

ECONOMY

Why Are Companies Sitting on So Much Cash?

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U.S. non-financial corporations are sitting on just over \$4 trillion dollars in cash, according to the latest Flow of Funds estimates, up from \$2.7 trillion a decade ago and just \$1.6 trillion in 2000. The question is why, and what should executives learn from this massive growth in corporate cash holdings?

Obviously, cash provides excellent insurance in times of escalating uncertainty. It insulates firms from risk in the financial markets, ensuring the ability to fund critical projects and compete strategically in their product market. But are firms holding so much cash just out of an abundance of caution? Since managing liquidity is one of the CFO's most important tasks, particularly in the face of a potential economic downturn, understanding what motivates peer firms' cash levels can help executives make more informed decisions for their own firm.

Our research in the *Review of Financial Studies* explores how much of the enormous increase in corporate cash reserves is driven by precautionary needs. By using non-public data from the Bureau of Economic Analysis to trace the location of corporate cash within firms, we document that the cash hoarding is concentrated in a limited number of multinational corporations (MNCs) and that 85% of the rise in cash held by MNCs is held in their foreign subsidiaries.

More importantly, risk and uncertainty concerns don't explain the lion's share of increased corporate cash. Our estimates suggest that 79% of the increase in foreign cash is due to a combination of declining international tax rates and active tax minimization behavior by U.S. corporations. While global uncertainty may be elevated, precaution doesn't explain why some corporations are sitting on more than \$100 billion dollars each. Taxes do.

So why don't all firms shift income into low-tax foreign jurisdictions and reduce their tax bills? Since the U.S. government doesn't look kindly on tax avoidance, firms aren't given free rein to attribute income to foreign

subsidiaries in low tax jurisdictions. Income generating assets need to be transferred to the desired locale. To relocate assets between subsidiaries, a firm must assign a value to an intercompany sale. Appropriate transfer prices – the price used for these within-firm sales – should reflect the value of the asset and minimize the tax benefits of shifting income. There is ample evidence that intellectual property, which is more difficult to value, can be moved more easily to foreign subsidiaries using strategic transfer pricing to facilitate tax minimization. Our research showed this as well; 92% of the rise in foreign cash documented in our paper occurs in firms with intellectual property (as measured by positive expenditures on R&D) and active intercompany sales to relocate assets between subsidiaries.

This is not to say that there is not a precautionary need for cash. To the contrary, risk and uncertainty affect domestic cash levels of both non-MNC and MNCs. However, the impact of tax and precautionary motivations on cash are vastly different in magnitude. We find that domestic cash, which isn't driven by tax concerns, increases only slightly faster than GDP. For comparison, MNC's foreign cash holdings increase almost three times as quickly during the same period. This can provide valuable information for executives. Doing the due diligence on peers' effective tax rate and use of tax havens can provide a useful lens for understanding how much a peer's cash is changing due to concerns about future financing or investment opportunities.

The Tax Cuts and Jobs Act of 2017 (TJCA) both permitted the transfer of cash between subsidiaries and the parent tax-free and lowered the corporate tax rate to 21%. Lowering the tax rate substantially reduces – but does not remove – the motivation to shift income since many countries still have far

lower corporate tax rates than the U.S. and income generated in low tax jurisdictions now can flow freely within the firm or be returned to shareholders. While the TJCA introduced a variety of other measures to minimize corporations' future shifting of intangible asset income out of the U.S., the effectiveness of those rules remains to be seen. Cash levels, according to the Flow of Funds estimates, have continued to rise since the law's passage. What we do see in our research is that firms aren't living in fear or hoarding increased levels of cash to cope with rising uncertainty. As executives survey their product market, understanding competitors' cash decisions can lead to more efficient liquidity management.

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