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AMERICAN COUNCIL FOR CAPITAL FORMATION

Special Report

December 2008

Macroeconomic Effects of a Reduction in the Effective Tax Rate on Repatriated Foreign Subsidiary Earnings in a Credit- and Liquidity-Constrained Environment

By

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New research with the Sinai-Boston Econometric Model of the U.S. shows that a temporary one year reinstatement of the dividends-received-deduction for repatriated foreign subsidiary earnings would have several stimulative results including: a significant increase in real GDP, significantly higher corporate cash flow, increased capital expenditures including R&D, improved business financial conditions, more jobs at nonfinancial corporations and at financial institutions as well. In addition, the U.S. Treasury would receive funds it would not otherwise get, thus helping to reduce the federal deficit.

Introduction: The U.S. economy is in recession, probably the longest and deepest since the recessions of 1973-75 and 1981-82, with a possibility of something worse. A global recession also is reality, the worst since the early 1980s. With a financial crisis—huge declines in asset prices, large contractions in the balance sheets and numbers of U.S. and global financial intermediaries and an implosion of credit—an even more serious and potentially severe economic downturn is indicated. A credit crunch within and outside the financial system overlays the economic downturn and intensifies it. The recession itself feeds increased credit risk, the contraction of credit, and intensifies the credit crunch; this loop is not easy to break.

Tax Reductions on the Repatriated Foreign Earnings of U.S. Subsidiaries: This new analysis examines the macroeconomic effects of a reduction in the U.S. corporate tax rate on repatriated earnings, similar to that used in the American Jobs Creation Act (AJCA) of 2004. The AJCA provided for a temporary, 85% dividends-received-deduction on repatriated funds that qualify, or an effective tax rate on foreign subsidiary earnings (FSE) of 5.25% instead of the corporate income tax rate of 35% when companies repatriated the corporate profits earned and residing abroad. Evidence on the AJCA's effects are generally positive with respect to its impact on the economy and for corporations that repatriated funds.

Methodology of the Study: The study examines the macroeconomic effects of once again establishing the 85

percent dividends-received-deduction for qualifying corporations starting in, or retroactive to, January 2009, by simulating the policy in a large-scale structural macroeconomic model of the U.S. economy, the Sinai-Boston (SB) Model. The SB Model is a full-blown, large-scale macroeconomic model of the U.S. economy and financial system and captures, more than others, the flows-of-funds, credit, borrowing, and balance sheet effects of measures like the AJCA.

The Results Show: *(All relative to the baseline forecast)*

■ **Economy-** A significant increase in the growth of real GDP, up by \$13 billion in 2009 and by \$110 billion in 2010 or an average of \$62 billion over 2009-2013. The stronger effect in 2010 than in 2009 comes about because of the time lags stemming from the uses of the additional cash flow for various purposes (see Table).

■ **Credit, Liquidity and Corporate Balance Sheets-** The financial position of nonfinancial corporations improves significantly as the initial sizeable injection (\$545.5 billion) of cash flow is used to reduce short- and long-term borrowing and outstanding debt. Interest rate charges relative to cash flow decline, indicating an improved financial condition for business.

■ **Capital Spending and R&D-** Since the tax reduction is oriented toward nonfinancial corporations and directly enhances business cash flow (a prime determinant of capital

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Table 1: Summary Results of a Temporary 85% Dividends-Received Deduction on Repatriated Earnings at an Effective 5.25% Rate -- 2009-2013* (Changes Relative to Baseline, Unless Otherwise Indicated)

	Years					Average
	2009	2010	2011	2012	2013	2009-2013
Economy						
Real GDP (\$ 00' Bils.)	12.6	109.5	92.3	56.7	36.7	61.6
Consumption (\$ 00'Bils.)	11.3	45.6	63.8	65.6	56.5	48.6
Business Capital Spending (\$ 00' Bils.)	3.1	95.0	96.8	53.4	33.6	56.4
R&D (\$ 00' Bils.)	5.3	14.7	10.7	3.4	1.4	7.1
Jobs and Unemployment						
Nonfarm Payroll (Thousands of Persons)	93	511	614	482	125	365
Unemployment Rate	---	-0.4	-0.5	-0.2	-0.1	-0.2
S&P500 Index (Pct. Chg. from Baseline)	1.8	5.1	10.9	10.7	7.1	7.1
Financial Position (Nonfin. Corps.)						
Cash Flow (\$ Bils.)	545.5	18.0	31.4	33.9	42.1	134.2
Interest Charges/Cash Flow (Ratio, Pctg Pts.)	-20.0	-2.4	-4.9	-6.4	-7.8	-8.3
Federal Government Budget						
Unified Budget Deficit (-)/Surplus (+)	35.4	38.9	62.0	54.4	47.3	47.6
Tax Receipts (\$ Bils., NIPA)	33.7	21.3	27.8	29.4	25.7	27.6
Corporate	32.0	10.6	9.8	8.0	6.5	13.4
Personal	0.9	5.5	9.4	12.4	12.1	8.1
Cap. Gains	0.3	2.5	6.6	9.2	8.6	5.5
Other	0.8	5.2	8.6	8.9	7.1	6.1

* Simulations with the Sinai-Boston (SB) Large-Scale Macroeconometric Model of the U.S. Economy. Monetary policy is held unchanged; a federal funds rate unchanged from the Baseline.

spending) it is not surprising to see business capital spending up by an average of \$56 billion annually and R&D up by approximately \$7 billion per year over 2009-2013.

■ **Consumption-** Consumption spending increases by an average of almost \$50 billion per year as a consequence of the increased economic activity, jobs creation, higher disposable income, and gains in household wealth.

■ **Federal Government Budget-** The reduction in the federal budget deficit stems from the gains in tax receipts on the otherwise untaxed funds that are repatriated by nonfinancial corporations. Thereafter, increases in tax receipts, relative to the Baseline, arise from the higher levels of economic activity that produce higher corporate, personal, capital gains, social security, and other tax receipts. Tax revenues are higher by an average of \$27.6 billion over the 2009-2013 period.

■ **S&P 500 Index-** Interest rates related to the nonfinancial corporate sector tend to decline as a consequence of the increased cash flow. Fewer issues of commercial paper and long-term bonds are necessary, reducing the supply of nonfinancial corporate paper and reducing yields. The reductions of interest rates lower the weighted average cost of debt-and-equity and raise the discounted present value of future earnings. Earnings, and expected earnings, rise and combined with lower corporate interest rates, reduce the cost of capital. This raises stock prices and increases the net worth

of households and stock issues to finance new and existing businesses.

■ **Jobs-** Nonfarm payroll jobs, essentially a measure of hiring and jobs creation by business, show a small gain of 93,000 persons in 2009 and then larger increases in subsequent years, peaking at 614,000 in 2011 relative to the Baseline. These jobs represent the direct and indirect increase in employment due to the repatriation of funds and improvement in the financial positions of corporations. The job gains lag the increases in capital spending and in real GDP but do reflect some use of the increased cash flow from repatriation. The lags are to be expected given that much of the initial funds flows to nonfinancial corporations are used first to shore up corporate finances and balance sheets. The unemployment rate declines by an average of 0.2 percent annually.

Conclusions: All-in-all, reducing the federal tax rate on the repatriated earnings of foreign subsidiaries provides an exogenous lift to the U.S. business sector through the uses of cash flow and thus to the overall economy.

Increased liquidity, less need for credit, and much greater cash flow to nonfinancial corporations stimulate spending on capital formation, R&D, and hiring that raises the growth and levels of real economic activity while reducing the federal government budget deficit.