Homeland Investment Charade

Republicans and Democrats in the US Congress are having a difficult time agreeing on changing a law that will allow the federal government to pay for what it has already spent. However, there does seem to be bipartisan support for giving American companies a tax holiday to repatriate funds that have been kept abroad. The discussion has been taking place for the better part of the first half, but recently more attention has been given to it by policy makers, business leaders and economists.

Economists at some of the largest investment banks conclude that such a tax break would be materially beneficial to the dollar and U.S. asset markets. Some have gone so far as to compare it favorably to QEIII. As often seems to be the case, the risk is that the advocates of a corporate tax holiday and their allies and benefactors in Washington and on Wall Street typically embellish and exaggerate the implications.

We will argue that the impact of a corporate tax holiday on the dollar and U.S. stocks will be sufficiently negligible for medium term investors who should not be distracted by this and instead focus on the real drivers of exchange rates and equity valuations.

Déjà Vu All Over Again

In part of 2004 and all of 2005, American companies were allowed to repatriate their foreign retained earnings at a tax rate of 5.25%. This was often compared to the 35% tax schedule rate. This, however, exaggerates the savings to business because few businesses pay the tax schedule rate due to numerous exemptions, loopholes and the untold hundreds of millions paid to accountants and lawyers to develop tax minimization strategies. A recent academic study concluded that the average effective tax rate of large US corporations is closer to 22.5%.

The tax holiday at the time was justified on grounds that it would create 500k jobs in two years. This did not happen. A 2009 NBER paper concluded that nearly every dollar that was repatriated generated about a dollar in payouts to shareholders, in the form of share buyback programs and dividends.

Technology and pharmaceutical companies are believed to have the most retained earnings then and now. Reports of their lobbying efforts now would seem to lend credence to that understanding.

The NBER report found that none of the top ten companies in terms of repatriation during the holiday expand their American work force. A large pharmaceutical company, for example, repatriated about $16 bln during the last tax holiday and reduced its workforce, increased its dividend and boosted its share buyback program. A large hardware maker repatriated $14.5 bln and cut its US workforce by 14.5k.

QEIII

A highly regarded economist, Allen Sinai of Decision Economics, has a somewhat more favorable read of the results, yet he acknowledges that the share buybacks violated the intention of the legislation. However, and, this is what present day advocates are emphasizing, not jobs and investment, but Sinai ultimately fell back on the wealth effect.

If the repatriated funds are used to buy back shares, the reduction in the number of shares is good for the overall stock market and share holders displaced, will either buy other shares, invest in other assets or consume. Each of these of course has a desirable impact on the economy. It is in this regard that references to QEIII are made.

As new investment and job creation were exaggerated so was the impact on the wealth effect and the overall stock market. In 2005, the S&P 500 rose 3%. Perhaps, in fairness, one would want to take the anticipation-effect. The S&P 500 rose almost 9.4% from the middle of 2004 through 2005. While this is better, it is below the long-term historical average.

The tax break on repatriated earnings did not appear to boost US personal income significantly. Consider that personal income rose at an average rate of 0.45% in 2003 and 2004 (adjusted for the one off $32.6 bln dividend payment by Microsoft at the end of 2004, which did not at the time, nor in hindsight, look to be a result of the tax holiday). The comparable pace in 2005 was almost 0.50%.

The rise in income was more a function of wages than dividends. Consider that the US economy created an average of 113k private sector jobs a month in 2005 after 110k private sector jobs a month in 2004 and 100k in 2003. Not only were there more workers, but they were getting paid more. Average hourly earnings rose 1.8% in 2003, 2.5% in 2004 and 3.2% in 2005.

Dollar Exaggeration

This seems to be nearly universal opinion that a tax holiday on repatriated earnings would be dollar positive. Here too skepticism may be good for one's financial health.

The potential amounts *are* quite substantial. Most estimates suggest that American corporations have $1-$1.5 trillion in retained earnings abroad. Foreign operations account for about a quarter of the S&P 500 profits according to recent estimate, which is nearly twice the proportion of a decade ago. However, Robert Pozen of the Harvard Business School and Brookings Institution told Bloomberg reporters in late June that figure may be almost $2 trillion.

There is no reason to believe that the full amount would be repatriated. Given the incentives of the corporate tax code, funds in relatively high tax centers are more likely to be repatriated than those in low tax centers.

According to an IRS report, roughly 40% of the earnings retain abroad are in 5 low tax centers (Switzerland, Bermuda, Ireland, Luxembourg and Cayman Islands). That still leaves $600 bln-$1.2 trillion. In comparison, after adjusting for the prevailing average, about $300 bln appears to have been repatriated in 2005.

In that year the dollar rose about 15% against both the euro and yen. Economists not only disagree with what is going to happen in the future, but they disagree what happened in the past. Many observers see the dollar's performance during that repatriation and claim a causal relationship.

There are several problems with such a claim. Most fundamentally, many do not fully appreciate that for a dollar-based; the overwhelming majority of the foreign retained earnings are already denominated in dollars. To do otherwise is to take on foreign exposures needlessly, which is something that would potentially add to the volatility of earnings to the dismay of Treasurers and investors. The repatriation is largely a transfer of Eurodollars into a domestic dollar account. It does not change the supply/demand for dollars or require portfolio rebalancing.

Some small fraction of those retained foreign earnings may be denominated in foreign currency. One large investment bank estimated this to be as little as 10%. Even this seems high, but even if true that would bring the repatriation that would impact the dollar to $60-$120 bln.

That sum would seem substantial for almost any other market, but not the foreign exchange market, where the average daily turnover is estimated by the Bank for International Settlements at $4 trillion and the dollar-euro exchange rate accounts for 37% alone. The US dollar is still on one side of more than 90% of the foreign exchange transaction.

There is a more compelling explanation of the dollar's rally in 2005 than the Homeland Investment Act. The Federal Reserve was raising interest rates. The Fed's tightening cycle began in June 2004 when Fed funds were hiked 25 bp to 2.25%. At every FOMC meeting thereafter in 2004 and through 2005, a 25 bp hike was delivered, with the Fed funds rate finished 2005 at 5.25%. A Fed rate hike does not seem likely for at least the better part of the next year.

There was another development in 2005 that may have helped the dollar and has some significance today. In 2005, referendums in France and the Netherlands rejected the institutional reforms embodied in a European constitution. In some ways the roots of the current political and economic crisis in Europe can be traced to then.

Conclusion

It is not clear that there is a political consensus for a stand-alone tax holiday. There may be support for the stand-alone tax holiday as part of a larger corporate tax reform effort. If it is enacted, job growth and capital investment is unlikely to be aided, if for no other reason than the lack of capital is not the reason for the jobless recover and sluggish investment.

Acknowledging that companies are likely to use the funds to pay shareholders directly or indirectly is an exercise in turning a necessity into a virtue and is similarly exaggerated. The stock market's performance in 2005 and rise in personal income do not appear to have been bolstered by the repatriation. The impact on the dollar is even less clear, with its 2005 appreciation more likely a function of the tightening of US monetary policy throughout the period. The dollar may rise if and when a new tax holiday is granted, but it is unlikely to be the cause.

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