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# *CROWE Policy Brief:*

# The Effects of Removing the Corporate Repatriation Tax

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## Abstract

Congress is currently considering substantial reform of the United States tax code. One important component of reform which has been largely overlooked is the treatment of corporate income of multinational firms. The bills under consideration move the U.S. from a worldwide system to a territorial one that taxes only domestic activity. My research shows that this change would lead to higher output, wages, and productivity in the U.S. In addition, while official government estimates suggest that removing this "repatriation tax" would cost hundreds of billions of dollars, I find that the increased economic activity resulting from the reform makes it roughly revenue neutral.


## Corporate Tax Reform

With the recent push toward tax reform in the United States, the effects of corporate tax reform have seen a great deal of discussion of corporate tax reform in media outlets, policy circles and the general public. However an important component of the proposed reforms, its changes to the international taxation of businesses, has been largely overlooked.

In addition to reducing the U.S. corporate tax rate from 35% to 20%, the bill passed in the Senate on December 2 also proposed moving away from the U.S.'s current worldwide system of taxing its multinational firms. Under the current system, when a U.S. firm's foreign subsidiary earns some income, it will pay taxes to the local government and additionally to the U.S. Government when the earnings are repatriated, or sent back to the U.S. parent company. This tax is often colloquially referred to as the "repatriation tax." Both the Senate bill and the earlier bill passed in the House or Representatives proposed moving toward a territorial tax system. This would remove this repatriation tax so the U.S. government would only collect corporate revenues on earnings generated domestically. Most developed countries have territorial systems in place, leading many proponents of the Senate bill to conclude that U.S. firms are currently at a global disadvantage relative to their foreign competitors. Others have opposed the bill based on fears that it will hurt the federal government's bottom line and will move U.S. manufacturing offshore.

Evaluation of the macroeconomic effects of tax policy changes requires the use of an economic model; this allows us to understand how the policy change would affect the location, incorporation and production decisions made by U.S. firms. In addition, this methodological approach captures the equilibrium impacts that ensue as the changes work through the economy, impacting household decisions. How would removing the repatriation tax affect real wages in the U.S.? The use of a model allows us to answer such questions quantitatively.

## Impact of Removing the Repatriation Tax

In my paper, Spencer (2017), I study the impact of removing the repatriation tax using a calibrated economic model with firms that have heterogeneous productivities. Firms in the model have the option of whether to service overseas markets through producing in the U.S. and exporting or establishing a subsidiary, which produces and sells its output directly in the foreign country. Each mode of servicing the foreign market involves payment of a flow fixed cost. Exporting incurs a lower fixed cost than having a foreign subsidiary, but involves incurring a transport cost equal to a fraction of its output; the optimal choice made by a firm involves trading-off these two types of costs. The model's solution is such that the most productive firms choose to be multinationals to circumvent losing some of their output to transport costs and less productive firms are exporters to avoid the high fixed cost of having a foreign subsidiary. Moving to a U.S. territorial tax system leads to a rise in the fraction of U.S. firms that operate as multinationals. The policy change alters the nature of the trade-off between being an exporter and a multinational --- in addition to saving on transport costs, multinationals get taxed at a lower rate on their earnings from selling to foreign consumers. More multinationals means fewer output losses to transport costs. This channel provides some support to the idea that the current worldwide system of taxation is hurting U.S. firms relative to their foreign competitors. Removing the tax results in more cash flow available for dividend distributions, which is beneficial for U.S. firms and investors.

A concern that some commentators have is that moving to a territorial system will give U.S. firms incentive to send their production of manufactured goods offshore. Indeed this is the case to an extent -- some firms that were previously producing domestically and exporting will offshore their production in upgrading to be multinationals. However, this negative impact of decreased export activity is negated by increased entry of new firms into the U.S. economy. Removing the tax raises the value to being a U.S. firm; there is an increase in the demand for U.S. labor as more firms are established, which has a positive effect on the real wage. A higher real wage means more consumption demand, which is met by higher domestic production. This effect of increased entry is quantitatively large enough to offset the offshoring of export production, leading to an overall increase in U.S. domestic output.

A prediction of the model, which is likely unforeseen by U.S. policymakers, is that removing the repatriation tax leads to an increase in the aggregate productivity of U.S. firms. As entry by new firms drives up domestic labor costs, unproductive firms that were operating under the worldwide system will become unprofitable and close-down their operations. This result indicates that a tax levied on large U.S. multinational firms also has an impact on small unproductive firms that operate only in the domestic market. The current repatriation tax seems to have a somewhat protectionist flavor to it by protecting these unproductive U.S. firms.

## Comparison to Repatriation Tax Holiday

In attempting to forecast the effectiveness of going territorial, some have pointed to a previous policy initiative of the U.S. Government known as the Homeland Investment Act of 2004. Colloquially, this Act has been referred to as the ``one-time repatriation tax holiday''. The policy allowed U.S. firms to repatriate their overseas earnings at a reduced U.S. tax rate for a temporary period of time and was enacted with a view to stimulate domestic investment and production.

A study by Dharmapala, Foley, and Forbes (2011) found that nearly all of the earnings that were repatriated under the Homeland Investment Act were paid-out to shareholders, with little eventuating in the way of real effects. I undertake a test of my model's predictions by running a counterfactual where I remove the U.S. tax, holding the number of U.S. firms constant and preventing exporters from changing their status. Doing so yields comparable results to the findings of Dharmapala et al. (2011). That is, when studying only the behavior of already established multinational firms such as Apple or IBM, this policy change mainly leads to increased distributions to investors and little changes to real investment. However, the crucial point of departure of the Homeland Investment Act from the recent Senate bill is that this territorial policy change is permanent. This permanence drives the creation of new firms and multinationals, which bring with them positive domestic real effects -- a point that has been overlooked when comparing the two policy initiatives.

## Overall Impact of Moving to a Territorial Tax System

The territorial policy change in my model results in higher dividend distributions to U.S. shareholders, higher output and higher real wages. These effects culminate in an increase in welfare when measured in terms of a representative U.S. household. These are all effects that can be viewed as positive for domestic workers, firms, and investors. A natural question to ask is, "How much do these positive effects cost the U.S. government in the way of foregone tax collections?" Estimates from the Joint Committee on Taxation suggest that the losses over the period 2018-2027 are substantial, at a value of $215.5 billion. However, my results show that there need not be any such tax losses: the policy change is roughly revenue neutral when accounting for incentive changes and equilibrium effects in the context of a model. This follows from the fact that corporate earnings made from domestic sales, labor income, and dividend distributions are all taxable by the U.S. government. The rise in these variables are enough to quantitatively offset the lost collections from firms that move their export production offshore and lost repatriation taxes.

Of course, there are many more aspects of the tax bill, which would also have an impact on the U.S. economy and tax collections of the federal government. An assessment of the full bill would involve evaluation of these additional aspects in the context of further carefully-designed counterfactuals. In isolation however, removing the repatriation tax appears to be good public policy: it removes a welfare-reducing distortion to the U.S. economy and it is approximately revenue neutral.

## References

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