

John H. Schnatter Institute for the Study of Free Enterprise

Understanding Precautionary Cash at Home and Abroad

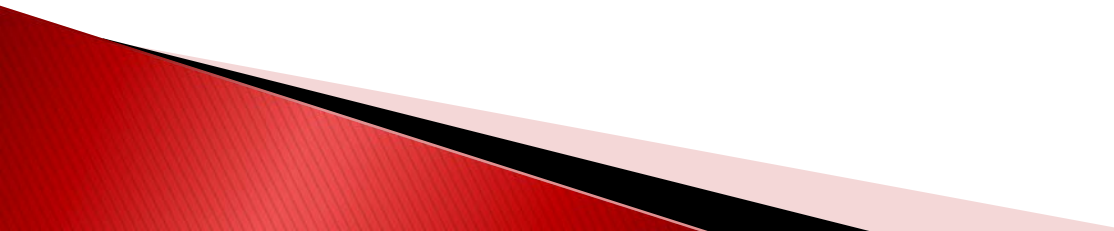
Michael Faulkender
University of Maryland

Kristine Hankins
University of Kentucky

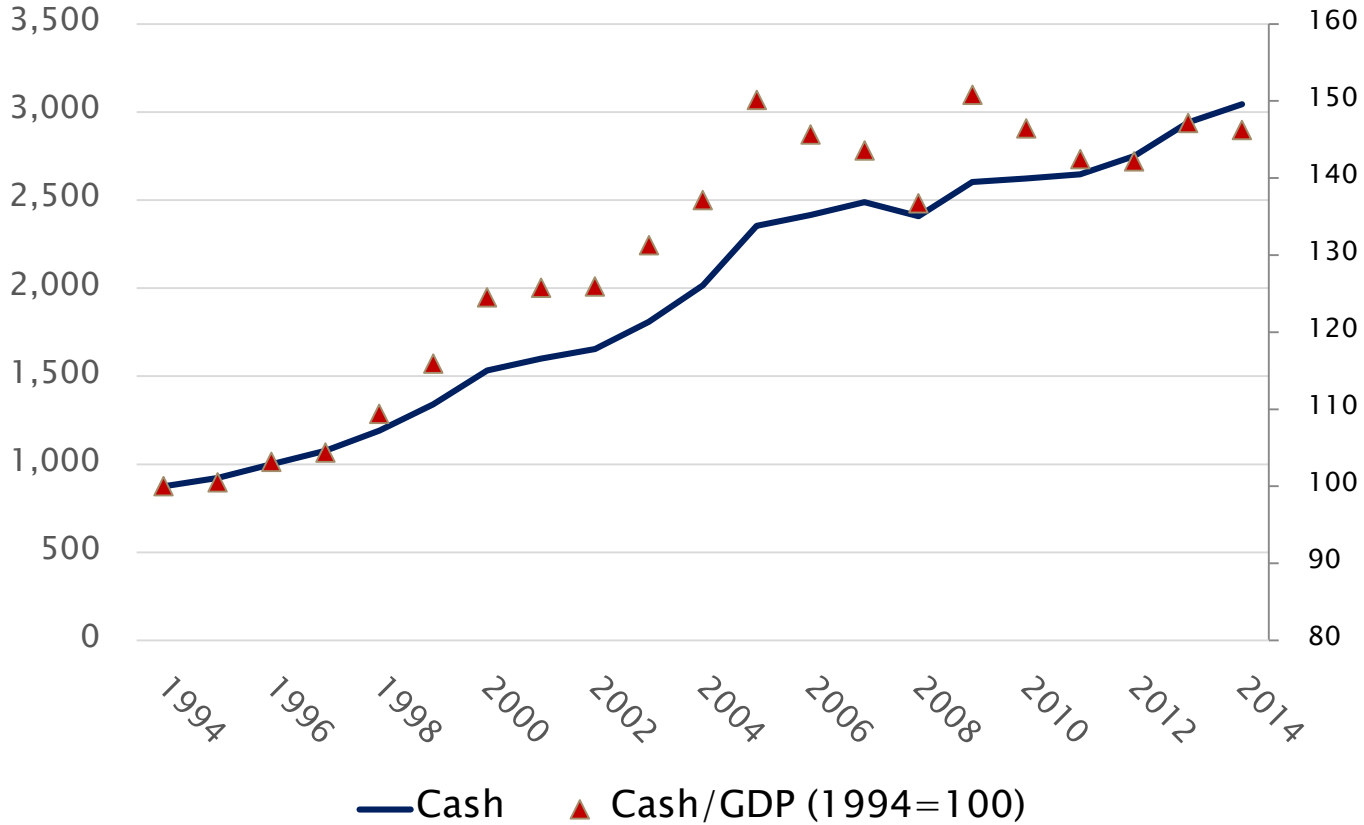
Mitchell Petersen
Northwestern University
and NBER

Disclosure

The statistical analysis of firm-level data on U.S. multinational companies was conducted at the Bureau of Economic Analysis, U.S. Department of Commerce, under arrangements that maintain legal confidentiality requirements. The views expressed in the paper are those of the authors and do not reflect official positions of the U.S. Department of Commerce.



Growth of Total Cash Holdings (\$B)



THE WALL STREET JOURNAL.

“U.S. Firms Build Up Record Cash Piles”

“Companies Shun Investment, Hoard Cash”

“Companies Cling to Cash”

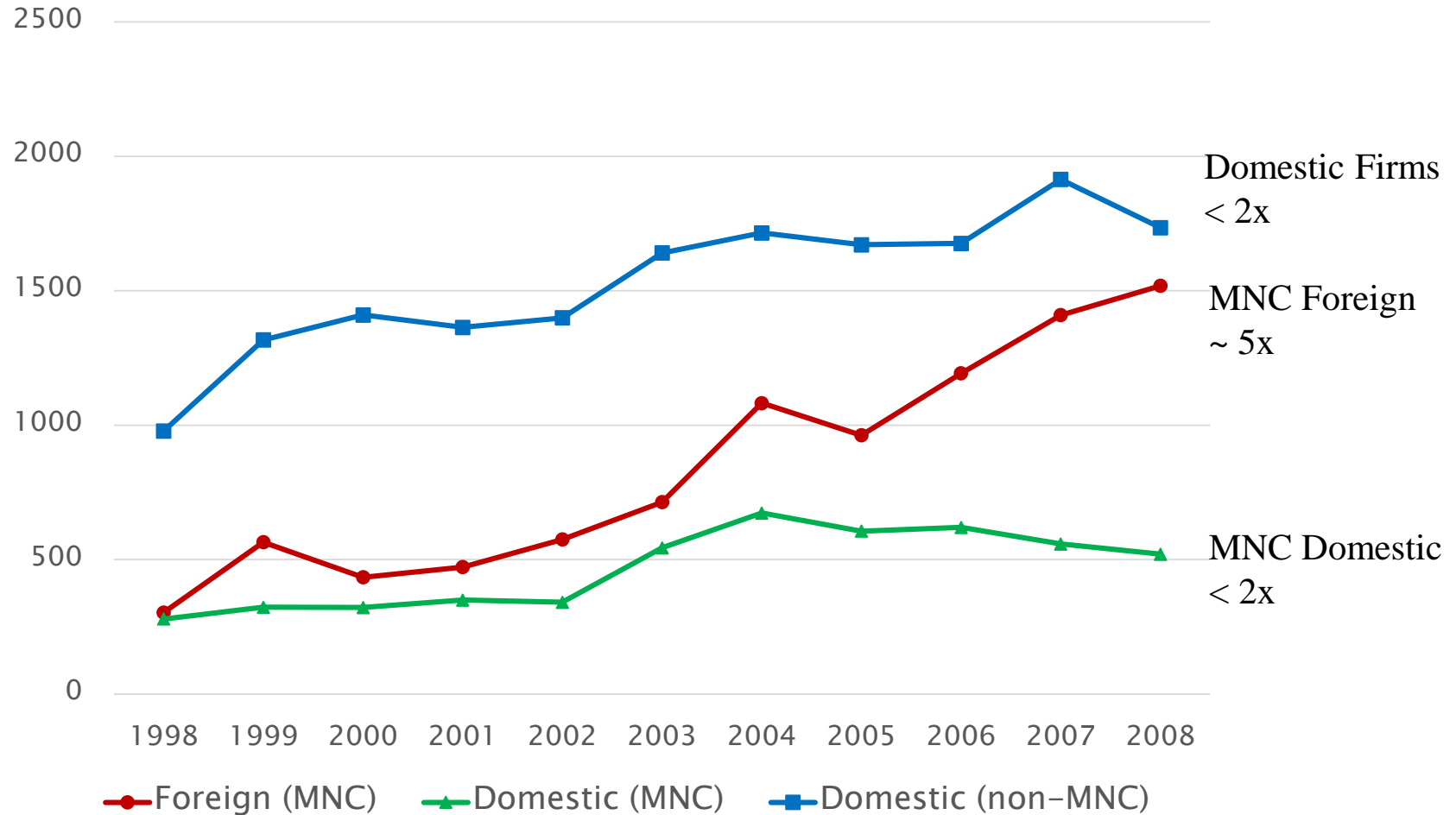
Why is Cash Growing?

- ▶ Many reasons to hold cash
 - Precautionary Motive
 - Provide sufficient funding of future investments
 - Tax Motive
 - Pay U.S. taxes on foreign earnings at time of repatriation
 - Foreign cash is ‘trapped’ abroad

Location of Cash

- ▶ Location affects use of cash
 - Does location tell us about its purpose?
- ▶ BEA mandatory survey of U.S. multinationals (MNC)
 - MNC subsidiary locations and foreign tax rates
 - Individual subsidiaries' total sales, cash, and within firm sales

Rise in Cash Revisited (\$B)



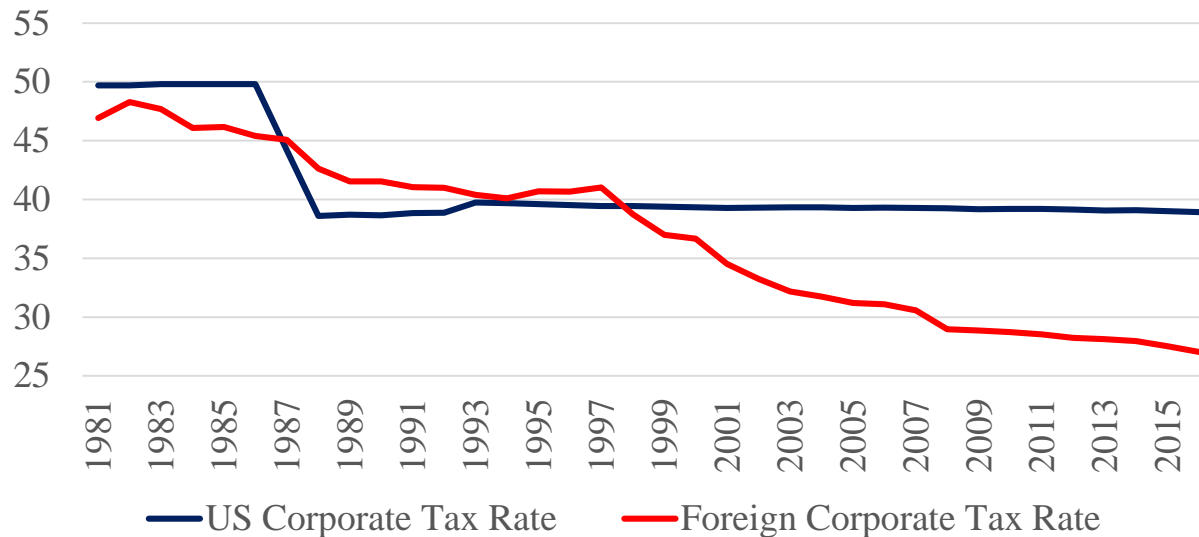
Need for Precautionary Cash

- ▶ Precautionary needs vary by firm
 - Uncertain investment opportunities
 - Valuable growth options
 - Product market competition
 - Cost of raising capital
- ▶ Empirics:
 - Precautionary variables explain trends in domestic cash
 - Do not explain foreign cash

Tax Motive

▶ Decreasing Foreign Tax Rates

- Value of deferring U.S. taxes increases with the wedge between U.S. and foreign rates



- Growing wedge contributes to run-up in foreign cash
 - Doesn't explain domestic cash

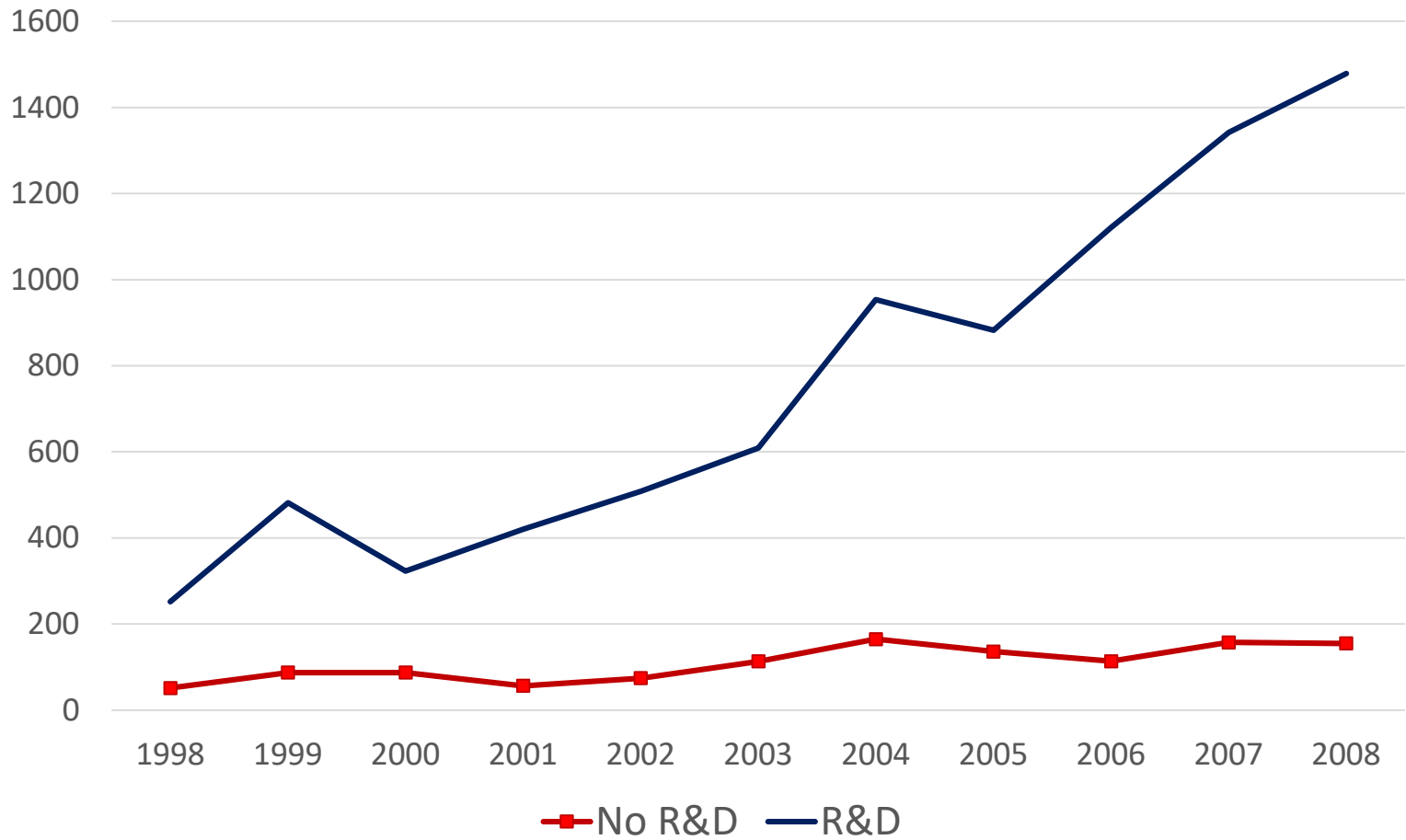
More Than 'Trapped' Cash

- ▶ MNCs Ability to Relocate Assets
 - Two shifts
 - Changes in tax law
 - Increased role of intellectual property (IP)
 - *Easier to move cash flow generating assets into low-tax countries*
- ▶ Active Tax Minimization
 - Minimizing taxes through transfer pricing
 - Sales between subsidiaries within firm or parent-sub sales (*Related*)
 - Intangible assets facilitate beneficial transfer pricing (*R&D*)
- ▶ Empirics
 - Tax rates matter for foreign cash run-up
 - But active within-firm sales of intangible assets is primary channel

Foreign Cash by Related Sales



Foreign Cash by R&D



Changing Patterns in Foreign Cash

▶ Top 6 Foreign Countries with Most MNC Cash

◦ 1998

<u>Cash</u>	<u>Sales</u>	<u>Tax Rate</u>
52.1%	41.8%	38.3%

- *Cash concentrated in foreign subsidiaries with foreign sales*

◦ 2008

<u>Cash</u>	<u>Sales</u>	<u>Tax Rate</u>
55.1%	25.3%	20.4%

- *Divergence of cash and sales*

Conclusion

- ▶ Precautionary Saving Motives
 - Explains domestic cash - not foreign cash
- ▶ Tax Motivations – Foreign Cash
 - Lower foreign tax rates lead to higher foreign cash
 - No effect on domestic cash
 - Related sales in high R&D firms → Foreign cash
- ▶ Rising Cash
 - Foreign cash is biggest driver
 - Active choice by firms to minimize taxes