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MEMO

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To: Norman Major, Chairman Ways and Means Committee, New Hampshire House of Representatives
From: Heather Brome, Policy Analyst; Bo Zhao, Economist; and Robert Tannenwald, Director
Re: **Answers to some of your questions**

This memo responds to many of the questions that you and other legislators raised at the seminar presented by Bo Zhao on December 13. A subsequent memo will address other questions raised at that time which we are still investigating. I am also sending a copy of this memo to you via regular mail, with accompanying supplementary material.

Will the tax-induced surge in repatriated profits significantly reduce the current account deficit?

To what extent, if any, are repatriated profits reflected in the U.S. current account deficit? The short answer is: very little. Dividend income is entered into the current account balance in the year that the dividend income is earned, not the year that the income is repatriated. Repatriation of dividend income from foreign investments will change only the *form* of the dividend, not the *amount*. Therefore, repatriation of dividend income as encouraged by the American Jobs Creation Act of 2004 will not affect the current account deficit through flows of capital into the United States. However, changing the form of the dividend income can trigger new payments of foreign withholding taxes. These payments can negatively impact the current account balance by raising the total amount of foreign taxes paid.

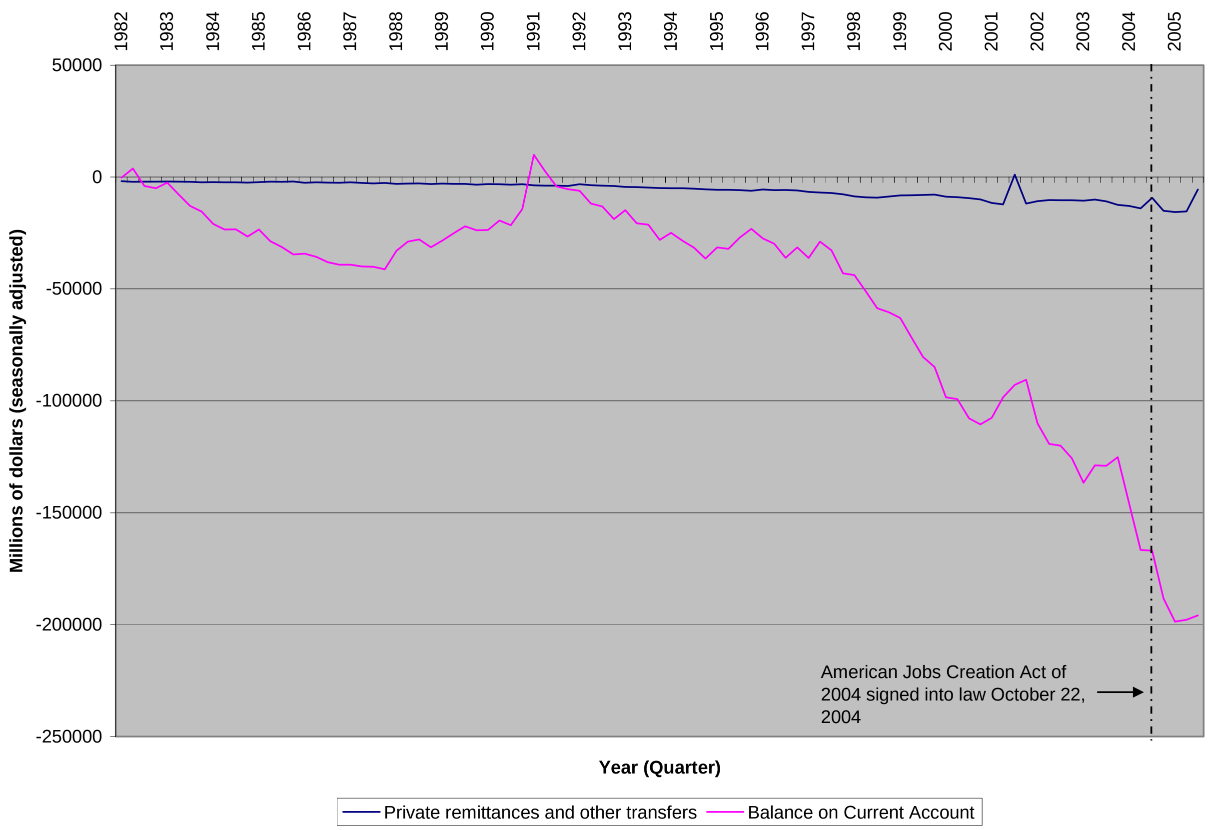
Background. In the current account, the full amount of US direct investors' shares in the earnings of their foreign affiliates is entered as direct investment income at the time that the earnings are earned, not when that income is repatriated and distributed as dividends. Payment of dividends changes the *form* of the direct investment income, but not the *amount*. Repatriated profits distributed as dividends would be entered into the account as direct investment dividend receipts. If profits from a foreign subsidiary are reinvested they are entered into the account as reinvested earnings. Repatriating direct investment dividends would raise direct investment distributed earnings and lower reinvested earnings by equal amounts, thereby offsetting any change to the balance. Therefore, this transaction would have *no net effect* on receipts of direct investment income.

The Bureau of Economic Analysis (BEA) reports: "In the current account, the size of income receipts (earnings) on U.S. direct investment abroad is unaffected by the (American Jobs Creation) Act, although the composition of earnings has been altered significantly as the amount of earnings reinvested in affiliates abroad has been drawn down to support the increased distribution of earnings to parents in the United States." (US International Transactions: Third Quarter 2005, December, 16, 2005) See Chart 2. Therefore, firms are responding to the incentives to repatriate dividend income, but this response does not affect income receipts.

While the trade-off has no net impact on the balance of the current account, a rise in dividend receipts may trigger payments of foreign withholding taxes. This causes the private remittances and other transfers to be more negative. This change is the entire change in the current account as a result of the tax incentive. The current account balance should become more negative—that is, the deficit should become larger—by the amount of the increase in payments of foreign withholding taxes. Private remittances and other transfers are a very small compared with the current account deficit. Chart 1 tracks the trends in the current account balance and private remittances and other transfers since 1982.

According to the BEA, the decrease in private remittances and other transfers that can be seen on Chart 1 is a most likely a result of unusually large claims received by US companies from foreign insurance companies as a result of extensive damage caused by hurricanes Katrina and Rita. Additionally, foreign donations to hurricane relief are reflected in this account. These two increases in U.S. receipts cause private remittances and other transfers to be less negative in the third quarter of 2005 and obscure or counter-balance any affect the American Jobs Recovery Act of 2004 may have on foreign tax payments by U.S. firms.

Chart 1: Current Account Deficit vs. Private Remittances and Other Transfers 1982 to present



Source: BEA http://www.bea.gov/bea/international/bp_web/simple.cfm?anon=71&table_id=1&area_id=3

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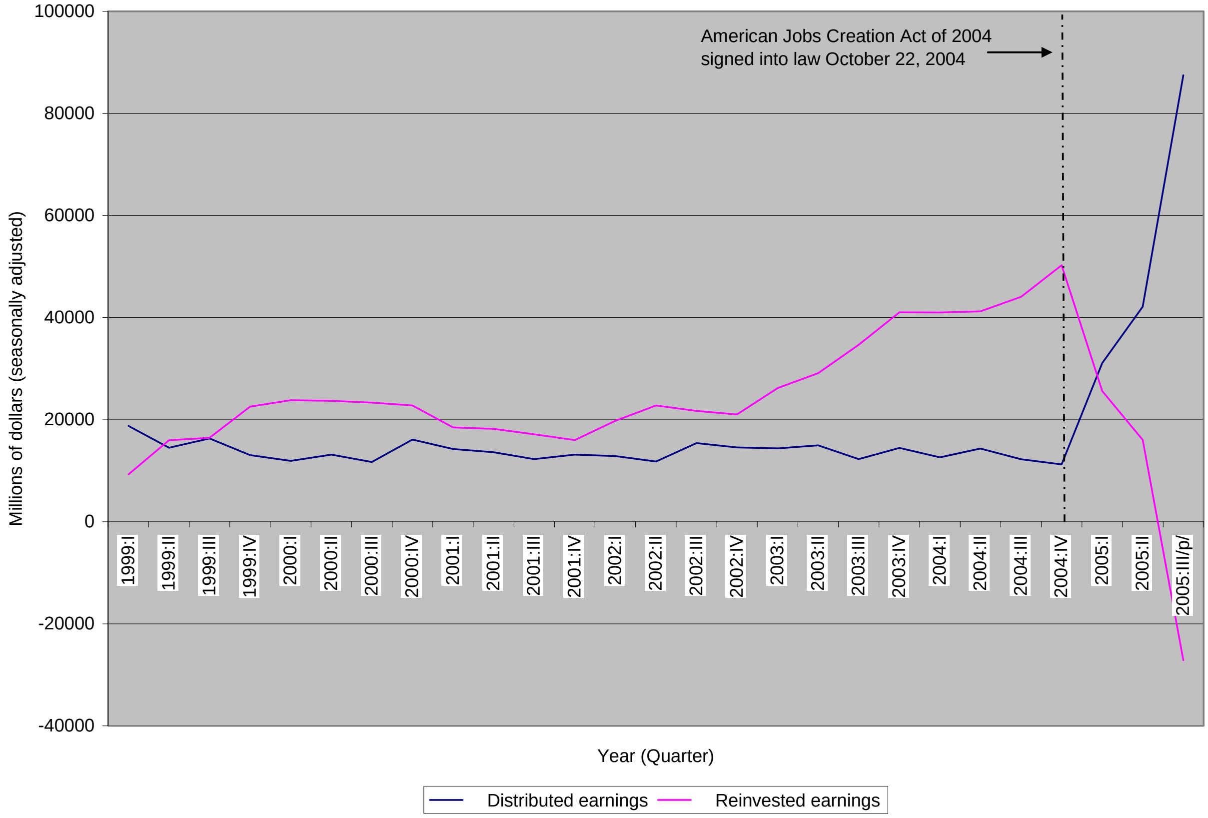
Chart 2: Dividend Distributions vs. Reinvestment of US Foreign Direct Investments 1999-present



Source: BEA http://www.bea.gov/bea/international/bp_web/simple.cfm?anon=71&table_id=18&area_id=3

Note: Third Quarter 2005 data are preliminary

Thus, even though firms are responding to the one-time tax incentives created by the American Jobs Recovery Act of 2004 for repatriation of foreign income to the U.S. from foreign subsidiaries, the impact has had little effect on the current account deficit. Dividend income is recorded at the time the dividend is earned, not at the time the dividend is repatriated. Therefore, repatriating dividends changes only the how the dividend is accounted for in the current account. Payment of foreign withholding taxes triggered by the repatriation of dividend income does negatively affect the current account balance. However, this impact is likely very small and has been obscured by insurance claims and foreign donations in the wake of hurricanes Katrina and Rita.

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How much is the United States spending in Iraq and Afghanistan? Isn't much of the money simply used to purchase U.S. goods and services and compensate U.S. personnel? If so, is the nation really losing that much as a result of this spending?

According to the Congressional Research Service, Library of Congress , since 9/11/01 approximately $357 billion dollars have been allocated to the wars in Iraq and Afghanistan and enhanced security of defense installations around the world. Estimated otal spending in Federal Fiscal Year 2005 was $108 billion. These estimates are necessarily rough because the federal government's accounts with respect to these efforts are so fuzzy. The breakdown is roughly 2/3 for Iraq, 24 percent for Afghanistan, and 9 percent for enhanced base security. The $108 billion was an estimated 33 percent of the federal deficit (on and off budget combined—on budge deficit was -507 billion) and 5 percent of total federal spending on and off budget. (Total : 2.142 trillion dollars; off budget: $576 billion).

While the funds allocated to these missions have purchased mostly U.S.-produced goods and services, they have been raised primarily through borrowing (since total annual spending on these missions is less than the federal deficit, and these missions are incremental projects—those added to those already in existence). So the notion that the missions don't really cost anything because they are being "given" right back to Americans (service men and women, defense contractors) is an illusion. Maybe we aren't paying for all this, but our children and grandchildren will pay for it.

The fiscal stimulus imparted by spending on these missions could reduce the net cost to the American people, if there are idle resources in the economy. However, we are no longer in recession. So, to the extent that the spending creates jobs and income in some industries, it comes largely at the expense of other industries. This zero-sum outcome could result directly (as resources are transferred from some industries to others), or indirectly (for example, by raising interest rates and inflation).

Did Federal Reserve Chairman Alan Greenspan say in a speech this month that the current account deficit and the federal deficit aren't such serious problems after all?

We believe that Representative Parker asked this question. We could find no such speech. Representative Parker alluded to some speech in London. On December 1, Chairman Greenspan addressed the G-7 annual meeting in that city. He indicated that the resilience and flexibility of the American economy have enabled the country to handle the deficits so far. He also said that a rise in protectionism would hinder the ability of the country to finance the deficits the future. He also said that "If the currently disturbing drift toward protectionism is contained and markets remain sufficiently flexible" then a rise in Americans' saving rates and other adjustments to reduce the U.S. trade deficit should proceed without problems. However, he never said that such adjustments wouldn't be painful. For example, why would savings rates rise unless interest rates rise? He also said explicitly that the trade deficit cannot exist forever, that the adjustments to which he is referring would have to reduce it. He also expressed deep concern about the federal deficit, particularly given the imminent retirement of baby boomers. The federal deficit is a very serious problem in Chairman Greenspan's view. Furthermore, according to the December 2 edition of the *International Herald Tribune*, "Greenspan called for America to stop the 'pernicious drift toward 'fiscal instability' created by the high current-account deficit". Mr. Greenspan was quoted as saying, "we do not as yet have a firm grasp on the implications of cross-border financial imbalances." According to the *Tribune* Chairman Greenspan said further that deficits that "cumulate to ever increasing net external debt, with its attendant rise in serving costs, cannot persist indefinitely."

Representative Almy raised concern about the volume of mortgage lending occurring outside of the relatively highly regulated banking industry. She is concerned that rising interest rates could cause serious economic dislocation, on a scale experienced during the savings and loan crisis of the 1980s, because so many loans are un-conventional, and as a result, mortgage interest rates will rise, causing a wave of defaults.

Representative Almy is correct to note that mortgages are owned by a wide variety of institutions (see accompanying pie chart). We do not yet have information on the financial condition of these institutions. However, it should be noted that, unlike 20 years ago, financial market have developed extremely sophisticated means of spreading the risk of rising mortgage rates. There is now a well-developed secondary mortgage market. Mortgages are packaged into mortgage-backed securities, which are then sold to a wide variety of financial entities. Partially as a result, few institutions (certainly not mortgage lenders, who unload their underwritten mortgages quickly) are actually exposed to potentially "lethal" doses of mortgage default risk. There has been some concerned about imbalances in the portfolios of Fannie Mae and Freddie Mac, but these concerns are being addressed.

As for individual households, while many low and low-moderate income households could have a nasty time of it if interest rates rise sharply (raising their mortgage and consumer credit servicing costs), the "average" American is still not so highly leveraged. Thus, the odds of a severe economic contraction induced by a significant rise in long-term interest rates are pretty low.

With respect to the rising incidence of non-conventional loans and allegations of a dangerous relaxation of credit standards, see materials that I will send you under separate cover.

How big Is the wage gender gap? Has it been growing?

Even though there has been extensive research on the gender differences in pay, there is no consensus on of the wage gap between men and women. General trends in the gender wage gap have emerged. After years of general constancy, the gender wage gap rapidly shrunk during the 1980s. That convergence slowed considerably during the 1990s even though women have gained ground in terms of education, experience, and other factors. The most recent Current Population Survey (CPS) data indicates that women earn **75 percent** what men do amongst full-time wage and salary earners. However, this difference does not include differences in education, experience, type of work, risk associated with work, or value of non-wage duties (childcare, parent care, cooking, cleaning). More rigorous econometric analyses controlling for many of these factors have been conducted, but many include data that is more than a decade old. GAO conducted a report in October of 2003. Their statistical analysis controlling for other factors[1] indicated that on average women earned **80 percent** of what men did in 2000. Not all of this difference is explainable by the GAO model; meaning there are many factors that are unmeasured or unmeasurable such as discrimination or trade offs between flexibility or other benefits and higher earnings. In short, some of this difference may arise from choices made by women to goals or

[1] Demographic data (age, race, education, marital status, number of children, age of youngest child, other family income, region, and urban or rural), Work Experience as self-reported, and labor market activity including hours worked, weeks out of the labor force, weeks unemployed, full-time or part-time employment, industry, occupation, and union status.

responsibilities other than the highest possible wage. Whether these trade-offs are voluntary or the result of societal expectations or pressures is undetermined. Additionally, what role discrimination plays in stereo-typing the "Mommy track" is also undetermined. Another trend in the gender wage gap, is that the gap varies significantly by age. Whether this indicates a trend towards future equity, or that wage gap between men and women are increases with age since on average men work more hours per year and are less likely to take time off and therefore gain experience more rapidly than women. The following table summarizes some of the most recent studies of the gender difference in pay.

Table 1: Estimates of the Gender Wage Gap in the United States

	Year of Data	Gender Gap Estimate
GAO	1983 to 2000	-.44 (no controls) -.21 (controls for independent variables)
GAO	2000	-.2025 (controls)
BLS	2000	(no controls; only full-time workers) -.24 – All Women -.32 – Ages 55-64 -.27 – 45-54 -.18 – 25-34 -.08 – 20-24
Blau and Kahn (2000)	1994-1999	-.24 (Full-time only)
Blau and Kahn (2004)	1998	-.20 (Full-time, non-farm wage and salary workers age 18-65)

NOTE: New Hampshire lags the New England Region and the national average in the gender wage gap. According to 2004 BLS calculations, Vermont had the narrowest pay gap in the region with women earning 85% of what men did while New Hampshire had the widest with women earning only 72.3% of what men did.

Sources:

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