Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

January 30, 2008

REPATRIATION MEASURE UNLIKELY TO STIMULATE THE U.S. ECONOMY OR BOOST U.S. INVESTMENT — BUT WILL PROMOTE INVESTMENT IN TAX HAVENS AND UNDERMINE THE CORPORATE INCOME TAX

By Aviva Aron-Dine

When the Senate Finance Committee considers stimulus legislation today, Senator John Ensign is expected to offer an amendment dealing with repatriated foreign earnings. Modeled on a provision included in the 2004 American Jobs Creation Act, Senator Ensign's amendment would create a tax holiday during which repatriated earnings would be taxed at a rate of just *5 percent*, rather than at the normal corporate income tax rate of 35 percent. That is, for a specified period, controlled foreign corporations could pay dividends to their U.S. parent corporations, and the parent corporations would pay tax on these dividends at an extremely low rate.

Senator Ensign's proposed repatriation measure suffers from the same basic problem that plagues most other business tax breaks offered as stimulus measures: it would infuse cash into large, profitable corporations unlikely to spend it quickly, and so would have little effect in stimulating the economy in the near term. Evidence from the 2004 repatriation tax holiday confirms that such a provision is more likely to provide a windfall to shareholders than to promote substantial new U.S. investment.

In addition, the Ensign Amendment would not only be ineffective as stimulus, but would also create significant new problems for the economy and the tax system. *A repeat of the 2004 tax holiday will lead firms to expect more tax holidays, with the unfortunate result that they will be more inclined to invest in tax havens and less inclined to reinvest earnings in the United States.*

The Bush Administration opposed the repatriation provision enacted in 2004, arguing that it was weak stimulus and bad tax policy. Then-Treasury Secretary John Snow wrote that an analysis by the Counsel of Economic Advisors found the provision "would not produce any substantial economic benefits,"[1] while *Tax Notes* reported that "Treasury questioned the true stimulative effect of the provision, given that money is fungible" and expressed concern over making "a fundamental change [to international tax rules] on a temporary basis."[2] For the same reasons, adding the Ensign Amendment to the Finance Committee stimulus package would be unsound economic and tax policy today.

[1] Glenn R. Simpson and Gregory Zuckerman, "Tax Windfall May Not Boost Hiring Despite Claims: Some Companies Plan to Use New Break on Foreign Profits for Debt and Other Needs," *Wall Street Journal*, October 13, 2004.

[2] Lee A. Sheppard, "News Analysis: Do-It-Yourself Repatriation," *Tax Notes*, October 19, 2004.

The Ensign Amendment would not provide effective stimulus. The 2004 experience suggests that while a tax holiday for repatriated earnings would entice firms to bring cash back to the United States, that does not mean they would actually reinvest it in the U.S. during the economic downturn. As a recent Goldman Sachs analysis notes, "companies don't spend money just because it's there to spend. To justify outlays for new projects, the expected returns have to exceed the costs, and that usually requires growth in demand strong enough to put pressure on existing resources."[3] The most promising strategy for boosting business production and investment during a slowdown or recession involves measures to boost consumer demand, not measures to simply boost business cash flows.

Requirement to reinvest repatriated earnings in the U.S. proved ineffectual in 2004. The 2004 repatriation provision did include a requirement that firms develop a plan for reinvesting repatriated earnings in the U.S, and it is likely that the Ensign amendment will include similar language. However:

- Even if firms comply with the requirement, this will not make the repatriation measure effective stimulus. As the Congressional Budget Office explains, "most business investment has a long lead time," and so investment that firms begin to plan in the next few months is unlikely to take place soon enough to constitute timely stimulus.[4]

- The investment requirement in the 2004 legislation proved largely ineffectual. As an Urban Institute-Brookings Institution Tax Policy Center brief explained, "Firms have substantial flexibility in how they finance new projects. By rearranging their financing sources, they will be able to meet the requirement of the law *without changing their underlying investment decisions*"[5] (emphasis added). Money is fungible: firms were able to comply with the law without investing significantly more in the U.S. than they otherwise would have.

- Most striking, even though the 2004 law specifically prohibited the use of repatriated earnings for share repurchases, dividend payouts, and executive compensation, a careful study by professors at the University of Pennsylvania Wharton School of Business and the University of Texas concluded that firms did, in fact, use a significant share of repatriated earnings for share repurchases.[6] That is, contrary to Congress's intent, some of the benefits of the repatriation provision were paid out immediately as a windfall to affluent shareholders.

Another tax holiday will lead firms to expect more tax holidays, with unfortunate consequences. If Congress enacts another tax holiday for repatriated earnings as part of this year's stimulus package, rational corporate executives will conclude that more tax holidays are likely in the future. This will make firms:

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[3] GS Weekly, September 21, 2007.

[4] Congressional Budget Office, "Options for Responding to Short-Term Economic Weakness," January 2008.

[5] Kimberly A. Clausing, "The American Jobs Creation Act of 2004: Creating Jobs for Accountants and Lawyers," Urban-Brookings Tax Policy Center, December 2004.

[6] Jennifer Blouin and Linda Krull, "Bringing It Home: A Study of the Incentives Surrounding the Repatriation of Foreign Earnings Under the American Jobs Creation Act of 2004," Wharton Working Paper, March 2007.

- *More likely to place investment capital in tax havens* outside the United States. Currently, firms that invest in tax havens know that, while they will be able to defer tax as long as they leave their profits abroad, they will probably eventually have to pay U.S. corporate income tax. That knowledge acts as some restraint on purely tax-motivated investments in tax haven countries. But if firms expect that there will be more tax holidays, they will invest in tax havens on the assumption that there will periodically be opportunities (such as during the next economic downturn) to repatriate earnings and pay very little U.S. tax.

- *Less likely to reinvest in the U.S. when there isn't a tax holiday*. Firms that expect future tax holidays will be reluctant to repatriate earnings at times when they would have to pay ordinary tax rates. That is, *the repatriation provision will exacerbate the "lock in" effect that makes firms reluctant to reinvest foreign earnings in the United States* — the exact opposite of what the measure is intended to accomplish. It will also reduce corporate revenues for years reaching far into the future, violating the principle that stimulus measures should not increase deficits beyond the next year or two.