant professor of economics and public policy at Carnegie Mellon University's Heinz College, who coauthored the study. "We identified a new way to answer this question—by looking at tax treaties that affect the costs of offshoring. Our findings suggest that changes in the global tax structure influence the hiring activity of U.S. multinational firms both domestically and abroad, with spillover effects to regional U.S. employment."

Historically, the fact that both offshore hiring and domestic employment reflect firms' decisions has made it difficult for economists to provide clear answers about how the two are related. Moreover, offshoring includes many different activities, with effects felt by workers at the firm that is offshoring, at competing firms, and at supporting industries in the same region.

To address these issues, the researchers used an instrument that allowed them to identify changes in the relative costs of offshore activity resulting from new bilateral tax treaties. These treaties allow U.S. firms to avoid double taxation, lowering the average effective tax rate and the overall cost of offshore activity.

The researchers looked at data on U.S. multinationals from the U.S. Bureau of Economic Analysis's Surveys of U.S. Direct Investment Abroad and from the Census Bureau's County Business Patterns (which provides county-level economic data by industry) to examine firms in all industries, including those outside manufacturing. Altogether, the study looked at 5,715 firms with 46,498 foreign affiliates spanning 121 industries and operating in 130 countries from 1987 to 2007.

"Our study identifies tax treaties as a new source of policy variation," according to Nicholas Sly, research and policy officer in the Economic Research Department at the Federal Reserve Bank of Kansas City, a coauthor of the study. "As such, this is the first time the treaties have been used to study the domestic labor market effects of offshoring."

The study found that a 10% increase in employment at offshore affiliate companies drove a 1.3% rise in employment at the U.S. parent firm, with smaller effects at the industry and regional levels. These effects appeared for firms in industries with large royalty, interest, and dividend payments, since they were most affected by the tax treaties.

In contrast, offshoring by vertical multinationals (companies whose foreign affiliates sell directly to their U.S. parent firms) drove declining employment among nonmultinational firms in the same industry, and firms opening new affiliates overseas saw smaller growth in domestic employment than firms expanding existing affiliates. The authors found that expanding offshore activity in these firms likely reduced their demand for products they had previously purchased from U.S. suppliers.

By considering offshore cost reductions driven by tax treaties rather than cost savings driven by firms' choices, the researchers were able to infer the causal implications of greater offshore employment for U.S. labor market outcomes. Changes in the hiring activity of U.S. multinationals demonstrate how shifts in the global tax structure can alter the geographic distribution of economic activity both within and across national borders.

"Our findings tell us that there is not a single effect of increased offshore activity on domestic employment, but that the effects vary depending on the circumstances," says Lindsay Oldenski, associate professor of international economics at Georgetown University, who coauthored the study.

More information: Brian K. Kovak et al, The Labor Market Effects of Offshoring by U.S. Multinational Firms, *The Review of Economics and Statistics* (2019). [DOI: 10.1162/rest_a_00878](https://dx.doi.org/10.1162/rest_a_00878)

Provided by Carnegie Mellon University