TAX POLICY AND THE GLOBAL SAVING GLUT

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The tax rules governing investment in the United States offer very favorable treatment to foreign investors: the typical foreign investor pays no U.S. tax on passive investment in the United States. These tax rules have been shaped by the assumption that the United States needs to attract scarce financial capital to fill the gap between domestic saving and investment. But that assumption is wrong; global financial capital is not scarce. Over the past three decades, regressive economic policies abroad have suppressed consumption and led to an overabundance of saving. What is more, instead of financing productive investment, the flow of that foreign saving to the United States has financed unproductive consumption, fueling a widening trade deficit and financial instability. This Article calls for a reevaluation of U.S. inbound tax rules, proposing to increase taxation on foreign investment to address trade imbalances and enhance financial stability.

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INTRODUCTION

Tax rules governing foreign investment in the United States have been shaped by the assumption that financial capital is globally scarce.[1] In order to attract scarce foreign capital, the United States must offer preferential terms, including favorable tax treatment, to foreign investors. That favorable treatment includes the tax exemption of most capital gains from the sale of U.S. investment assets and interest from U.S. bank deposits and most private and public debt obligations.[2] The purported need for scarce foreign capital, in turn, is driven by the gap between America's appetite for consumption and investment and the ability of the domestic economy to satisfy that appetite.[3] To bridge that gap, the United States needs to import goods and services from abroad and borrow from foreign investors to finance the purchase of those imports. On this

1 A note on terminology: This Article refers throughout to "foreign investment," but that is distinct from "investment" in the sense of expenditures on capital goods and services. As used here, foreign investment refers to the demand for financial assets, which might be used to finance spending on capital goods and services, through the creation of new financial claims. But it might also be used to purchase existing financial assets or to finance spending on consumer goods or government spending on social programs. It is therefore important that these two senses of "investment" not be conflated. *See* Harry Grubert & John Mutti, *Financial Flows Versus Capital Spending: Alternative Measures of U.S.-Canadian Investment and Trade in the Analysis of Taxes*, *in* INTERNATIONAL ECONOMIC TRANSACTIONS: ISSUES IN MEASUREMENT AND EMPIRICAL RESEARCH 293, 293–94 (Peter Hooper & J. David Richardson eds., 1991).

2 *See infra* Sections I.B–D.

3 *See infra* Section II.C.

account, the tax treatment of foreign investment in the United States results from "American profligacy, both at home and abroad, that has transformed the United States from the world's largest exporter of capital to its largest importer."[4]

But the scarce capital assumption is wrong. Over the past thirty years, saving in foreign countries has exceeded investment, leading to a "global saving glut."[5] The global saving glut is the product of regressive policies in those countries that have shifted the distribution of income toward the wealthy and away from the middle and working classes. Since the wealthy consume a relatively smaller share of their incomes, aggregate saving rates in those countries have risen.[6] But those countries do not have sufficient demand to soak up those savings: the same regressive policies that have given rise to high saving rates have also suppressed domestic investment and consumption.[7] Instead, those excess savings must be channeled abroad; they end up in the United States, with its deep and open financial markets.[8]

For the United States to accommodate those financial inflows, there must be a gap between domestic saving and investment.[9] Either domestic investment must go up, because foreign inflows finance productive investments, in things like new factories or research and development. Or domestic saving must go down, if foreign investors purchase financial assets that would have otherwise been held by Americans or lent to Americans to finance consumption.[10] In practice, foreign capital inflows over the past thirty years have not financed productive investment.[11] Instead, they have mostly resulted in a reduction in net saving, through an increase in U.S. government and household debt. This increase in debt has subsidized domestic demand, allowing Americans to consume more than they produce, but has also fueled speculative investment and financial instability.[12] In addition, the willingness of foreign savers to exchange current goods and services for future claims on U.S. assets has displaced American production, especially in the manufacturing sector.[13]

4 BRET WELLS, INTERNATIONAL TAXATION 130 (5th ed. 2022).

5 Ben S. Bernanke, Governor, Fed. Rsrv., Remarks at the Sandridge Lecture, Virginia Association of Economists: The Global Saving Glut and the U.S. Current Account Deficit (Mar. 10, 2005), https://www.federalreserve.gov/boarddocs/speeches/2005/200503102 [https://perma.cc/D2UQ-UM94].

6 *See infra* Section II.B.

7 *See infra* Section II.B.

8 *See infra* notes 200–214 and accompanying text.

9 *See infra* Section II.C.

10 *See infra* notes 217–229 and accompanying text.

11 *See infra* notes 212–214 and accompanying text.

12 *See infra* notes 225–234 and accompanying text.

13 *See infra* notes 200–214 and accompanying text.

The United States does not need to import scarce financial capital because it consumes more than it produces; it consumes more than it produces because it absorbs excess foreign capital.

This Article argues that the abundance of foreign financial capital, and the distortions caused by its inflow into the United States, should lead to a fundamental reevaluation of the U.S. inbound tax rules. Rather than attempting to attract foreign financial capital with favorable tax treatment, U.S. tax rules should increase the tax burden on foreign investment. That can be accomplished in part through administrative action, though more significant changes to the taxation of foreign investment in the United States would require statutory revisions or the renegotiation of existing tax treaties.[14] If foreign demand for U.S. financial assets is sufficiently strong, that increased tax burden will fall primarily on foreign investors. Even if it does not, taxing foreign investment could help address U.S. trade imbalances and enhance the stability of the U.S. financial system.[15] More generally, this Article demonstrates that tax policy cannot be beholden to decades-old economic assumptions, but must be calibrated to current economic realities.

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Part I of this Article outlines the tax rules applicable to foreign investment in the United States, highlighting how specific provisions have been shaped by the scarce capital assumption. Capital gains from the sale by foreign investors of most U.S. investment assets are exempt from tax.[16] Broadly construed safe harbors ensure that most foreign investors will not be treated as engaged in a U.S. trade or business, which would trigger more onerous tax consequences.[17] More importantly, interest income from U.S. bank deposits and "portfolio" debt (which includes most private and public debt obligations) is also tax exempt.[18] And certain foreign investors, such as foreign central banks and sovereign wealth funds, benefit from tax exemptions that are even more generous.[19]

Part II explains how the "global saving glut" of the past three decades has undermined the scarce capital assumption. Domestic saving imbalances arise when local savings exceed local investment opportunities—when a country produces more than it demands as consumption or investment.[20] In the case of the global saving glut, these

14 *See infra* Section III.B.

15 *See infra* Section III.A.

16 *See infra* Section I.B.

17 *See infra* Section I.B.

18 *See infra* Section I.C.

19 *See infra* Section I.D.

20 *See infra* Section II.A.

imbalances are the result of regressive policies that suppress domestic consumption by redistributing income upward, to individuals and business that save a higher proportion of their incomes.[21] Because production and demand must balance on a global level, excess production in surplus countries must show up as excess demand in deficit countries.[22] Over the past thirty years, the United States has been the destination of choice for foreign financial capital, leading to a widening trade deficit.[23] Domestic demand in the United States, which exceeded domestic production, was sustained by cheap borrowing from abroad, fueling asset bubbles and financial instability.[24]

Part III returns to tax policy. If foreign financial inflows are not *pulled* by a domestic need for scarce foreign capital but *pushed* onto the United States by excess saving abroad, then there is no reason why they should receive preferential tax treatment. The United States should instead aim to increase the tax burden on foreign investment. Options include challenging structures relied on by foreign investors to ensure favorable tax treatment for lending to U.S. borrowers; eliminating tax exemptions for portfolio interest income; taxing foreign investors on their capital gains; and limiting the tax exemptions available to foreign central banks and sovereign wealth funds. In a world of overabundant financial capital, the United States does not need to subsidize foreign financial inflows with favorable tax treatment. If anything, it should use tax policy to deter—not attract—foreign financial inflows.

I. THE SCARCE CAPITAL ASSUMPTION AND THE TAX TREATMENT OF FOREIGN INVESTMENT

The current tax treatment of foreign investment in the United States rests on basic assumptions about the scarcity of financial capital and its

21 *See infra* Section II.B.

22 *See infra* Section II.C.

23 *See infra* Section II.C.

24 The economic argument *infra* Part II draws on the work of several economists. *See, e.g.*, Bernanke, *supra* note 5; Ben S. Bernanke, Carol Bertaut, Laurie Pounder DeMarco & Steven Kamin, *International Capital Flows and the Returns to Safe Assets in the United States, 2003–2007* (Fed. Rsrv. Bd., Int'l Fin. Discussion Paper No. 1014, 2011); Kenneth Austin, *Communist China's Capitalism: The Highest Stage of Capitalist Imperialism*, 12 WORLD ECON. 79 (2011); Kenneth Austin, *Systemic Equilibrium in a Bretton Woods II-Type International Monetary System: The Special Roles of Reserve Issuers and Reserve Accumulators*, 36 J. POST KEYNESIAN ECON. 607 (2014); MATTHEW C. KLEIN & MICHAEL PETTIS, TRADE WARS ARE CLASS WARS: HOW RISING INEQUALITY DISTORTS THE GLOBAL ECONOMY AND THREATENS INTERNATIONAL PEACE (2020); Atif R. Mian, Ludwig Straub & Amir Sufi, *The Saving Glut of The Rich* (Nat'l Bureau of Econ. Rsch., Working Paper No. 26941, 2021), https://www.nber.org/papers/w26941 [https://perma.cc/X8Z8-K32Q].

importance for economic development. This Part traces the evolution of key U.S. tax rules governing foreign investment, highlighting how this scarce capital assumption was repeatedly invoked to justify favorable tax treatment for foreign investors. It begins with a League of Nations report on cross-border taxation, which relied on the scarce capital assumption to argue for the reduction of taxation at source—at least for passive income—a position that was reflected in early U.S. tax treaties. It then shows how, from early discussions about the taxation of capital gains to the more recent exemption for portfolio interest, U.S. tax policy has been driven by the persistent notion that reducing the tax burden on foreign investment was necessary to encourage the inflow of much-needed financial capital.

A. *The Scarce Capital Assumption and Cross-Border Tax Principles*

In 1921, the newly established League of Nations commissioned four economists to study the problem of double taxation on cross-border business and investment activities, where both source jurisdictions (where income is produced) and residence jurisdictions (where it is consumed or saved) claim the right to tax income.[25] Their report, which was finalized in 1923, included an economic analysis of double taxation as well as a discussion and development of general principles for international taxation.[26] The analysis of the economic incidence of double taxation applied (or anticipated) the standard, neoclassical account of international capital flows, according to which financial capital is pulled from advanced economies with large capital stocks and low marginal returns to investment, to developing economies with relatively small capital stocks and higher marginal returns to investment.[27]

In equilibrium, the return to capital is set at the global level, at the rate that balances the supply of financial capital (saving) with demand (investment).[28] As a result, any tax imposed by a source jurisdiction on cross-border capital flows will be borne by residents of that jurisdiction; if the tax were to instead reduce investors' rate of return, they would

25 *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, & Sir Josiah Stamp*, League of Nations Doc. E.F.S.73 F.19 at 3 (1923).

26 *See id.* at 5–39.

27 *See id.* at 7–8; *see also* Robert E. Lucas, Jr., *Why Doesn't Capital Flow from Rich to Poor Countries?*, 80 AM. ECON. REV. 92 (1990) (describing the simple neoclassical model).

28 *See Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, & Sir Josiah Stamp*, *supra* note 25, at 8, 15.

invest elsewhere at the global rate.[29] Taxes imposed by a source country on foreign investors raise the cost of capital in that country, making it more difficult for residents of that country to attract scarce capital and make productive investments.[30] According to the report, source countries recognize that they bear the burden of source-based taxes, which is why they issue tax-exempt government bonds to foreign investors: "[W]hen Government and powerful municipalities are borrowing and attempting to attract foreign capital, they are willing to forego the tax on the foreigner."[31]

Based on this analysis of the incidence of source-based taxes, the report recommended universal residence-based taxation as a first-best option: source countries should relinquish all tax jurisdiction over cross-border income, so that all income is fully taxable in residence countries.[32] Not only would full residence-based taxation encourage free and efficient international capital flows,[33] it would also be most consistent with taxation based on a taxpayer's "ability to pay," since only a residence country can observe all a taxpayer's income.[34] The report, however, acknowledged that source countries were unlikely to fully cede their tax authority over foreign investors' income.[35] As such, it suggested alternative methods of divvying up tax jurisdiction, including the "classification and assignment" method: income from active business activities should be primarily taxed by the source country (with those taxes credited by the residence country) while income from passive investment activities should be taxed by the residence country.[36] The report concluded that the "classification and assignment" method was the most likely to be applied in practice.[37]

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29 *See id.* at 8–10, 14–15; *see also* Roger H. Gordon, *Taxation of Investment and Savings in a World Economy*, 76 AM. ECON. REV. 1086, 1095–96 (1986) (stating that a government in a small open economy should not impose any source-based taxes on capital); Rachel Griffith, James Hines & Peter Birch Sørensen, *International Capital Taxation*, *in* DIMENSIONS OF TAX DESIGN: THE MIRRLEES REVIEW 914, 927–29 (Stuart Adam et al. eds., 2010) (describing theoretical models that conclude that source-based taxation of capital income is inefficient).

30 *See Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, & Sir Josiah Stamp*, *supra* note 25, at 41.

31 *See id.*

32 *See id.* at 41–42, 48–49.

33 *See id.* at 41–42.

34 *See id.* at 18–20.

35 *Id.* at 40 ("A survey of the whole field of recent taxation shows how completely the Governments are dominated by the desire to tax the foreigner . . . . From this flows the consequence that, when double taxation is involved, Governments would be prepared to give up residence rather than origin as establishing the prime right."); *see also id.* at 49–51 (describing source countries' reluctance to give up tax jurisdiction over foreign investors).

36 *See id.* at 42.

37 *See id.* at 51.

Although the historical significance of the economists' report has been the subject of scholarly debate,[38] its distinction between active business income and passive investment income proved influential.[39] The distinction was incorporated into two of the League of Nations' three initial model income tax treaties.[40] While all three model treaties allowed source countries to tax active business income of a taxpayer that established sufficient nexus with the source country in the form of a "permanent establishment," two limited the extent to which source countries could tax passive investment income.[41] Under these two model tax treaties, the authority to tax interest and dividend income was assigned to residence countries, as recommended by the economists' report.[42] These two model treaties differed in their treatment of withholding taxes at source on passive investment income: under one, source countries were required to refund any such taxes on foreign investors; under the other, source countries were entitled to levy limited withholding taxes on that income, in which case the residence country was expected to exempt the income from tax or provide a credit on foreign tax paid.[43]

A similar distinction between active and passive income influenced U.S. cross-border tax policy. An early legislative effort was made to fully exempt, on condition of reciprocity, dividends and interest paid to

38 *Compare* Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 TAX L. REV. 565, 567 (1992) (describing the League of Nations report as the "intellectual base from which modern treaties developed"), *and* Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1306 (1996) (arguing that the principles outlined in the League of Nations report "underlie the development of the current consensus regarding the proper allocation of taxable income among taxing jurisdictions"), *with* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1027, 1074–89 (1997) (downplaying the historical importance of the League of Nations report), *and* John F. Avery Jones, *Sir Josiah Stamp and Double Income Tax*, *in* 6 STUDIES IN THE HISTORY OF TAX LAW 27 (John Tiley ed., 2013) ("One would like to have been able to say that the 1923 Report was the economic foundation for the future of double taxation relief, or even of tax treaties, but that is not the case.").

39 *See* H. David Rosenbloom & Stanley Langbein, *United States Tax Treaty Policy: An Overview*, 19 COLUM. J. TRANSNAT'L L. 359, 366 (1981) (explaining that the "classification and assignment" structure is "used today in virtually all tax treaties").

40 *Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.562.M.178 (1928).

41 *See id.* at 8 (providing language for draft convention 1a); *id.* at 16 (draft convention 1b); *id.* at 19 (draft convention 1c).

42 *See id.* at 16; *id.* at 20 (providing language for draft convention 1c).

43 JOHN G. HERNDON, JR., RELIEF FROM INTERNATIONAL INCOME TAXATION: THE DEVELOPMENT OF INTERNATIONAL RECIPROCITY FOR THE PREVENTION OF DOUBLE INCOME TAXATION 239–41 (1932).

foreign investors from withholding tax at the source.[44] Although that bill died in the House Ways and Means Committee, the draft legislation was reflected in subsequent tax treaties.[45] The United States' bilateral tax treaty with Sweden, finalized in 1939, provided that the active business income of an enterprise resident in one country that was allocable to a permanent establishment in the other country would be taxable in the source country.[46] Dividends, interest, and capital gains, by contrast, were allocated to the residence country of the recipient, with the source country allowed to withhold tax on dividend (up to 10%) and interest income.[47] Tax treaties with Canada (in 1936 and 1942) and the United Kingdom (in 1945) included similar provisions,[48] with the United Kingdom treaty exempting interest income from withholding tax at source entirely.[49] Reduction of source taxation on passive income would become the cornerstone of U.S. tax treaty policy.[50]

While the United States has long pursued the reciprocal reduction of source country taxation in its bilateral tax treaties, it did not initially offer favorable tax treatment to inbound passive investment on a unilateral basis. In the earliest days of the federal income tax, the United States asserted the right to tax foreign investors on their passive

44 *See* Mitchell B. Carroll, *Evolution of U.S. Treaties to Avoid Double Taxation of Income Part II*, 3 INT'L LAW. 129, 129–30 (1968).

45 *See id.*

46 *See* Convention for the Avoidance of Double Taxation and the Establishment of Rules of Reciprocal Administrative Assistance in the Case of Income and Other Taxes, Swed.-U.S., art. II, Mar. 23, 1939, T.S. No. 958.

47 *See id.* arts. VII–IX (pertaining to dividends, interest, and capital gains, respectively).

48 *See* Rates of Income Tax on Nonresident Individuals and Corporations, Can.-U.S., Dec. 30, 1936, T.S. No. 920; Convention and Protocol for the Avoidance of Double Taxation and Prevention of Fiscal Evasion in the Case of Income Taxes, Can.-U.S., Mar. 4, 1942, T.S. No. 983; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.K.-U.S., Apr. 16, 1945, T.I.AS. No. 1546.

49 *See* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, *supra* note 48, at 5–6.

50 *See* Julie Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 VA. L. REV. 1753, 1755 (1995) (arguing that "the desire to reduce source taxation to the lowest possible level" is one of the United States' "most time-honored treaty policies"). Since it was first issued, the U.S. model income tax treaty, which serves as the point of reference for all U.S. tax treaty negotiations, has applied a reduced rate of withholding on dividends and exempted interest income from withholding by the source country. *See* U.S. Dep't of Treasury, United States Model Income Tax Convention, art. 10, 2016 (addressing dividends); *id.* art. 11 (interest); *id.* art. 13 (gains); Rosenbloom & Langbein, *supra* note 39, at 383–84; U.S. DEP'T OF TREASURY, IRS, TABLE 1: TAX RATES ON INCOME OTHER THAN PERSONAL SERVICE INCOME UNDER CHAPTER 3, INTERNAL REVENUE CODE, AND INCOME TAX TREATIES (2023), https://www.irs.gov/pub/irs-lbi/tax-treaty-table-1.pdf [https://perma.cc/5Y69-R96A] (listing treaty withholding and tax rates for interest and dividend income).

investment income.[51] Passive income earned by foreign investors in the United States was first subject to tax on a net basis at graduated rates, then to flat-rate taxation on a gross basis.[52] Even under current law, foreign investors are subject to withholding at a 30% flat rate on the gross amount of any "fixed, determinable, annual or periodic" income from U.S. sources, unless the income qualifies for a specific exemption.[53] Yet, as U.S. tax policy evolved over subsequent decades, the scarce capital assumption would continue to be invoked to justify the creation of tax exemptions for foreign investors that eventually swallowed the general rule.

B. *Capital Gains and the Securities Trading Safe Harbor*

The rules governing the taxation of foreign investors' capital gains exemplify the evolution toward favorable tax treatment of foreign investors. These rules have been revised repeatedly with the aim of attracting foreign investment in the United States. In the early 1930s, the Treasury Department made halting efforts to tax foreign investors on gains from the sale of securities and other capital assets in the United States.[54] As a technical matter, such tax was owed under a plain-sense reading of the relevant statutes, which provided that upon the sale or exchange of property "the entire amount of the gain or loss . . . shall be recognized," regardless of the residence of the taxpayer.[55] Gain realized on the sale of a capital asset by a foreign investor was taxable so long as the asset was sold within the United States.[56] As a result, any foreign investor who sold American securities through a banker or broker in the United States owed tax on any gain realized on the sale.[57]

The Treasury's attempts to collect tax on foreign investors' capital gains were limited by both practicality and policy. Foreign investors looking to avoid the tax could shift their selling orders to brokers in

51 *See* Montgomery B. Angell, *The Nonresident Alien: A Problem in Federal Taxation of Income*, 36 COLUM. L. REV. 908, 908–10 (1936).

52 *See infra* notes 78–79 and accompanying text.

53 *See* I.R.C. §§ 871(a), 881(a).

54 *See* Arthur H. Kent, *The Federal Tax Program for 1935 and 1936*, 29 PROCS. ANN. CONF. ON TAX'N UNDER AUSPICES NAT'L TAX ASS'N 207, 219 (1936); Angell, *supra* note 51, at 910–11; Carroll, *supra* note 44, at 156.

55 Revenue Act of 1934, Pub. L. No. 73-216, § 112, 48 Stat. 680, 704.

56 *Id.* § 119(e). The Supreme Court confirmed that the United States had jurisdiction to assess tax on nonresidents. Burnet v. Brooks, 288 U.S. 378, 393 (1933) (holding that stocks and bonds of a British citizen held for safekeeping in the United States are subject to estate taxes); *see also* Comm'r of Internal Revenue v. Nevius, 76 F.2d 109 (2d Cir. 1935) (extending *Brooks* to a case in which a British citizen, residing in England, exercised trustee authority over stocks and bonds of American corporations).

57 *See* Angell, *supra* note 51, at 913–15.

Toronto, London, or other foreign cities, which arguably deprived the United States of tax jurisdiction.[58] Even if the sale was consummated in the United States, it could be difficult for the Treasury to discover sales by foreign investors who did not otherwise file a U.S. tax return.[59] The Treasury was also reluctant to collect taxes, even where owed, out of concern that doing so would discourage foreign investment.[60]

As a result of these difficulties, Congress abandoned efforts to tax most foreign investors on their U.S.-source capital gains. The Revenue Act of 1936 exempted from tax the capital gains of purely passive foreign investors—those not engaged in trade or business in the United States.[61] That exemption was coupled with a new flat-rate tax, withheld at source, from dividends, interest, rents, and royalties and other recurring income (some foreign investors were eligible to reduce, or eliminate, these withholding taxes under applicable tax treaties).[62] Foreign investors who were engaged in an active U.S. trade or business, however, continued to be subject to tax on their net income from U.S. sources, including capital gains and any other passive investment income. This rule became known as the "force of attraction" doctrine, because the investor's U.S. trade or business "attracted" all of the foreign investor's U.S.-source income and subjected it to tax at regular rates—whether or not it was actually attributable to that business.[63]

That basic structure remained in place until the 1960s, when the tax rules governing foreign investment in the United States were revisited as part of efforts to resolve its burgeoning "balance of payments" problem.[64] The postwar Bretton Woods system required the United States to guarantee convertibility of foreign currencies into U.S. dollars at fixed exchange rates, while ensuring that dollars could be exchanged for gold at a fixed rate. This system, which replaced the gold standard with a dollar standard, meant that foreign central banks had to hold U.S. dollars and other short-term U.S. government debt to manage the value of their own currencies relative to the dollar.[65] Throughout the 1950s, Americans bought more financial assets abroad than foreign investors bought in the United States. These purchases were financed in part by the United States'

58 *See* Carroll, *supra* note 44, at 156; Kent, *supra* note 54, at 219.

59 *See* Carroll, *supra* note 44, at 156; Angell, *supra* note 51, at 911–12.

60 *See* Angell, *supra* note 51, at 910.

61 *See* Carroll, *supra* note 44, at 156; Kent, *supra* note 54, at 219.

62 *See* Revenue Act of 1936, Pub. L. No. 74-740, § 211(a), 49 Stat. 1648, 1714.

63 *Id.* § 211(b); *see also* Carroll, *supra* note 44, at 156–57 (describing how the "force of attraction" doctrine affected U.S. tax treaties).

64 *See* John F. Kennedy, President, Special Message to Congress on Balance of Payments (July 18, 1963) (promoting "tax reduction" for foreign investors in U.S. securities).

65 *See* Allan H. Meltzer, *U.S. Policy in the Bretton Woods Era*, 73 FED. RSRV. BANK ST. LOUIS 54, 55–56 (1991).

trade surplus: Americans spent less on imports than they earned from exports.[66] But they were primarily funded by the willingness of foreign central banks to accumulate U.S. dollars, leading to a growing balance-of-payments deficit.[67]

In effect, the United States was operating like a bank, issuing short-term notes (U.S. dollars) to foreigners to fund long-term investment abroad.[68] The amount of short-term debt could increase indefinitely, but it was backed by a limited supply of gold. As dollar reserves accumulated abroad, foreign central banks began exercising their right to redeem their dollars for gold.[69] That led to concerns of a run on the dollar: the growing gap between the amount of U.S. dollars (claims on American gold) and actual U.S. gold holdings would call into question the credibility of the dollar, accelerating gold redemptions by foreign central banks and further undermining the dollar, leading to the collapse of the dollar-reserve system and with it the global economy.[70]

To address the balance of payments deficit, President John F. Kennedy, and subsequently President Lyndon B. Johnson, sought to implement measures that would "stimulate a greater inflow of capital" from foreign countries.[71] These measures would encourage foreigners to swap their dollars for longer-term investments in the United States. A task force appointed by Kennedy highlighted the role of inbound tax rules in discouraging foreign investment.[72] The force of attraction doctrine discouraged foreigners engaged in a U.S. trade or business from making passive investments, since they would no longer be eligible for the capital gain exemption or any favorable withholding tax rates accorded to passive investment income by treaty.[73] In addition, courts had determined that foreign investors were engaged in a U.S. trade or business—and thus ineligible for the capital gain exemption—if they were present during the trading of securities or if trades were effected by a U.S.

66 *See id.* at 56; Edward M. Bernstein, *Reflections on Bretton Woods 1944*, *in* THE INTERNATIONAL MONETARY SYSTEM: FORTY YEARS AFTER BRETTON WOODS 15, 19 (1984).

67 *See* Meltzer, *supra* note 65, at 56–57.

68 *See* ROBERT TRIFFIN, GOLD AND THE DOLLAR CRISIS: THE FUTURE OF CONVERTIBILITY 3–14 (1960).

69 *Id.* at 8–9; Meltzer, *supra* note 65, at 56–57.

70 *See* TRIFFIN, *supra* note 68, at 3–14; Michael D. Bordo & Robert N. McCauley, *Triffin: Dilemma or Myth?* 3–4 (Bank for Int'l Settlements, Working Paper No. 684, 2017).

71 Lyndon B. Johnson, President, Special Message to the Congress on International Balance of Payments (Feb. 10, 1965).

72 TASK FORCE ON PROMOTING INCREASED FOREIGN INV. IN U.S. CORP. SEC. & INCREASED FOREIGN FIN. FOR U.S. CORPS. OPERATING ABROAD, REPORT TO THE PRESIDENT OF THE UNITED STATES 21–30 (1964).

73 *See id.* at 27.

agent with discretionary trading authority.[74] Those decisions deterred foreign investment both because many foreign investors considered discretionary authority to be necessary in the event of a crisis, and because they increased foreign investors' uncertainty about their eligibility for the capital gain exemption in any given case.[75]

The Foreign Investors Tax Act of 1966 aimed to reduce the tax burden on foreign investment in the United States in two primary ways.[76] First, it replaced the force of attraction doctrine with a new regime for foreign taxpayers engaged in a U.S. trade or business. Under the new rules, only income that was "effectively connected" with the active U.S. trade or business would be subject to tax on a net basis; income that was not "effectively connected," such as capital gains on the sale of passive investment assets, would still be exempt from such tax.[77] Second, it added a safe harbor for securities trading, clarifying that a foreign investor trading in stocks, securities, and certain commodities for their own account would not be treated as engaged in a U.S. trade or business, even if they were present in the United States or granted discretionary trading authority to a U.S. agent.[78] These two changes, which allowed foreign investors to trade U.S. securities without paying tax on their capital gains, continue to define the scope of the capital gain exemption for foreign investors.[79]

C. *Bank Deposits and Portfolio Interest*

As it did in the case of capital gains, Congress has over time created broad tax exemptions for U.S.-source interest income earned by foreign taxpayers in order to attract foreign investment in U.S. debt. One such exemption, which dates to the early 1920s, applies to interest on bank deposits.[80] Until 1976, when the bank-deposit exemption was made permanent,[81] it was enacted serially on a "temporary" basis for a period

74 *See* Comm'r of Internal Revenue v. Nubar, 185 F.2d 584 (4th Cir. 1950); Adda v. Comm'r of Internal Revenue, 10 T.C. 273 (1948).

75 *See* TASK FORCE ON PROMOTING INCREASED FOREIGN INV. IN U.S. CORP. SEC. & INCREASED FOREIGN FIN. FOR U.S. CORPS. OPERATING ABROAD, *supra* note 72, at 28–29.

76 Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539.

77 *Id.* §§ 103(a)(1), 104(a)–(b).

78 *Id.* § 102(d). The Act also provided that capital gains of foreign investors not engaged in a U.S. trade or business would not be taxable unless the investor was present in the United States for at least 183 days during the taxable year. *Id.* § 103(a)(1).

79 *See* I.R.C. §§ 864(c)(2), 871(a), 871(b)(1), 881(a), 882(a).

80 *See* O.C. Lockhart, *The Revised Income Tax*, 7 BULL. NAT'L TAX ASS'N 111, 112 (1922).

81 *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1041, 90 Stat. 1520, 1634.

of two or three years.[82] The connection between the permanent exemption for interest on bank deposits and the perceived need to attract foreign capital was explicit: "The exemption for bank deposit interest has been in the law for 50 years in this country. Why? . . . [I]t just makes good sense to attract capital so that we can create jobs."[83]

But the most significant tax exemption for foreign investors was introduced in 1984, when Congress repealed the flat-rate tax on "portfolio interest" paid to foreign investors.[84] Efforts to abolish the tax on *all* U.S.-source interest income earned by foreign investors had begun as early as 1975, with proponents, including the Treasury, the financial industry, and U.S. companies, arguing that repeal of the tax would attract new capital to the United States and stimulate economic growth: "Too many Americans are unemployed due to a lack of capital growth through sufficient investments. [Exempting interest income of foreign investors from U.S. tax] will motivate greater capital flow to this country and will subsequently economically benefit all Americans."[85] Surveys undertaken by the Securities Industry Association (now the Securities Industry and Financial Markets Association) reported that repeal of the flat-rate tax on portfolio interest would attract billions of dollars of new foreign investment to the United States.[86] That influx of new capital, according to the Treasury, would drive down the cost of borrowing for U.S. companies.[87] That, in turn, would allow them to lower the costs of their goods and compete with imported products.[88] Proponents of repeal also argued that by lowering U.S. companies' borrowing costs, repeal would increase domestic production, leading to an increase in domestic

82 *See* 122 CONG. REC. 23875–76 (1976). In addition to interest paid on bank deposits, under prior law, interest paid to foreign taxpayers by U.S. corporations earning less than 20% of their gross income from U.S. sources, by insurance companies, and original issue discount on short-term debt was also exempt from tax. *See* I.R.C. §§ 861(a), 871(a)(1), 881(a)(1), (3).

83 *See* 122 CONG. REC. 23875.

84 *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 127(a), 98 Stat. 494, 648–49.

85 *See Improper Use of Foreign Addresses to Evade U.S. Taxes: Hearing Before a Subcomm. of H. Comm. on Gov't Operations*, 97th Cong. 330 (1982) (record vote analysis of vote number 418 on the Packwood Amendment to the Tax Reform Act of 1976).

86 *See Foreign Convention Tax Rules & Minor Tax Bills: Hearing Before Subcomm. on Select Revenue Measures of Comm. on Ways & Means*, 96th Cong. 91–94 (1980) (estimating capital inflows of $5–$7 billion following repeal). Proponents of repeal also argued that it was necessary to balance the treatment of short-term debt—like bank deposits—which was already exempt from withholding, and longer-term debt. The disparity discouraged longer-term foreign investment in favor of more volatile short-term investment. *Id.* at 93.

87 *See Tax Treatment of Interest Paid to Foreign Persons: Hearing Before Comm. on Ways & Means on H.R. 3025 & H.R. 4029*, 98th Cong. 47 (1984) (statement of Thomas J. Healey, Assistant Sec'y for Domestic Fin., Treasury Dep't).

88 *See id.* at 33 (statement of Ronald A. Pearlman, Deputy Assistant Sec'y for Tax Pol'y, Treasury Dep't).

employment.[89] For its part, the Treasury argued that the tax on foreign investors' interest income precluded the U.S. government from borrowing from foreigners to finance the increasing budget deficit.[90]

Ultimately, repeal of the flat-rate tax was limited to "portfolio interest income": interest on registered debt instruments received from an unrelated borrower, other than interest received by a bank on ordinary course lending.[91] That includes interest on U.S. government bonds, bonds issued by U.S. corporations (unless the bondholder holds a 10% or more equity stake in the corporation), and interest on U.S. bank deposits or certificates of deposit.[92] The exemption is available to any foreign investor as long as they are not a U.S. resident for tax purposes.[93] Repealing the tax on portfolio interest led to an immediate, nearly tenfold increase in foreign borrowing by U.S. companies.[94] Foreign purchases of Treasury securities also increased.[95] Concerned about losing scarce capital flows to the United States, other countries soon abolished their own withholding taxes on interest paid to nonresident investors.[96]

Although the portfolio interest exemption benefited foreign investors who held U.S. debt directly, it did not immediately help foreign investors who gained exposure to U.S. debt indirectly through investment vehicles like mutual funds.[97] Those vehicles are eligible to be treated as regulated investment companies (RICs) for tax purposes. Although RICs are corporations for U.S. federal income tax purposes, they can reduce or eliminate entity-level tax by distributing at least 90% of their taxable

89 *Foreign Portfolio Investments in the United States: Hearing Before Subcomm. on Int'l Fin. and Res. of S. Comm. on Fin.*, 94th Cong. 21 (1976) (statement of Robert Roosa, Chairman, NYSE Advisory Comm.) ("The price of less capital formation is higher unemployment."); *Foreign Convention Tax Rules & Minor Tax Bills Hearing*, *supra* note 86, at 137 (statement of Barry N. Roth, Dir. of Gov't Affs., The Williams Cos.).

90 *See Tax Treatment of Interest Paid to Foreign Persons Hearing*, *supra* note 87, at 26 (statement of Ronald A. Pearlman, Deputy Assistant Sec'y for Tax Pol'y, Treasury Dep't).

91 *See* I.R.C. §§ 871(h), 881(c). The interest cannot vary based on the borrower's profits or revenues. *Id.* §§ 871(h)(4), 881(c)(3)(B).

92 *See* I.R.C. §§ 871(h)(2), (3), 881(c)(3).

93 The exemption also does not require foreign investors to show that the interest income in question was subject to tax in the investor's country of residence. *But see* I.R.C. § 871(h)(6) (authorizing the Treasury to suspend application of the portfolio interest exemption to prevent evasion of tax by U.S. taxpayers).

94 *See* Christopher L. Bach, *U.S. International Transactions, Fourth Quarter and Year 1983*, SURV. CURRENT BUS., Mar. 1984, at 38, 38–40; Leslie E. Papke, *One-Way Treaty with the World: The U.S. Withholding Tax and the Netherlands Antilles*, 7 INT'L TAX & PUB. FIN. 295, 305–06 (2000).

95 *See* Papke, *supra* note 94, at 306.

96 *See* Reuven S. Avi-Yonah, *A Coordinated Withholding Tax on Deductible Payments*, 119 TAX NOTES 993, 994 (2008).

97 *See* Jeffrey M. Colon, *Foreign Investors in U.S. Mutual Funds: The Trouble with Treaties*, 35 VA. TAX REV. 483, 496–97 (2016).

income each year.[98] However, those distributions were treated as ordinary dividends and therefore subject to the flat-rate tax when paid to foreign investors, even if they were attributable to interest income that would be exempt portfolio interest if earned directly by those foreign investors. In 2004, Congress revised the tax treatment of RIC distributions to provide that dividends attributable to portfolio interest income would be exempt from the flat-rate tax when paid to foreign investors.[99] The motivation for the change was explicit: Congress wanted to reduce the tax burden on foreign taxpayers investing in the United States indirectly.[100]

D. *The Foreign Sovereign Exemption*

Another set of tax rules that have been shaped by the desire to attract scarce foreign capital are those governing the tax treatment of investment by foreign sovereigns and entities they own or control. The tax treatment of foreign sovereign investment is rooted in the longstanding doctrine of sovereign immunity, which limits the jurisdiction of one sovereign government over another.[101] But the way in which the doctrine of sovereign immunity has been implemented in U.S. tax law has been informed by a more tangible policy concern: encouraging foreign sovereigns to invest in the United States.[102]

Although the doctrine of sovereign immunity was well-established by the time the United States enacted its first income tax in 1913, federal tax authorities argued that U.S.-source dividends and interest paid to foreign governments were subject to U.S. tax because they were derived

98 Technically, they are required to distribute at least 90% of their "investment company taxable income," which equals taxable income less net capital gain and other modifications, including the deduction for dividends paid, reflecting its RIC status. *See* I.R.C. § 852(b)(2); JAMES R. BROWN & SUSAN A. JOHNSTON, TAXATION OF REGULATED INVESTMENT COMPANIES AND THEIR SHAREHOLDERS § 3.03 (2024).

99 American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 411(a)(1), 118 Stat. 1418, 1500.

100 *See* H.R. REP. NO. 108-548, at 161–67 (2004).

101 The general doctrine of sovereign immunity is not limited to taxation and is reflected in early U.S. case law. *See, e.g.*, Schooner Exch. v. McFaddon, 11 U.S. (7 Cranch) 116 (1812) (French warship exempt from U.S. jurisdiction). The doctrine of foreign sovereign immunity was codified by statute with the enactment of the Foreign Sovereign Immunities Act of 1976, Pub. L. No. 94-583, § 1602, 90 Stat. 2891, 2892 (limiting sovereign immunity to noncommercial activities of foreign government and their instrumentalities).

102 STAFF OF J. COMM. ON TAX'N, 110TH CONG., ECONOMIC AND U.S. INCOME TAX ISSUES RAISED BY SOVEREIGN WEALTH FUND INVESTMENT IN THE U.S. 2 (Comm. Print 2008) ("The economic analysis presented here suggests that investment in the United States by foreign sovereigns, like that of investment by foreign private investors, is a necessary and desirable consequence of the long-term trade deficit position of the United States.").

from "commercial transactions" beyond the scope of traditional sovereign immunity.[103] In response, as part of the War Revenue Act of 1917, Congress added a tax exemption for foreign sovereigns for income derived from "investments in the United States in stocks, bonds, or other domestic securities . . . or from interest on deposits in banks in the United States."[104] The exemption, enacted when the country was at war and in need of financing, was intended to encourage investment by foreign sovereigns.[105] The next year, Congress passed the Revenue Act of 1918, which broadened the foreign sovereign tax exemption to include all U.S.-source income.[106]

The statutory text, however, only extended the tax exemption to "foreign governments," which raised the question of exactly who was covered by it.[107] When the exemption was first extended, the Bureau of Internal Revenue interpreted its scope broadly to include organizations that were legally distinct from but closely affiliated with foreign governments. In 1920, the Bureau ruled that the Australian central bank was entitled to the exemption, even though it was established as a separate corporation.[108] More than two decades later, the Bureau revoked that ruling and began applying a formal test to determine who was eligible for the exemption, which excluded government-owned entities that were "separate and distinct" from the foreign government itself.[109]

This more formal approach to the foreign sovereign tax exemption called into question the status of foreign central banks, and raised the

103 *See* T.D. 2425, 18 Treas. Dec. Int. Rev. 276 (1916); *see also* David R. Tillinghast, *Sovereign Immunity from the Tax Collector: United States Income Taxation of Foreign Governments and International Organizations*, 10 L. & POL'Y INT'L BUS. 495, 531–55 (1978) (describing the "governmental versus commercial" distinction in the context of sovereign immunity); Howard J. Levine & Saul M. Shajnfeld, *U.S. Tax Exemption for Foreign Governments and Controlled Entities After TRA*, 66 J. TAX'N 222, 222–23 (1987) (noting the State Department's determination that investment income was "commercial" in nature).

104 War Revenue Act of 1917, Pub. L. No. 65-50, § 30, 40 Stat. 300, 337.

105 *See* Kenneth Wood, Colleen O'Neill & Andy Le, *Sovereign Wealth Funds: The Benefits and Burdens of the Sovereign Immunity Exemption from Tax Under § 892*, 37 TAX MGMT. INT'L J. 79 (2008).

106 *See* Revenue Act of 1918, Pub. L. No. 65-254, § 213(b)(5), 40 Stat. 1057, 1066. The legislative history is silent as to why the provision was broadened. *See* Levine & Shajnfeld, *supra* note 103, at 222.

107 Revenue Act of 1918, Pub. L. No. 65-254, § 213(b)(5), 40 Stat. 1057, 1066.

108 *See* O.D. 628, 3 C.B. 124–25 (1920).

109 *See* I.T. 3789, 1946-1 C.B. 100–01. The revocation was in response to the Joint Committee on Taxation's objection to an income tax refund filed by a corporation owned by a foreign government. *See* I.T. 4082, 1952-1 C.B. 69, 71 (explaining that the railway owned and operated by a foreign government qualified for the exemption and distinguishing an earlier decision in I.T. 3789 on the ground that the entity in that case was a corporation); Rev. Rul. 66-73, 1966-1 C.B. 174 (noting that the organization owned by a foreign government only qualifies for exemption if it does not constitute a corporation as generally understood in the United States).

possibility that they would be subject to tax on investments in the United States, including in Treasury debt.[110] Congress responded in 1961 by enacting a specific tax exemption for foreign central banks, which covered any income derived from "obligations of the United States" unless it was used in connection with commercial activities.[111] The foreign central bank exemption can only be understood in the context of the "balance of payments" crisis described in Section I.B.[112] Concerned about protecting U.S. gold reserves, Congress wanted to make it more attractive for foreign central banks to hold longer-term Treasuries instead of redeeming their dollar reserves for gold.[113] By exempting income on Treasuries from tax, foreign central banks would be more willing to use their dollar reserves to purchase Treasuries and less likely to convert them into gold.[114]

Subsequently, the Internal Revenue Service (IRS) (the Bureau's successor) reverted to a more functional approach to the foreign sovereign tax exemption, ruling that an organization that is wholly owned and controlled by a foreign government would be eligible for the exemption so long as (1) it had no private investors or beneficiaries, (2) it did not engage in material commercial activities in the United States, (3) all of its income was credited to the entity or foreign government directly, and (4) any investments in the United States produced only passive income.[115] This approach was largely incorporated into statutory law by revisions to the foreign sovereign tax exemption in 1986 and 1988, which define the current scope of the exemption.[116]

Under current law, the sovereign tax exemption applies both to the foreign sovereign itself as well as "controlled entities," including foreign central banks and sovereign wealth funds—actively managed, government-owned pools of capital.[117] The exemption is limited to

110 *See* S. REP. NO. 87-163, at 3–4 (1961).

111 Pub. L. No. 87-29, 75 Stat. 64 (1961) (codified as amended at I.R.C. § 895).

112 *See supra* notes 64–75 and accompanying text.

113 *See* S. REP. NO. 87-163, at 4.

114 *See id.*

115 Rev. Rul. 75-298, 1975-2 C.B. 290, *revoked by* Rev. Rul. 2003-99, 2003-2 C.B. 388. This ruling refined earlier rulings that defined the scope of the tax exemption for government-owned entities based on whether the entity was engaged in passive investment or active business activities and whether the foreign government or private persons ultimately benefited from those activities. *See* Rev. Rul. 66-73, 1966-1 C.B. 174. It also meant that section 895, which explicitly exempted certain income of foreign central banks from tax, was mostly obsolete, since foreign central banks were once again within the scope of the general foreign sovereign tax exemption. Rev. Rul. 75-298, 1975-2 C.B. 290.

116 I.R.C. § 892.

117 Treas. Reg. § 1.892-2T(a)(3); STAFF OF J. COMM. ON TAX'N, 110TH CONG., ECONOMIC AND U.S. INCOME TAX ISSUES RAISED BY SOVEREIGN WEALTH FUND INVESTMENT IN THE U.S. 45–46 (Comm. Print 2008).

income from passive investments in the United States such as domestic securities, financial instruments held in the execution of government financial or monetary policy, and bank deposits.[118] Income "derived from the conduct of any commercial activity," on the other hand, is excluded from the exemption.[119] Treasury regulations clarify that investment and trading activities are not considered to be commercial activities.[120] The tax preferences for passive income available to all foreign investors, such as the portfolio interest exemption, mean that in practice the benefit from the foreign sovereign exemption is relatively limited. The exemption is only relevant where it relieves foreign sovereigns of tax another foreign investor would be subject to, such as (1) withholding tax on U.S. source dividends,[121] (2) withholding tax on U.S. source interest that is not otherwise exempt,[122] and (3) net income tax on gain from the sale of U.S. real property holding corporations, which does not qualify for the capital gain exemption.[123]

II. THE GLOBAL SAVING GLUT AND THE U.S. TRADE DEFICIT

If global financial capital were scarce, then it might make sense for the United States to compete for foreign capital by offering attractive tax treatment. But financial capital is not scarce. Indeed, over the past thirty years, saving in foreign countries has exceeded investment in those countries, leading to a "global saving glut" and massive inflows of financial capital in the United States.[124] This Part describes the global saving glut and its causes, highlighting how regressive tax-and-transfer systems in countries like China, Germany, and Saudi Arabia have shifted income to the wealthy, who are more likely to save than spend.[125] Those excess savings make their way to the United States, drawn by its deep and open financial markets and the perceived safety of dollar-denominated assets.[126] Although this capital can be used to finance productive investment, in practice these financial inflows have helped fuel financial instability and harmed the U.S. economy.[127]

118 I.R.C. § 892(a)(1).

119 I.R.C. § 892(a)(2).

120 Treas. Reg. § 1.892-4T(c).

121 Treas. Reg. § 1.892-3T(a)(1)(i).

122 Treas. Reg. § 1.892-3T(a)(2).

123 Treas. Reg. § 1.892-3T(b) (example 1).

124 *See infra* Section II.A.

125 *See infra* Section II.B.

126 *See infra* Section II.C.

127 *See infra* Section II.D.

A. *The Mechanics of International Imbalances and the Global Saving Glut*

The term "global saving glut" was coined by then-Federal Reserve Governor (and soon-to-be Fed Chairman) Ben Bernanke in a famous 2005 speech to explain the decline in long-term interest rates despite the Federal Reserve's repeated increases in short-term rates amid a strong economy.[128] Though it focused on lower U.S. interest rates as the outcome of interest, Bernanke's speech shifted attention to global trade and financial imbalances as the key explanatory mechanism. He argued that the fall in global interest rates was driven by increased saving in foreign countries, including Germany, East Asian countries, and oil-exporters in the Middle East and Africa.[129]

On a global level, all production and demand balance out. The world's entire economic output (production) is either consumed or invested in the development of new productive assets (demand).[130] However, at the level of individual countries, production and demand are not equal: some countries use (either in the form of consumption or investment) more than they produce domestically, while others produce more than they use. Those gaps are accounted for through trade between countries. Countries that use more than they produce import that missing output from countries that produce more than they use:[131]

Imports – exports = domestic demand – domestic production

Trade relationships are mediated by financial flows between countries. Again, at the global level, all saving and investment must balance: one person's (or country's) saving is another's investment.[132] In individual countries, however, that is not the case: a country can save more than it invests if some of that saving is used to purchase foreign assets. The proceeds of those asset sales can be used to finance investment, in which case investment in that foreign country will rise. Or they can be used to finance consumption, in which case saving in that country will decline (since saving is the difference between production and consumption). Either way, the gap between saving and investment in that

128 *See* Bernanke, *supra* note 5; Bernanke et al., *supra* note 24, at 1.

129 *See* Bernanke, *supra* note 5; Bernanke et al., *supra* note 24, at 8–13.

130 *See* IMF, BALANCE OF PAYMENTS AND INTERNATIONAL INVESTMENT POSITION MANUAL 9 (6th ed. 2009). "Production" here refers to gross domestic product (GDP), which includes all output whether it is consumed or not (consumption plus saving). *See id.* at 22–24.

131 *See id.* at 227–30; Timothy Taylor, *Untangling the Trade Deficit*, 134 PUB. INT. 82, 90–91 (1999).

132 *See* IMF, *supra* note 130, at 11–12.

foreign country will increase: if one country saves more than it invests, another country must invest more than it saves.[133]

These financial and trade relationships are formalized in a country's balance of payments, which records all payments between a country and the rest of the world.[134] The balance of payments is divided into two parts: the current account and the financial account.[135] A country's current account records the net flow of payments between a country and the rest of the world: all payments made to a country less payments made by the country.[136] Accordingly, the current account equals all exports, minus all imports, plus net earnings (such as dividends and interest) from foreign assets and unilateral transfers (such as remittances):

Current account = (exports – imports) + net foreign payments

The other part of the balance of payments, the financial account, tracks net changes in the ownership of assets and liabilities.[137] A country's financial account is equal to financial inflows (increase in liabilities) less financial outflows (increase in assets):

Financial account = financial inflows – financial outflows

The balance of payments must sum to zero.[138] If a country has a current account deficit—i.e., it imports more than it exports—then its residents pay more to residents of other countries than they receive. That can only be the case if they borrow more from the rest of the world than they lend to it—i.e., if the country is running a financial account surplus. Conversely, if a country has a current account surplus because its residents receive more payments from abroad than they pay to foreign residents, then it must have a financial account deficit. Formally:

Financial inflows – financial outflows = imports – exports – net foreign payments

But recall that any gap between a country's exports and imports reflects a difference between the amount that a country produces domestically and the amount that its residents consume or invest.[139] Accordingly:

133 *See id.* at 227–29.

134 *See id.* at 9.

135 *See id.*

136 *See id.*

137 *See id.* at 9–10.

138 *See id.* at 10. In practice, incomplete records of cross-border transactions lead to differences between the measured current account and financial account. *See id.* at 11.

139 *See supra* notes 130–131 and accompanying text. Technically, the difference between domestic demand and production will be equal to the current account, which includes net foreign

Financial inflows – financial outflows = imports – exports = domestic demand – domestic production

Financial surplus = trade deficit = domestic demand – domestic production

Financial deficit = trade surplus = domestic production – domestic demand

A country in which domestic demand exceeds production will have a trade deficit. The gap between domestic production and demand will be bridged with goods and services imported from abroad, paid for by issuing liabilities abroad. By the same token, a country in which economic production exceeds domestic demand will have a trade surplus. The excess production will be exported abroad, in exchange for claims on foreign assets.

Bernanke proposed that an expanding gap between production and demand in certain foreign countries, ranging from developed countries like Germany and Japan to developing countries like China, led to a "glut" of financial capital.[140] Since global interest rates are set at the level that balances supply and demand for financial capital, any increase in supply will have the effect of pushing down interest rates in order to bring global saving and investment back into equilibrium. When there is an excess of supply over demand at an initial interest rate, real interest rates must fall to restore equilibrium between global supply and demand. The "glut" in those countries necessitated a fall in world interest rates and showed up as financial inflows to trade deficit countries such as the United States.[141]

The trends identified by Bernanke nearly two decades ago have persisted. From the mid-1990s until very recently, the United States experienced a secular decline in long-term real interest rates. Over the decade spanning the latter half of the 1990s to the onset of the global financial crisis, the ten-year real interest rate in the United States declined by approximately 1.5 percentage points (from about 3.5% to 2%).[142] Between the global financial crisis and the COVID-19 epidemic, it fell another two percentage points. Since then, the ten-year real interest rate has risen close to levels that prevailed prior to the global financial crisis.[143]

payments. Since the trade account is the largest part of the current account, the role of net foreign payments can be ignored for simplicity of exposition.

140 *See* Bernanke, *supra* note 5.

141 *See id. But see* Joseph B. Steinberg, *On the Source of U.S. Trade Deficits: Global Saving Glut or Domestic Saving Drought?*, 31 REV. ECON. DYNAMICS 200, 215–17 (2019) (arguing that other factors, not the global saving glut, accounted for most of the decline in interest rates).

142 *10-Year Real Interest Rate*, FED. RSRV. ECON. DATA (Dec. 11, 2024, 3:03 PM), https://fred.stlouisfed.org/series/REAINTRATREARAT10Y [https://perma.cc/4RJA-YAKK].

143 *Id.*

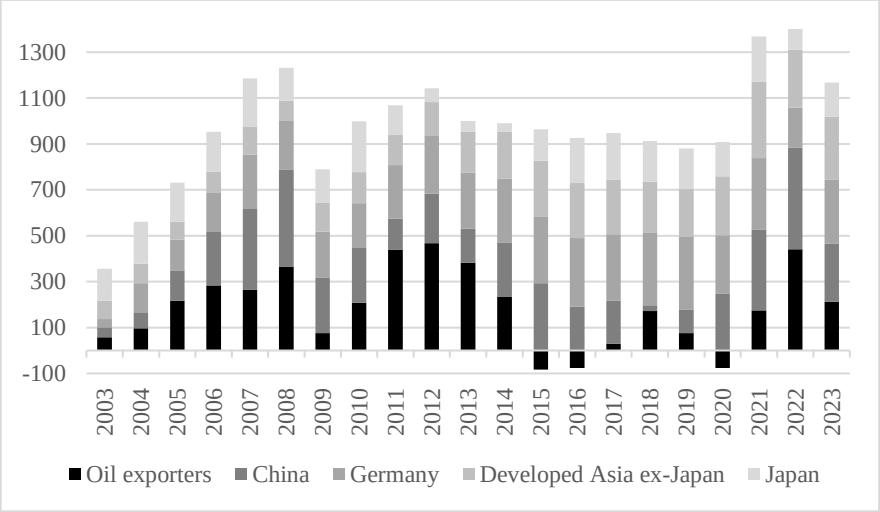
As U.S. interest rates were declining, output in several foreign countries continued to far exceed demand there. These included developed countries like Germany, Japan, and the newly industrializing economies of Asia (Hong Kong, Singapore, South Korea, and Taiwan); developing countries, especially China; and oil exporters in the Middle East and North Africa.[144] Figure 1 shows how the current account surpluses of the main source countries of the "global saving glut" have evolved over the past two decades.[145] Beginning in 2004, Germany experienced a persistent increase in savings, reflected in steady current account surpluses. China's current account surplus surged around the same time, then fell dramatically around 2015, only to rebound past its previous highs in recent years.[146] Saving in the oil-exporting countries of the Middle East and North Africa largely reflected profits from oil sales, showing pronounced volatility with notable surpluses during periods of high oil prices (in 2011–2013 and 2022) and even brief deficits in 2014–2015 and 2020. Instead of investing (or consuming) domestic output, those countries ran trade surpluses, using excess savings to acquire foreign financial assets.

144 This includes the Gulf Cooperation Council countries ("the Gulf countries") (Saudi Arabia, United Arab Emirates, Kuwait, Oman, Qatar, and Bahrain), as well as Algeria, Iran, Iraq, Libya, and Yemen.

145 *Infra* Figure 1; *Current Account Balance U.S. Dollars*, IMF (2025), https://www.imf.org/external/datamapper/bca@weo/oemdc/advec/weoworld [https://perma.cc/JWU9-C7MK].

146 According to Brad Setser, China's reported current account surplus understates its actual surplus by approximately $300 billion due to changes to its treatment of contract manufacturing in China for foreign companies introduced in 2022. *See* Brad W. Setser, *China's Imaginary Trade Data*, COUNCIL ON FOREIGN RELS. (Aug. 14, 2024, 5:13 PM), https://www.cfr.org/blog/chinas-imaginary-trade-data [https://perma.cc/25XZ-LF7T].

Figure 1. Major "Source" Country Current Accounts, Billions of U.S. Dollars



B. *The Global Saving Glut of the Rich*

What caused the global saving glut? The primary force behind the increase in the savings rate in major foreign economies has been rising inequality. Regressive distributions of income in these economies force up the saving rate in those countries by shifting income to those who are more likely to save than to spend.[147] This can take at least two forms. In one case, the share of total income received by wealthy households increases relative to the share received by poorer households.[148] Because wealthy households tend to save a larger share of their income than poorer households, rising income inequality can increase saving overall.[149] Alternatively, the share of income received directly by all households can decrease relative to the share received by businesses, which are disproportionately owned by the wealthy.[150] In this case,

147 *See* Karen E. Dynan, Jonathan Skinner & Stephen P. Zeldes, *Do the Rich Save More?*, 112 J. POL. ECON. 397 (2004) (finding that savings in the United States are positively correlated with household income); Adrien Auclert & Matthew Rognlie, *Aggregate Demand and the Top 1 Percent*, 107 AM. ECON. REV. 588 (2017) (finding that the rise of the top 1% led to an increase in desired savings).

148 *See* Mian et al., *supra* note 24, at 4.

149 *See id.* (noting that rising inequality is associated with increased saving by rich households).

150 *See* Océane Blomme & Jérôme Héricourt, *Inequality, Current Account Imbalances, and Middle Incomes*, 152 J. INT'L MONEY & FIN., Mar. 2025, at 2 (finding that a decrease in labor share

national saving can rise even if overall household saving declines, but lower household income is more than offset by increased business profits that are channeled into savings. According to one study, the share of private saving accruing, both directly and indirectly, to the wealthiest 10% of households in major economies increased by 60% over the past three decades.[151]

This dynamic is particularly evident in three major sources of the global saving glut: China, Germany, and the oil-exporting Gulf countries.[152] Regressive policies in these countries contribute to savings surpluses by shifting income from poorer residents who would consume more of what they earn to wealthier residents and businesses that save more. The concentration of income among wealthy households and businesses leads to persistent gaps between domestic production and consumption.

The concentration of income in these countries has been accomplished in part by regressive tax systems. In China, consumption and wage taxes that disproportionately burden poorer households raise three times as much revenue as taxes on personal and corporate income.[153] As a result, the effective tax rate on lower income earners is often higher than tax rates faced by the rich.[154] Germany likewise imposes some of the highest taxes on low-paid workers among developed economies: In 2023, the effective tax rate (including income tax and social security contributions) for a worker earning the average wage was 47.9%.[155] Taxes that would disproportionately fall on wealthier Germans,

of income was associated with an increase in current account surplus); Jan Behringer & Till van Treeck, *Income Distribution and the Current Account*, 114 J. INT'L ECON. 238 (2018) (same).

151 Luis Bauluz, Filip Novokmet & Moritz Schularick, *The Anatomy of the Global Saving Glut* 2, 31–37 (Ctr. for Econ. Rsch., Working Paper No. 9732, 2022) https://papers.ssrn.com/abstract=4103945 [https://perma.cc/J8U5-3CK7] (tracking the distribution of savings in the United States, Europe, and China).

152 *See* KLEIN & PETTIS, *supra* note 24, at 111, 147–48; WADE JACOBY, SURPLUS GERMANY 11–14 (2017). The Gulf countries referred to in this Section are: Saudi Arabia, United Arab Emirates, Kuwait, Oman, Qatar, and Bahrain.

153 *See* ALEXANDER KLEMM, ISAIAS COELHO, ALAN DUNCAN & LI LIU, IMF, PEOPLE'S REPUBLIC OF CHINA: TAX POLICY AND EMPLOYMENT CREATION 10 (2017) (noting that personal income taxes contribute approximately 1% of GDP and corporate taxes contribute approximately 4% of GDP); Sonali Jain-Chandra et al., *Inequality in China—Trends, Drivers and Policy Remedies* 17–18 (IMF, Working Paper No. 18/127, 2018) (explaining that revenues from personal income tax contribute only 5% of total government revenues, compared to Organsation for Economic Co-operation and Development average of 25%).

154 *See id.*

155 Anke Hassel, *No Way to Escape Imbalances in the Eurozone? Three Sources for Germany's Export Dependency: Industrial Relations, Social Insurance and Fiscal Federalism*, 26 GERMAN POL. 360, 369–70 (2017). Part of the regressivity of wage taxes is due to linear payroll taxes that apply to the first Euro earned up to a certain threshold. *Id.* In addition, the income tax schedule is compressed compared to other high-income countries. *Id.*

such as property, inheritance, and wealth taxes, are assessed based on below-market valuations or not at all.[156] Businesses can be passed from one generation to the next without paying any inheritance tax if employees are retained at their former salaries for a defined period of time.[157] The abolition of the wealth tax, after it was outlawed by Germany's constitutional court in the 1990s, was alone responsible for a three percentage point increase in Germany's household saving rate.[158]

Unlike China and Germany, pre-tax income inequality in the Gulf countries has been persistently high, although it has increased slightly over the past three decades.[159] Their heavy reliance on oil revenues concentrates income among those who are connected to the oil industry, especially their respective royal families.[160] Income disparities are further exacerbated by a large population of low-wage migrant workers.[161] The Gulf countries' tax policies, however, do little to ameliorate income inequality. Their governments rely heavily on oil revenues, which account for approximately three-quarters of total government revenues to finance expenditures.[162] Non-oil related taxes are limited and regressive: While the Gulf countries have no personal income tax, they recently introduced value-added taxes, which disproportionately affect those with lower incomes, who consume a relatively larger share of those incomes.[163] While citizens and domestically-owned companies are

156 KLEIN & PETTIS, *supra* note 24, at 157.

157 *See* Henriette Houben & Ralf Maiterth, *Inheritance Tax-Exempt Transfer of German Businesses: Imperative or Unjustified Subsidy?—An Empirical Analysis* 8 (Arbeitskreis Quantitative Steuerlehre, Working Paper No. 95, 2009).

158 *See* Alena Bachleitner, *Abolishing the Wealth Tax: A Case Study for Germany* 6, 20 (Austrian Inst. of Econ. Rsch., Working Paper No. 545, 2017).

159 *See* ROWAIDA MOSHRIF, WORLD INEQ. LAB, INCOME INEQUALITY IN THE MIDDLE EAST (2020); Facundo Alvaredo, Lydia Assouad & Thomas Piketty, *Measuring Inequality in the Middle East 1990–2016: The World's Most Unequal Region?*, 65 REV. INC. & WEALTH 685, 700–01 (2019); LYDIA ASSOUAD, INEQUALITY AND ITS DISCONTENTS IN THE MIDDLE EAST 2–4 (2020).

160 *See* ASSOUAD, *supra* note 159, at 3–4; Steffen Hertog, *Arab Gulf States: An Assessment of Nationalisation Policies* 4–5 (Migration Pol'y Ctr., Research Paper No. 1, 2014) (finding that oil rents are distributed through government jobs for citizens).

161 ASSOUAD, *supra* note 159, at 6.

162 *See* IMF, TAX POLICY REFORMS IN THE GCC COUNTRIES: NOW AND HOW? 5, 7 (2015).

163 *See id.* at 5–6; Yasmine Saleh & Tom Arnold, *Six Gulf Nations Aiming for Simultaneous VAT Adoption in January: UAE Official*, REUTERS (Feb. 12, 2017, 5:20 AM), https://www.investing.com/news/economy-news/six-gulf-nations-aiming-for-simultaneous-vat-adoption-in-january:-uae-official-459398 [https://perma.cc/STR6-R6KJ]; Alastair Thomas, *Reassessing the Regressivity of the VAT*, 43 FISCAL STUD. 23, 30–32 (2022) (noting that value-added tax is "strongly regressive" when measured as a percentage of income). Nontax fees also contribute to inequality in the Gulf countries: Foreign workers in Saudi Arabia, most of whom are low-paid, are subject to monthly fees, the revenue from which is used to finance job training for Saudi citizens. *See* IMF, *supra* note 162, at 6.

subject to Zakat—a legally mandated charitable obligation that resembles a wealth tax—its implementation and enforcement are inconsistent.[164]

Beyond formal tax systems, these economies employ various non-tax policies that exacerbate inequality. China's *hukou* (household registration) system limits internal migrants' access to social security benefits—including pension, unemployment, education, housing, and health insurance benefits—despite mandatory contributions.[165] As a result, the social security system plays a limited role in reducing post-tax-and-transfer income inequality.[166] In addition, China's state-controlled banking system effects a sustained transfer of income from ordinary depositors to well-connected business borrowers by holding down interest rates on deposits, which allows banks to lend to companies at artificially low rates yet still earn a profit.[167] The Gulf countries rely heavily on regressive in-kind benefits like energy subsidies that disproportionately favor higher-income households, which consume more energy.[168] More conventional social welfare programs are limited, and those that exist exclude those employed in informal sectors and migrant workers.[169]

While Germany spends more than China and the Gulf countries on social welfare programs, fundamental changes to those programs (particularly unemployment insurance) in the early 2000s reduced their

164 *See* IMF, *supra* note 162, at 5. Real property is generally exempt from Zakat, although Saudi Arabia imposes Zakat on real estate held for speculative purposes. *See id.*

165 The *hukou* system places formal limits on the ability of workers to move and work outside of where they were born. In practice, the limits preventing internal migration are seldom enforced, which enables businesses to find workers they need. But while all workers are obligated to pay into the social security system, they are only eligible for those benefits if they live where they are officially registered. *See* Christian Dreger, Tongsan Wang & Yanqun Zhang, *Understanding Chinese Consumption: The Impact of Hukou*, 46 DEV. & CHANGE 1331, 1335–36 (2015) (describing the basic principles of the *hukou* system).

166 *See* Jain-Chandra et al., *supra* note 153, at 19; Dreger et al., *supra* note 166, at 1338–42 (assessing the role of *hukou* in explaining the decline in China's consumption ratio).

167 *See* Lerong Lu, *Private Banks in China: Origin, Challenges and Regulatory Implications*, 31 BANKING & FIN. L. REV. 585, 586–90 (2016); Dennis Tao Yang, *Aggregate Savings and External Imbalances in China*, 26 J. ECON. PERSPS. 125, 134, 138–39 (2012) (state-controlled banks are incapable of providing effective loans to private firms, which rely on private financing instead); *see also* Brad Setser, *Shadow Reserves—How China Hides Trillions of Dollars of Hard Currency*, CHINA PROJECT (June 29, 2023), https://thechinaproject.com/2023/06/29/shadow-reserves-how-china-hides-trillions-of-dollars-of-hard-currency [https://perma.cc/S7F3-SEXC] (explaining that state-controlled banks buy dollar-denominated assets as a form of "shadow reserves").

168 *See generally* Steffen Hertog, *The Political Economy of Distribution in the Middle East: Is There Scope for a New Social Contract?*, *in* 7 COMBINING ECONOMIC AND POLITICAL DEVELOPMENT: THE EXPERIENCE OF MENA 88 (G. Luciani ed., 2017) (explaining that in-kind benefits disproportionately benefit larger and richer consumers).

169 *See id.*; Markus Loewe, *Social Protection Schemes in the Middle East and North Africa: Not Fair, Not Efficient, Not Effective*, *in* SOCIAL POLICY IN THE MIDDLE EAST AND NORTH AFRICA 35, 38, 41–47 (Rana Jawad, Nicola Jones & Mahmood Messkoub eds., 2019).

generosity, leading to increased post-transfer inequality.[170] Labor market reforms that weakened unions exacerbated the unequal distribution of income: The share of German workers covered by collective bargaining agreements nearly halved from 80% in the mid-1990s to just 45% two decades later.[171] One consequence of the decline of German labor unions has been low wages compared to other European countries, especially in the manufacturing sector.[172]

These results of these policies are reflected in aggregate measures of inequality. In the late 1990s, the share of post-tax national income going to the bottom 50% of earners in Germany exceeded the share going to the top 10% by five percentage points; as of 2018, they were equal.[173] Inequality in China rose even more drastically: Between 2005 and 2018, China's Gini coefficient—a common measure of income inequality that ranges from zero (perfect equality) to one (perfect inequality)—increased from 0.35 to 0.52.[174] In the Gulf countries, the top 10% of income earners consistently earned more than half of all income over the past two decades.[175]

These regressive income distributions create a common pattern. As income inequality increases, with more income going to property and business owners than to workers and recipients of social welfare spending, more of it accrues (directly or indirectly) to households that are

170 *See* KLEIN & PETTIS, *supra* note 24, at 148–54; Jan Brulle & Markus Gangl, *The German Transfer System for the Working-Age Population: Design, Changes and Consequences*, *in* 3 DIMENSIONS OF INEQUALITY: THE IFS DEATON REVIEW i1182, i1186–88 (Supp. 1, Angus Deaton et al. eds., 2024).

171 *See* KLEIN & PETTIS, *supra* note 24, at 157–58; Hassel, *supra* note 155, at 366–68.

172 *See* JACOBY, *supra* note 152, at 12; Robert Kollmann, Marco Ratto, Werner Roeger, Jan Veld & Lukas Rogel, *What Drives the German Current Account? And How Does It Affect Other EU Member States?*, 30 ECON. POL. 47, 59 (2015); Jan Behringer, Till van Treeck & Victor Vincent, *Family Firms and Their Role in the Fall of the Labor Share and the Rise of Corporate Saving in Germany* 18–19 (Inst. for Socio-Econ., Working Paper No. 47, 2025) (finding that family firms experienced a sharper decline in wages than non-family firms).

173 *See Germany*, WORLD INEQ. DATABASE, https://wid.world/country/germany [https://perma.cc/SWL6-XKUE]; *see also* Thilo N.H. Albers, Charlotte Bartels & Moritz Schularick, *Wealth and Its Distribution in Germany, 1895–2018*, 28–36 (World Ineq. Lab, Working Paper No. 09, 2022) (describing the increase in wealth inequality in Germany between 1990 and 2018).

174 *See* Ravi Kanbur, Yue Wang & Xiaobo Zhang, *The Great Chinese Inequality Turnaround*, 49 J. COMPAR. ECON. 467, 471 (2021); *see also* Junsen Zhang, *A Survey of Income Inequality in China*, 59 J. ECON. LITERATURE 1191, 1192 (2021) (describing rising income inequality in China); Thomas Piketty, Li Yang & Gabriel Zucman, *Capital Accumulation, Private Property, and Rising Inequality in China, 1978–2015*, 109 AM. ECON. REV. 2469 (2019) (finding that the top 10% income share in China rose from 27% to 41% between 1978 and 2015, while the bottom 50% share dropped from 27% to 15%).

175 *See* MOSHRIF, *supra* note 159, at 1.

more likely to save than spend.[176] That leads to a sustained gap between domestic demand and domestic production: Domestic businesses produce more output than domestic consumers can buy. Between 2003 and 2016, German consumption decreased from 76.6% of GDP to 73.3%, with household consumption falling even more dramatically from 56.1% to 51.8%.[177] In China, households "consume less than 40[%] of Chinese output—a lower ratio than in every other major economy in the world, by far."[178]

In the Gulf countries, oil revenue windfalls flow disproportionately to those who are likely to save it, not consume it. Those savings take a particular form: financial outflows into havens offering financial secrecy. Increases in the price of oil leads to corresponding increases in financial haven deposits owned by petroleum-rich countries.[179] In fact, as much as 60% of wealth in Gulf countries is held in financial havens.[180] Importantly, just because financial havens are the proximate destination of those excess savings does not mean that they stay there. Financial havens simply act as intermediaries that channel financial capital from oil producers in the Middle East and other surplus countries to deficit countries, such as the United States.[181]

C. *Global Saving and the U.S. Trade Deficit*

Excess savings in surplus countries like China, Germany, and the Gulf countries must go somewhere. The mechanics of international imbalances require that a surplus in one country correspond to a deficit

176 *See* DEUTSCHE BUNDESBANK, *Private Consumption in Germany Since Reunification*, *in* MONTHLY REPORT 41, 48–49 (2007) ("Households with higher income tend to spend a smaller portion on consumption.").

177 *See* JACOBY, *supra* note 152, at 18; *see also* Kollman et al., *supra* note 172, at 80 (finding that an increase in household saving accounted for an increasingly larger share of the German current account surplus after 2003).

178 KLEIN & PETTIS, *supra* note 24, at 111.

179 *See* Jørgen Juel Andersen, Niels Johannesen, David Dreyer Lassen & Elena Paltseva, *Petro Rents, Political Institutions, and Hidden Wealth: Evidence from Offshore Bank Accounts*, 15 J. EUROPEAN ECON. ASS'N 818, 820 (2017). Tax evasion does not appear to be a significant motivation for these deposits since taxes on citizens of Gulf countries are low or nonexistent. *See id.* at 856.

180 *See generally* Annette Alstadsæter, Niels Johannesen & Gabriel Zucman, *Who Owns the Wealth in Tax Havens? Macro Evidence and Implications for Global Inequality*, 162 J. PUB. ECON. 89 (2018).

181 *See* Sergio Florez-Orrego, Matteo Maggiori, Jesse Schreger, Ziwen Sun & Serdil Tinda, *Global Capital Allocation* 31–32 (Nat'l Bureau of Econ. Rsch., Working Paper No. 31599, 2023) (documenting the amount of global cross-border financing recorded as flowing to tax havens as destinations of investment and coming from tax havens as sources of investment).

in another.[182] If economic production in one country exceeds domestic demand, that excess production will be exported abroad in exchange for foreign assets. The country will run a trade surplus that equals the net amount of foreign assets that the country receives from abroad.[183] The relationships formalized in the balance-of-payments equations, however, are only accounting identities—equations that hold because of the way their components are defined. Those accounting identities do not reveal the direction of the causal relationship between the different sides of the equation. More specifically, balance-of-payments equations do not explain the individual decisions of any country's government and residents that make the equation hold. They do not explain *how* net savings in one country translate to net financial inflows—and a trade deficit—in another country.

One possibility is that surplus countries save more than they invest because other countries, like the United States, have trade deficits that must be financed by selling financial assets to foreign investors.[184] This is the conventional account of the U.S. trade deficit, according to which it is caused by the fact that residents of the United States use—either in the form of consumption or investment—more than they produce.[185] To make up the difference between domestic demand and production, the United States must import more goods and services from abroad than it exports. And to finance the purchase of those excess imports, the United States must borrow more from foreign lenders than it lends abroad. According to this account, the reason why the United States has run a

182 *See supra* Section II.A.

183 *See supra* Section II.A.

184 *See* MARC LABONTE, CONG. RSCH. SERV., RL33140, IS THE U.S. TRADE DEFICIT CAUSED BY A GLOBAL SAVING GLUT? 2–4 (2007); Jeffrey D. Sachs, *Will Economic Illiteracy Trigger a Trade War?*, PROJECT SYNDICATE (Apr. 20, 2017), https://www.project-syndicate.org/commentary/trump-economic-illiteracy-trade-war-by-jeffrey-d-sachs-2017-04 [https://perma.cc/5QBU-K9AG] ("It's not hard to see why the US runs chronic current-account deficits. The US national saving rate—the sum of private saving plus government saving, measured as a share of GNI—has declined markedly during the past 30 years."); George P. Shultz & Martin Feldstein, *Everything You Need to Know About Trade Economics, in 70 Words*, WASH. POST. (May 5, 2017, 7:52 PM), https://www.washingtonpost.com/opinions/everything-you-need-to-know-about-trade-economics-in-70-words/2017/05/05/a2b76a02-2f80-11e7-9dec-764dc781686f_story.html [https://perma.cc/V8DC-DZLS] ("Federal deficit spending, a massive and continuing act of dissaving, is the culprit. Control that spending and you will control trade deficits."); Alan S. Blinder, *A Brief Introduction to Trade Economics*, WALL ST. J. (July 8, 2018, 2:20 PM), https://www.wsj.com/articles/a-brief-introduction-to-trade-economics-1531074006 [https://web.archive.org/web/20231109101011/https://www.wsj.com/articles/a-brief-introduction-to-trade-economics-1531074006] ("Ultimately, given America's domestic profligacy, its ability to borrow from abroad is a blessing. And borrowing from abroad means running trade deficits.").

185 *See* LABONTE, *supra* note 184, at 2 (describing the "conventional view" that attributes the cause of the U.S. current account deficit to its low national saving rate).

persistent trade deficit (and why it has been a net seller of financial assets) over the past several decades is because U.S. demand for goods and services has exceeded its domestic ability to produce those goods and services.[186]

This conventional account presumes that the U.S. trade deficit is determined by domestic production and consumption decisions. Residents of a country decide on a certain level of consumption and investment based on their individual preferences, and to the extent that level of consumption exceeds the productive capacity of the domestic economy, then they must import the difference from abroad. In order to finance that excess demand, they must borrow more from residents of foreign countries than they lend to residents of those countries, which leads to a financial account surplus.

But the conventional account goes farther than that. It assumes not just that demand and production in the United States determine the U.S. trade deficit, but that they determine production and demand levels *abroad* as well.[187] Recall that, at the global level, all demand and production must balance.[188] If U.S. demand exceeds U.S. production, then by definition the rest of the world's production must exceed its demand by the same amount. The same is true for global saving and investment. At the global level, all saving and investment must balance: One country's excess saving is another country's excess investment (or dissaving). If the United States sets its own domestic investment and saving rate completely autonomously—and needs to import financial capital to bridge the gap between low saving and high investment—then it must also set foreign investment and saving rates.

Causality, however, may run in the other direction.[189] Instead of the United States determining foreign demand and production decisions, foreign demand and production decisions might drive the gap between demand and production in the United States. If foreign countries have decided to produce (save) more than they demand (invest), then that excess production must go somewhere. If it ends up in the United States, then the U.S. financial account—and trade deficit—must expand to accommodate it. The question, then, is which assumption is more

186 *See* Blinder, *supra* note 184.

187 *See* Michael Pettis, *Will a Smaller Fiscal Deficit Cause the Trade Deficit to Decline or Unemployment to Rise?*, CHINA FIN. MKTS. (May 22, 2017), https://carnegieendowment.org/chinafinancialmarkets/70042 [https://perma.cc/5VVW-52FU].

188 *See* supra notes 128–131 and accompanying text.

189 *See* Kenneth Austin, *American Trade Deficits and the Unidirectionality Error*, 90 REAL-WORLD ECON. REV. 13, 30–33 (2019); Steinberg, *supra* note 141, at 213–14 (arguing that the global saving glut accounted for the vast majority of the cumulative U.S. trade deficit between 1995 and 2011).

plausible: Does the gap between demand and production in the United States require its residents to look abroad to meet that demand and to borrow from foreign countries to bridge the financing gap? Or do conditions in foreign countries cause production to exceed demand, such that the United States must absorb the surplus, leading it to run a trade deficit?

Section II.B outlined how excess saving in major foreign economies—the global saving glut—is, in large part, the product of domestic policy decisions that concentrate income among households and businesses that are less likely to spend and more likely to save.[190] These countries have excess savings because domestic demand is insufficient to absorb their domestic production of goods and services.[191] That excess production is exported—ultimately consumed or invested abroad. In exchange for those exported goods and services, surplus countries accept as payment financial claims on U.S. assets. Surplus countries' excess savings just represent the amount of production that is not consumed or invested domestically.[192] On the other side of the equation, the United States must consume or invest more than it produces—it must run a trade deficit—and pay for the excess by transferring claims on its assets to those other countries.[193]

These transactions play out at the multilateral, not bilateral, level.[194] Just because a country (say, China) runs a bilateral trade surplus with—exports more to than it imports from—another country (such as Mexico) does not mean that the financial claims it ultimately holds must be issued by that other country. The surplus country can decide to turn financial claims it receives into claims on the assets of a third country (the United States).[195] The way bilateral surpluses and deficits balance at the global level can involve multiple countries. But if there is a country in which production exceeds demand, there must be another country in which demand exceeds production. For the balance-of-payment identities to hold, a surplus country just has to hold *some* foreign financial assets that equal the difference between the goods and services it exports and those it imports. And *some* other country must issue financial claims to foreign

190 *See supra* Section II.B.

191 *See supra* notes 174–176 and accompanying text.

192 *See supra* Section II.A.

193 *See* Bernanke, *supra* note 5.

194 *See* Austin, *supra* note 24, at 611–19.

195 In that hypothetical example, while Mexico runs a bilateral trade deficit with China, it will run a bilateral trade surplus with the United States that matches its deficit with China. But the cause of Mexico's bilateral surplus with the United States is China's purchase of U.S. financial assets. *See* Austin, *supra* note 189, at 34–35.

holders equal to the excess of its imports from all other countries over exports to those countries.[196]

The conventional account of the U.S. trade deficit says that domestic decisions give rise to a trade deficit, and, in turn, the need for inflows of scarce financial capital to finance that deficit.[197] But this account ignores the possibility that the direction of causation largely runs in the other direction: Foreign decisions create a buildup of savings that need to be absorbed by the United States.[198] According to this alternative account, the United States does not primarily run a trade deficit because it consumes or invests more than it produces, but because other countries produce more than they consume or invest. Those excess savings generate an outflow of financial capital, which is absorbed by the United States in the form of capital inflows. As a result of those inflows, the United States runs a financial account surplus. That financial account surplus translates into a trade deficit. In other words, the U.S. trade deficit does not drive its financial account surplus; its financial account surplus drives its trade deficit.[199]

D. *The Cost of Absorbing Excess Savings*

From the standpoint of international accounting identities, excess savings must go somewhere—they must be balanced by financial inflows elsewhere. An obvious destination is the country with the deepest, most accessible financial markets in the world: the United States. There are several, interrelated reasons why savings from surplus countries end up in the United States. Since the adoption of the Bretton Woods system in 1944, the U.S. dollar has functioned as the world's primary reserve currency: foreign central banks hold dollars, and dollar-denominated assets, in significant quantities in order to set their exchange rates.[200]

196 *See id.*

197 *See supra* notes 182–183 and accompanying text.

198 *See* Austin, *supra* note 189, at 30–33.

199 *See id.*

200 *See* REBECCA M. NELSON & MARTIN A. WEISS, CONG. RSCH. SERV., IF11707, THE U.S. DOLLAR AS THE WORLD'S DOMINANT RESERVE CURRENCY 1 (Sept. 15, 2022); Linda S. Goldberg & Robert Lerman, *The U.S. Dollar's Global Roles: Where Do Things Stand*, LIBERTY ST. ECON. (Feb. 11, 2019), https://libertystreeteconomics.newyorkfed.org/2019/02/the-us-dollars-global-roles-where-do-things-stand [https://perma.cc/KW8C-BMNB] ("[T]he dollar remains the world's dominant currency by broad margins."); Carol Bertaut, Bastian von Beschwitz & Stephanie Curcuru, "*The International Role of the U.S. Dollar*" *Post-COVID Edition*, FED. RSRV. (June 23, 2023), https://www.federalreserve.gov/econres/notes/feds-notes/the-international-role-of-the-us-dollar-post-covid-edition-20230623.html [https://perma.cc/2JS4-XBAT] ("[T]he dollar remains the dominant currency and plays an outsize international role as measured by usage in international reserves . . . .").

The U.S. dollar, and U.S. financial assets more generally, serve a variety of other important roles in international trade and finance. Approximately half of international trade is conducted using U.S. dollars; likewise, half of all international debts are denominated in dollars.[201] The dollar's status as the predominant global currency is bolstered by the status of dollar-denominated assets, especially U.S.-government issued or guaranteed assets, as "safe assets"—assets that have very little credit risk and are therefore almost guaranteed to pay back their nominal value.[202] In addition to having the world's reserve currency and serving as a safe haven for global financial flows, the United States also has the largest capital market in the world, accounting for two-fifths of global equity and debt securities by value.[203] The U.S. capital markets are also the deepest and most liquid in the world, offering investors the highest trading volumes and the lowest spreads.[204] The predominance of the U.S. financial system is bolstered by politically independent institutions like the Federal Reserve and a tradition of credible, expertise-driven policymaking at the Treasury, as well as the United States' history of legal and political stability.[205] These factors—as well as the fact that U.S. financial markets are highly accessible to foreign investors—help explain why financial flows from abroad gravitate to the United States.

The dollar's status has long been regarded as an "exorbitant privilege" enjoyed by the United States: While other countries need to provide $100 worth of goods or services in order to obtain $100, the

201 *See* NELSON & WEISS, *supra* note 200, at 1; Gita Gopinath & Jeremy C. Stein, *Banking, Trade, and the Making of a Dominant Currency*, 136 Q.J. ECON. 783, 783–84 (describing that the overwhelming fraction of international trade is invoiced and settled in dollars, and bank funding and corporate borrowing is issued in dollars).

202 *See* Bernanke, *supra* note 24; Ricardo J. Caballero, Emmanuel Farhi & Pierre-Olivier Gourinchas, *The Safe Assets Shortage Conundrum*, 31 J. ECON. PERSPS. 29, 32–36 (2017) (describing global demand for U.S.-issued "safe assets"); Gopinath & Stein, *supra* note 201 (describing the U.S. dollar's role as a unit of account for trade and debt issuance is complementary to its role as a safe store of value); William Barcelona, Nathan Converse & Anna Wong, *U.S. Housing as a Global Safe Asset: Evidence from China Shocks* (Fed. Rsrv. Bd., Int'l. Fin. Discussion Paper No. 1332, 2021), https://www.federalreserve.gov/econres/ifdp/files/ifdp1332.pdf [https://perma.cc/U2ZY-AU7P] (noting that U.S. residential real estate functions as a safe haven for financial inflows from China).

203 *See* KATIE KOLCHIN, JUSTYNA PODZIEMSKA & DAN DONG, SIFMA RSCH., 2023 CAPITAL MARKETS FACT BOOK 7 (2023).

204 *See* Phil Mackintosh, *How Much Does Trading Cost the Buy Side?*, NASDAQ (Feb. 17, 2022, 4:38 PM), https://www.nasdaq.com/articles/how-much-does-trading-cost-the-buy-side [https://perma.cc/4U72-9S3G]; Phil Mackintosh, *Is the U.S. Really the Most Liquid Market in the World?*, NASDAQ (Feb. 8, 2024), https://www.nasdaq.com/articles/is-the-us-really-the-most-liquid-market-in-the-world [https://perma.cc/FC8P-QQTW].

205 ERNIE TEDESCHI, YALE BUDGET LAB, POLITICAL RISKS TO THE U.S. SAFE HARBOR PREMIUM 3–4 (2024), https://budgetlab.yale.edu/sites/default/files/2024-05/The%20Budget%20Lab%20Safe%20Harbor%20Analysis%202024_0.pdf [https://perma.cc/QQ8X-SPZV].

Federal Reserve can just print $100.[206] The predominance of U.S. financial assets also means that foreign lenders are willing to pay a "convenience yield"—forgoing a sizeable financial return paid on other assets—to hold them.[207] That lowers financing costs for U.S. borrowers.[208]

But the fact that the United States soaks up excess foreign savings can also be an "exorbitant burden."[209] When the United States absorbs savings from abroad, it uses more goods and services than are produced domestically, and in exchange, transfers financial claims on U.S. assets to foreign investors.[210] The goods and services imported from abroad can be put toward an increase in productive investment: The financial assets transferred to foreigners can represent claims on the profits from those investments. Indeed, if productive investment in the United States were constrained by a lack of domestic saving—by the scarcity of financial capital—additional financial inflows from abroad could be welcome.[211] For the past two decades, however, U.S. investment has not been held back by the high cost of capital. The United States has experienced persistently low real interest rates.[212] And foreign investors continue to

206 *See* BARRY EICHENGREEN, EXORBITANT PRIVILEGE: THE RISE AND FALL OF THE DOLLAR 3 (2011).

207 *See* Gopinath & Stein, *supra* note 201, at 785 (defining the "exorbitant privilege" based on the fact that dollar liabilities pay a lower rate of return than comparable assets); *see also* Pierre-Olivier Gourinchas & Helene Rey, *From World Banker to World Venture Capitalist: U.S. External Adjustment and the Exorbitant Privilege*, *in* G7 CURRENT ACCOUNT IMBALANCES: SUSTAINABILITY AND ADJUSTMENT 11 (Richard Clarida ed., 2007) (defining the "exorbitant privilege" to capture the phenomenon whereby assets owned by the United States earn a higher return than it pays on its liabilities). *But see* Robert N. McCauley, *Does the U.S. Dollar Confer an Exorbitant Privilege?*, 57 J. INT'L MONEY & FIN. 1 (2015) (explaining that the purported benefits of the U.S. dollar's international role are small, not unique to the United States, or unrelated to dollar's role).

208 *See, e.g.*, Arvind Krishnamurthy & Annette Vissing-Jorgensen, *The Aggregate Demand for Treasury Debt*, 120 J. POL. ECON. 233 (2012) (documenting the lower return on U.S. Treasury bonds); Ralph S.J. Koijen & Motohiro Yogo, *Exchange Rates and Asset Prices in a Global Demand System* (Nat'l Bureau of Econ. Rsch., Working Paper No. 27342, 2020), https://www.nber.org/papers/w27342 [https://perma.cc/4WVX-9TEP] (measuring convenience yield on U.S. debt and equity).

209 *See* Michael Pettis, *An Exorbitant Burden*, FOREIGN POL'Y (Sept. 7, 2011), https://foreignpolicy.com/2011/09/07/an-exorbitant-burden [https://perma.cc/WKV5-HQND] (stating that the U.S. dollar's global role is a "massive drag" on the U.S. economy); *see also* Pierre-Olivier Gourinchas & Helene Rey, *Exorbitant Privilege and Exorbitant Duty* 2 (Ctr. for Econ. Pol'y Rsch., Discussion Paper No. DP16944, 2022), https://repec.cepr.org/repec/cpr/ceprdp/DP16944.pdf [https://perma.cc/5XVS-JE83] (describing the United States' role as an "insurer" during crisis periods).

210 *See supra* Section II.A.

211 *See* Taylor, *supra* note 131, at 98–99.

212 FED. RSRV. ECON. DATA, *supra* note 142; *see also* Gauti B. Eggertsson, Neil R. Mehrotra & Lawrence H. Summers, *Secular Stagnation in the Open Economy* (Nat'l Bureau of Econ. Rsch., Working Paper No. 22172, 2016) (modeling a scenario in which capital flows transmit recessions from one country to another by forcing down the real interest rate).

invest in the U.S. financial assets even when those assets offer comparatively low returns.[213] As long as the United States is not starved for scarce capital, the inflow of foreign savings will not finance profitable investment that would not have been undertaken otherwise. Even as the size of foreign financial claims on the United States has steadily increased, real investment as a share of economic output has remained stagnant.[214]

If foreign financial inflows do not finance product investment, financial claims on U.S. assets must come from one of two sources: either from displaced domestic savings—financial assets that otherwise would have gone to U.S. savers—or from financing consumption or unproductive investment. How can the import of foreign financial capital displace domestic savings? An influx of foreign financial capital means that more goods and services are imported than exported. Goods and services—especially goods—are imported from abroad because foreign labor is cheaper than domestic labor.[215] That foreign labor is cheaper in part because the same regressive policies that push up foreign saving leave foreign workers with a smaller share of the national income.[216] But the fact that foreign workers are relatively worse off means they cannot afford to buy goods and services from the United States. As a result, U.S. exports will not offset increased imports. Instead, foreign imports displace domestic production, leading to higher domestic unemployment or lower wages. When domestic unemployment rises or wages fall, domestic saving goes down; workers who have lost their jobs or earn less are less likely to save as much of their income. Financial claims that would have gone to domestic savers are instead diverted to foreign savers.[217]

This story matches what occurred in the United States, especially its manufacturing sector, over the past two decades. Between 2000 and 2012,

213 *See* sources cited *supra* notes 207–208.

214 *U.S. Net International Investment Position*, FED. RSRV. ECON. DATA (June 26, 2024, 7:37 AM), https://fred.stlouisfed.org/series/IIPUSNETIA [https://perma.cc/SS2A-3R8U]; *Gross Domestic Investment*, FED. RSRV. ECON. DATA (Dec. 19, 2024, 7:54 AM), https://fred.stlouisfed.org/series/W170RC1Q027SBEA [https://perma.cc/3JYC-XTVM]; *see also* Gianluca Benigno, Luca Fornaro & Martin Wolf, *The Global Financial Resource Curse*, 115 AM. ECON. REV. 220 (2025) (explaining that capital inflows into the United States depress productivity growth by inducing a reallocation of economic activity and investment from the tradable sector to the non-tradable one).

215 Mai Chi Dao, Mitali Das, Zsoka Koczan & Weicheng Lian, *Why Is Labour Receiving a Smaller Share of Global Income?*, 34 ECON. POL'Y 723, 734–36 (2019).

216 *See supra* Section II.B.

217 *See* Austin, *supra* note 189, at 27–28; David H. Autor, David Dorn & Gordon H. Hanson, *The China Shock: Learning from Labor-Market Adjustment to Large Changes in Trade*, 8 ANN. REV. ECON. 205 (2016) (trade shocks originating in China caused U.S. employment and wages to fall in industries exposed to import competition without employment gains in other industries).

U.S. manufacturing employment declined by more than 25%.[218] Over the same period, the manufacturing sector's contribution to U.S. production stagnated and then started to decline.[219] That is not because U.S. manufacturers only started facing foreign competition in 2000. Beginning in the early 2000s, however, cheap foreign imports began to displace American manufacturing and manufacturing jobs.[220] Chinese import penetration into the United States rose relatively slowly in the 1990s, before accelerating in the 2000s.[221] But increased imports were not offset by increased U.S. exports. Instead, the rise in imports coincided with a decline in demand for U.S. manufactured goods abroad.[222] Trade was not necessarily only freeing up U.S. workers to work in more productive sectors; it was also replacing them with foreign workers who did not earn enough to buy what U.S. workers could produce.[223]

The import of foreign financial capital can also lead to the creation of new financial assets used to finance consumption or unproductive investment. In the unproductive investment scenario, financial claims issued to foreign investors lead to increased domestic investment, rather than a decline in domestic production. But since the investment is unproductive, the income generated from that investment will not be sufficient to support the financial claims.[224] Rather, the value of the

218 *See All Employees, Manufacturing*, FED. RSRV. ECON. DATA (Jan. 10, 2024, 7:51 AM), https://fred.stlouisfed.org/series/MANEMP [https://perma.cc/86PJ-LVXV]; Teresa Fort, Justin R. Pierce & Peter K. Schott, *New Perspectives on the Decline of US Manufacturing Employment*, 32 J. ECON. PERSPS. 47, 48 (2018). *Compare* ROBERT E. SCOTT, ECON. POL'Y INST., MANUFACTURING JOB LOSS (2015), https://files.epi.org/2015/ib402-manufacturing-job-loss.pdf [https://perma.cc/W3YX-ZLU6] (attributing U.S. manufacturing job losses to its trade deficits), *with* Timothy J. Kehoe, Kim J. Ruhl & Joseph B. Steinberg, *Global Imbalances and Structural Change in the United States*, 126 J. POL. ECON. 761, 762 (2018) (estimating that the global saving glut accounted for only 11 to 20 percent of the overall decline in U.S. manufacturing employment between 1992 and 2012).

219 *See* Fort et al., *supra* note 218, at 48.

220 *See id.* at 51–52.

221 *See id.* at 51; Autor et al., *supra* note 217, at 211–14.

222 *See* Fort et al., *supra* note 218, at 52.

223 *See* Autor et al., *supra* note 217, at 227–31; David Autor, David Dorn & Gordon Hanson, *On the Persistence of the China Shock* (Nat'l Bureau of Econ. Rsch., Working Paper No. 29401, 2021) (manufacturing job loss "translated nearly one for one" into a fall in the employment-population ratio and its effects persisted long after import penetration plateaued in 2010); Nicholas Bloom, Kyle Handley, Andre Kurmann & Philip A. Luck, *The China Shock Revisited: Job Reallocation and Industry Switching in U.S. Labor Markets* (Nat'l Bureau of Econ. Rsch., Working Paper No. 33098, 2024) (finding that firms that pay lower wages and are located in areas with lower human capital did not respond to Chinese import penetration by reallocating to service sector jobs); David H. Autor, David Dorn, Gordon H. Hanson, Maggie R. Jones & Bradley Seltzer, *Places Versus People: The Ins and Outs of Labor Market Adjustment to Globalization*, *Markets* (Nat'l Bureau of Econ. Rsch., Working Paper No. 33424, 2025) (finding that manufacturing workers in areas exposed to Chinese import competition were more likely than other residents to exit employment or get lower-paying jobs in the service sector).

224 *See* Fort et al., *supra* note 218, at 52.

investment can only be justified by the expectation that its price will rise, including as part of an asset bubble.[225] An increase in asset prices can also facilitate consumption, if households respond to an increase in the value of assets they own—like their houses—and respond by increasing their consumption.[226] An inflow of foreign savings can also lead to increased investment and consumption if it causes banks and other financial intermediaries to reach for yield by making riskier loans.[227] As lenders relax credit standards, businesses and households that would have otherwise been denied access to credit can find it easier to borrow.[228] In response, they expand investment (in the case of businesses) or consumption (in the case of households). In either case, the financial claims that offset net imports come from increasing domestic debt to fund additional unproductive investment or household consumption.[229]

The 2007 to 2008 global financial crisis—and the housing market collapse that preceded it—is generally attributed to failures of the U.S. financial system and its regulation.[230] But the role played by the flow of excess foreign savings into the United States should not be overlooked.[231] The surge in foreign demand for U.S. financial assets—particularly safe, government-backed Treasury and agency securities—during the early 2000s precipitated the creation of complex chains of financial intermediation that channeled safe, government-backed assets into risky mortgages.[232] Financial inflows fueled unproductive real estate

225 *See* Austin, *supra* note 189, at 25–27.

226 *See id.*; Atif Mian, Ludwig Straub & Amir Sufi, *Indebted Demand*, 136 Q.J. ECON. 2243 (2021) (describing how increased lending can generate a short-run, debt-financed boom).

227 *See* Atif Mian & Amir Sufi, *Finance and Business Cycles: The Credit-Driven Household Demand Channel*, 32 J. ECON. PERSPS. 31, 40–42 (2018) (describing how expansions of credit supply can boost firm investment or enabling households to increase consumption).

228 *See id.* at 36–37 (describing relaxation of credit standards in the United States in the lead up to the financial crisis).

229 Atif Mian, Ludwig Straub & Amir Sufi, *The Saving Glut of the Rich* (Nat'l Bureau of Econ. Rsch., Working Paper No. 26941, 2021) (describing a similar dynamic, although focused on excess savings of wealthy Americans rather than excess foreign savings).

230 *See generally* Viral V. Acharya & Matthew Richardson, *Causes of the Financial Crisis*, 21 CRITICAL REV. 195 (2009).

231 *See* BRAD SETSER, CTR. FOR FIN. STABILITY, CAPITAL FLOWS INTO THE UNITED STATES AHEAD OF THE GREAT NORTH ATLANTIC FINANCIAL CRISIS (2018); ANTON BRENDER & FLORENCE PISANI, GLOBAL IMBALANCES AND THE COLLAPSE OF GLOBALISED FINANCE (Francis Wells trans., 2010) (linking the global saving glut to financial innovations that precipitated the financial crisis).

232 *See* Caballero et al., *supra* note 202, at 32–34, 40–41; BRENDER & PISANI, *supra* note 231, at 99–115; SETSER, *supra* note 231, at 3–7, 9–11. For a more recent example of how financial inflows finance American consumption through chains of financial intermediation, see Joshua Younger & Brad Setser, *What Does Taiwan Have to Do with US Mortgage Rates?*, FIN. TIMES (Feb. 3, 2025), https://www.ft.com/content/df22b05f-2139-44ce-8077-68097df896f3 [https://perma.cc/L2QX-B92J] (describing how Taiwanese life insurance savings translate, through derivative markets, to lower mortgage rates for U.S. homeowners).

investment that was only justified by the expectation of rising prices. Those rising prices unleashed further consumption, as U.S. households borrowed against the inflated value of their homes to facilitate additional consumption.[233] When the housing bubble burst, the big banks were unable to absorb their mortgage losses, triggering the global financial crisis.[234]

The decline in U.S. manufacturing described above (lower domestic production) can be linked to the debt-fueled increase in domestic consumption that characterized the housing bubble (increased domestic demand). The inflow of excess foreign savings into the United States took the form of an exchange of foreign imports—imports that displaced U.S. manufacturing—for foreign claims on households used to finance consumption. One study connects vulnerability to foreign competition with increasing household debt. It shows that "household debt increases significantly in regions where manufacturing industries are more exposed to import competition."[235] In places where workers were more likely to be affected by foreign import competition, they were more likely to take on debt, especially in the form of home equity extraction.[236]

The United States' role as the preferred destination of global excess savings carries significant costs. Foreign financial inflows have fueled financial instability and displaced domestic production and employment. Far from being scarce, foreign financial capital is abundant—so abundant that the United States has more of it than it needs or wants. The question facing policymakers, then, should not be how to reduce the tax burden on foreign investment to attract financial inflows, but how to increase it in order to deter financial inflows.

III. TAX POLICY IN A WORLD OF ABUNDANT FINANCIAL CAPITAL

The previous Part explained that the United States' financial account surplus—the excess of overseas financial inflows to the United States over outflows to foreign countries—drives the trade deficit. These financial inflows are not *pulled* by a domestic need for scarce foreign capital. Rather, the redistribution of income upwards in foreign countries has led to a situation where those countries are overflowing with excess savings, which are then *pushed* to the United States. These financial inflows do not necessarily finance productive investment. They can also harm

233 *See* Mian & Sufi, *supra* note 227, at 40–42.

234 *See* BRENDER & PISANI, *supra* note 231, at 117–27; SETSER, *supra* note 231, at 12–13.

235 Jean-Noël Barrot, Erik Loualiche, Matthew Plosser & Julian Sauvagnat, *Import Competition and Household Debt*, 77 J. FIN. 3037, 3037 (2022).

236 *See id.* at 3057–60.

domestic producers and workers and disrupt the stability of the U.S. financial system. By rejecting the scarce capital assumption, the argument outlined in the previous Part calls into question the current U.S. tax treatment of foreign investment. If the United States does not need foreign financial inflows—indeed, if those inflows are harmful—then it should not subsidize them by offering favorable tax treatment. This Part focuses on policy options available to revise the tax rules applicable to inbound foreign investment. The effect of these policies would be to increase the tax burden on foreign investment in the United States. Though most of them would require statutory changes, some unilateral administrative action is possible. This Part also considers other efforts to use tax policy to reduce the trade deficit and explains why they are unlikely to succeed if they do not address financial account imbalances.

A. *Taxing Foreign Investment*

The current tax exemptions for foreign investment income operate as a subsidy for foreign financial inflows. If foreign financial capital were scarce, then such a subsidy might be warranted. In a world where financial capital is abundant, there is no need for the United States to create tax preferences for foreign financial inflows. Instead, the United States should increase the tax burden on foreign investment income.

The effect of taxing financial inflows will depend on the elasticity of foreign investors' supply of financial capital: the extent to which a reduction in the (after-tax) return on financial capital affects how much foreigners are willing to invest in the United States. For a variety of reasons, as noted above, the United States has served as the preferred destination for foreign financial capital: Foreign investors are willing to pay a "convenience yield" to hold U.S. financial assets. U.S. financial assets offer something to foreign investors, such as liquidity or safety, that generally is not available elsewhere.[237] If the supply of financial capital to the United States is inelastic, and foreign investors cannot substitute foreign assets for U.S. assets at all, then foreign investors will bear the entire cost of any additional tax.[238] That will not reduce foreign financial inflows, but it will lead to increased tax revenue for the U.S. government: The United States would "charge rent on the place in the sun."[239] The

237 *See supra* notes 200–208 and accompanying text; Lawrence H. Goulder, *Implications of Introducing U.S. Withholding Taxes on Foreigners' Interest Income*, 4 TAX POL'Y & ECON. 103, 116–17 (1990).

238 Goulder, *supra* note 237.

239 Rudiger Dornbusch, *Flexible Exchange Rates and Excess Capital Mobility*, 1986 BROOKINGS PAPERS ECON. ACTIVITY 209, 225.

government could use that additional tax revenue to lower taxes on U.S. taxpayers or reduce its own borrowing. Alternatively, the revenue could be put toward supporting domestic manufacturing (offsetting its displacement by foreign imports), increasing investment in domestic infrastructure, or expanding the social safety net. Domestic investment and consumption would still exceed domestic production, but that investment and consumption could be managed in a way that leads to fewer distortions and protects those who are most vulnerable to displacement from foreign competition.

If supply of financial capital to the United States is elastic, however, increasing the tax burden on foreign financial inflows will raise U.S. issuers' cost of funds and reduce the level of financial inflows. The more something is taxed, the less of it there will be. Some empirical evidence suggests that foreign investment may be sensitive to U.S. taxes. For example, studies indicate that reducing the U.S. tax burden on foreign real estate investment induces more foreign investment in U.S. real estate.[240] Of course, that may represent a shift in the composition of demand for U.S. financial assets—from non-real estate to real estate investment—not the overall level of demand. Other studies have found that imposing withholding taxes on foreign investors' income raises issuers' financing costs.[241] By raising the cost of foreign financial capital, taxing foreign investment income would discourage demand for U.S. financial assets.

If foreign financial inflows led to more productive investment in the United States, then taxing foreign investment income might not be good policy.[242] The U.S. government would still collect tax revenue, which could be used to lower the tax burden on domestic taxpayers or to increase spending on government programs. But domestic investment

240 *See* Margot Howard, Katherine A. Pancak & Douglas A. Shackelford, *Taxes, Investors, and Managers: Exploring the Taxation of Foreign Investors in U.S. REITs*, 38 J. AM. TAX'N ASS'N 1 (2016) (observing that reduction in tax on real estate investment trust (REIT) capital gain distributions to some foreign investors led to an increase in foreign REIT investment); Margot Howard & Katherine A. Pancak, *Do Taxes Matter to Foreign Real Estate Investors? Evidence from FIRPTA Reform*, 45 J. PORTFOLIO MGMT. 160 (2019) (finding that foreign pension funds responded to tax exemption for investment in U.S. real estate by increasing their investment in U.S. real estate).

241 *See, e.g.*, Harry Huizinga, *Withholding Taxes and the Cost of Public Debt* (IMF, Working Paper No. 94/18, 1994) (finding that issuers bear approximately half the cost of withholding tax on government debt); *see also* Dan Amiram & Mary Margaret Frank, *Foreign Portfolio Investment and Shareholder Dividend Taxes*, 91 ACCT. REV. 717 (2016) (finding that foreign investors' equity holdings in a country are negatively related to withholding tax rate on dividends); Martin Jacob & Maximilian Todtenhaupt, *Withholding Taxes, Compliance Cost and Foreign Portfolio Investment*, 98 ACCT. REV. 299 (2023) (finding that withholding tax on foreign investment income reduces foreign portfolio investment due to difficulties in claiming foreign tax credits).

242 *But see* Goulder, *supra* note 237, at 123–27 (arguing that unilateral withholding tax on foreign investment would increase U.S. welfare).

would have to be financed at a higher cost,[243] and some marginal productive investments may be forgone entirely. However, as argued above, the flow of excess savings into the United States has not led to productive domestic investment.[244] It has adverse effects on domestic production, including by displacing U.S. manufacturing.[245] If increased taxation reduces the flow of excess foreign savings, that could help rebalance the United States' trade deficit by facilitating greater domestic production. It could also help enhance financial and economic stability, by reducing the likelihood of asset price bubbles driven by debt-fueled investment and consumption.[246]

In effect, taxes on foreign investment income can be thought of as a Pigouvian tax on foreign financial inflows.[247] At the "micro" level, foreign financial inflows can be voluntary and beneficial: American banks may solicit foreign deposits, which they use to finance an individual consumer's purchase of a home or car. But at the "macro" level, the United States' open financial markets mean that it has no control over financial inflows, absorbing whatever excess savings foreigners choose to invest. The disparity between individual benefits and aggregate harms is a negative externality, which can be reduced or eliminated through the imposition of a tax on the offending activity.[248]

The idea of reducing foreign financial inflows by taxing them was behind the proposal, in a 2019 bipartisan bill sponsored by Senators Tammy Baldwin and Josh Hawley to impose a fee (or "Market Access Charge") on foreign purchases of dollar-denominated assets.[249] The Federal Reserve would set the fee amount, but the revenue earned would accrue to the Treasury.[250] The Market Access Charge would effectively

243 *See id.* at 115. Some of this loss would be offset by the higher return of U.S. investors on their domestic investments, which would not face any additional tax but would now earn the same, higher return paid to foreign investors. *See id.*

244 *See supra* Section II.D.

245 *See supra* notes 217–223 and accompanying text.

246 *See supra* notes 225–236 and accompanying text.

247 *See* Jonathan S. Masur & Eric A. Posner, *Toward a Pigouvian State*, 164 U. PA. L. REV. 93, 95 (2015) ("A Pigouvian tax is a tax equal to the harm that the firm imposes on third parties.").

248 The notion that saving creates externalities that can be corrected through capital income taxation features in the new dynamic public finance literature. *See, e.g.*, Mikhail Golosov, Marayana Kocherlakota & Aleh Tsyvinski, *Optimal Indirect and Capital Taxation*, 70 REV. ECON. STUD. 569 (2003). Economists have also proposed Pigouvian taxes on debt to deter excessive borrowing. *See, e.g.*, Olivier Jeanne & Anton Korinek, *Managing Credit Booms and Busts: A Pigouvian Taxation Approach*, 107 J. MONETARY ECON. 2, 3 (2019) (finding that the optimal debt tax would be 0.6% of outstanding borrowing).

249 *See* Competitive Dollar for Jobs and Prosperity Act, S. 2357, 116th Cong. (2019).

250 *See id.* § 5.

operate as a transaction tax on foreign financial inflows.[251] While a transaction tax of this sort may be warranted, transaction taxes generally, and a novel tax on financial inflows in particular, are likely to suffer from design and implementation difficulties.[252] A better first step in addressing the United States' financial account imbalance would be to unwind the tax preferences for foreign investors embedded in current tax law.

Any unilateral attempts by the United States to reverse those tax preferences will run headlong into its network of bilateral tax treaties. Those tax treaties in large part reflect the conclusions of the 1923 League of Nations double-taxation report, which recommended that passive investment income of foreign investors be exempted from tax in the source jurisdiction.[253] Accordingly, they generally reduce, and in some cases, eliminate, U.S. tax on passive income, such as interest and dividends, paid to residents of treaty countries.[254] That does not mean that Congress has no recourse. Courts have held that tax statutes override inconsistent treaty provisions where the statute was enacted after the treaty went into effect.[255] Indeed, Congress has periodically passed legislation that imposes tax at source on income that was otherwise exempted from tax by treaty. In the 1980s, for example, Congress passed "branch profits tax" and "earnings stripping" legislation that unilaterally restrict eligibility for certain treaty benefits, thereby increasing the U.S. tax obligations of residents of treaty countries.[256]

Following that example, Congress could pass legislation making eligibility for treaty benefits contingent on the recipient of income paying tax in their home country, ensuring that any foreign investment income

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251 *See* Leonard E. Burman et al., *Financial Transaction Taxes in Theory and Practice*, 69 NAT'L TAX J. 171, 173–74 (2016).

252 *See id.* at 181–85.

253 *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, & Sir Josiah Stamp*, *supra* note 25.

254 *See supra* text accompanying notes 35–51.

255 *See, e.g.*, Jamieson v. Comm'r of Internal Revenue, 584 F.3d 1074 (D.C. Cir. 2009) (finding that a later-in-time alternative minimum tax provision overrode a U.S.-Canada tax treaty); Kappus v. Comm'r of Internal Revenue, 337 F.3d 1053 (D.C. Cir. 2003) (same); Lindsey v. Comm'r of Internal Revenue, 98 T.C. 672 (1992) (finding that a later-in-time alternative minimum tax provision overrode a U.S.-Switzerland tax treaty).

256 *See* John I. Forry & Michael J.A. Karlin, *1986 Act: Overrides, Conflicts, and Interactions with U.S. Income Tax Treaties*, 35 TAX NOTES 793, 797, 800 (1987). Congress strengthened the earnings-stripping rules in 1993. *See* David Hardy, *New Rules Have Drastic Impact*, 5 INT'L TAX REV. 11 (1994). For a more comprehensive discussion of tax treaty overrides by the United States, see Reuven S. Avi-Yonah, *Tax Treaty Overrides: A Qualified Defence of U.S. Practice*, *in* TAX TREATIES AND DOMESTIC LAW 65, 65–70 (Guglielmo Maisto ed., 2006).

is at least taxed once.[257] More drastically, Congress could make eligibility for treaty benefits depend on the recipient's home country not running a trade surplus so that countries pay a tax penalty for channeling their excess savings to the United States.[258] That said, any such override could put the United States in violation of its tax treaty obligations, which could lead treaty partners to reciprocate by unilaterally terminating their treaties.[259] It may therefore be preferable to renegotiate those tax treaties to reduce or eliminate treaty-based tax preferences for passive foreign investment.[260]

Negotiating tax treaties, however, takes time. In the shorter term, Congress still has room to act. The current statutory tax preferences for foreign investment go well beyond what is required by the United States' tax treaties. The U.S.-China income tax treaty, for example, allows the United States to impose a tax of up to 10% of interest income of Chinese investors in the United States, more than the 0% currently imposed on those investors' portfolio interest income.[261] Even more important, the unilateral tax preferences described earlier are available to foreign investors that reside in non-treaty jurisdictions, such as the Cayman Islands and the oil-exporting counties of the Middle East.[262] In recent years, residents of those jurisdictions have been among the largest net investors in U.S. financial assets.[263]

The tax exemptions for foreign investors' passive interest income stand in stark contrast to the treatment of active business income: A

257 The latest U.S. model tax treaty includes several "kill-switch" provisions that strip treaty benefits where income is subject to low or no taxation abroad. For example, the treaty provides that preferential treaty rates on dividends, interest, royalties, and other income may be denied if a treaty partner reduces its tax rates below a threshold amount or exempts foreign source income from taxation. *See* United States Model Income Tax Convention, *supra* note 50, arts. 11(2)(c), 12(2)(a), 21(2)(a).

258 At the 1944 Bretton Woods conference, John Maynard Keynes proposed a tax on the excess reserves of trade surplus countries. *See* G. John Ikenberry, *The Political Origins of Bretton Woods*, *in* A RETROSPECTIVE ON THE BRETTON WOODS SYSTEM: LESSONS FOR INTERNATIONAL MONETARY REFORM 155, 174 (Michael D. Bordo & Barry Eichengreen eds., 1993).

259 Tax treaties generally allow either country to terminate the treaty unilaterally by giving notice through diplomatic channels. *See, e.g.*, United States Model Income Tax Convention, *supra* note 50, art. 30.

260 *See* Roin, *supra* note 50, at 1756–59 (arguing that renegotiation is preferable to strategic overrides of tax treaties).

261 *See* Income Tax Convention, China-U.S., art. 10(2), Apr. 30, 1984, T.I.A.S. No. 12,065.

262 *See supra* Sections I.B–.D.

263 *See* Colin R. Weiss, *Financial Flows to the United States in 2022: Was There Fragmentation?*, FED. RSRV. (Aug. 4, 2023), https://www.federalreserve.gov/econres/notes/feds-notes/financial-flows-to-the-united-states-in-2022-was-there-fragmentation-20230804.html [https://perma.cc/ZS58-LHZ7] (stating that the Cayman Islands was the largest net purchaser of U.S. assets in 2022); Florez-Orrego et al., *supra* note 181, at 31–32 (describing the role of "tax havens" as sources of financial capital).

foreign taxpayer's income that is "effectively connected" with the conduct of a U.S. trade or business is taxed in the same manner, and at the same graduated tax rates, as if they were U.S. taxpayers.[264] The distinction appears to reflect the greater comfort that policymakers have traditionally felt regarding passive foreign investment in the United States relative to active participation in a U.S. business. When a foreign investor participates in the U.S. economy through passive investment, policymakers seem content to allow that participation to occur on a largely tax-free basis. By contrast, when a foreign investor actively participates in the U.S. economy, then policymakers want that foreign taxpayer to be on a level tax playing field with U.S. business owners. The higher tax imposed on active business activities is the cost of acquiring active control over a U.S. business.[265]

As this Section illustrates, the distinction between active business involvement and passive investment is wrong—or at the very least, incomplete. Passive investment in the United States can drastically shape the economy in much the same way that active business participation can. Foreign financial inflows can depress U.S. production if they displace domestic manufacturing. And they can also create unstable, debt-fueled investment and consumption bubbles. The capacity of foreign financial inflows to adversely affect the U.S. economy should lead policymakers to revisit the favorable tax treatment of passive investment income.

B. *Eliminating Tax Preferences for Foreign Investment*

This Section outlines several policy options for taxing foreign financial flows into the United States, all of which involve eliminating tax preferences currently enjoyed by foreign investors. The first option involves taxing direct private lending by foreign investors to U.S. borrowers. This can be accomplished without any statutory changes, by challenging the arrangements that foreign investors use to avoid taxation on loan origination activities in the United States. The other options would have broader impact but would require congressional action. They include eliminating the favorable taxation of "portfolio interest," imposing tax on the capital gains of foreign investors from the sale of U.S. assets and restricting the foreign sovereign income tax exemptions.

264 *See* I.R.C. §§ 871(b), 882(a).

265 *See* WELLS, *supra* note 4, at 129–31.

1. Taxing Foreign Investors in Private Credit Funds

Unlike the tax preferences for foreign investors described earlier, the structures used by foreign investors to avoid tax on loan origination in the United States have developed gradually, without any explicit statutory sanction or clear policy objective.[266] Nevertheless, as the business of lending to U.S. companies has shifted from banks to nonbanks, these structures play an increasingly important role in facilitating the flow of foreign capital to the United States.[267] Over the past two decades, an increasing share of debt investment in the United States has been made by "private credit" funds—investment funds that lend or extend other forms of credit to private companies outside typical bank lending channels.[268] Over the past fifteen years, the private credit market in the United States has grown from $200 billion to nearly $1.7 trillion, accounting for more than 30% of the entire credit market.[269] Historically, private credit was typically extended to middle-market companies with annual revenues between $10 million and $1 billion.[270] But as the private credit market has grown, funds now lend to larger companies that were traditionally funded by bank-held or -originated loans.[271] And private credit funds are now making inroads into areas of finance typically dominated by banks, like auto lending and residential mortgages.[272]

Although many investors in private credit funds are U.S. taxpayers, a significant share are foreign investors. Precise data on the composition of private credit investors is unavailable. Survey evidence shows that the largest investors in private credit funds include pension funds, insurance companies, family offices, foreign sovereign wealth funds, and high-net-worth individuals.[273] Public filings suggest that most, if not all, of the

266 *See* David S. Miller, *The Tax Guide to Offshore Lending*, 74 TAX L. 523, 606 (2021).

267 *See* Jared A. Ellias & Elisabeth de Fontenay, *The Credit Markets Go Dark*, 134 YALE L.J. 779 (2025).

268 *See id.* at 784–85.

269 *See* Fang Cai & Sharjil Haque, *Private Credit: Characteristics and Risks*, FED. RSRV (Feb. 23, 2024), https://www.federalreserve.gov/econres/notes/feds-notes/private-credit-characteristics-and-risks-20240223.html [https://perma.cc/7TWM-39SZ].

270 *See id.*

271 *See id.*

272 *See* Paula Seligson, *Private Credit Plots Expansion in Bid for $40 Trillion Prize*, BLOOMBERG (Dec. 19, 2024, 7:00 AM), https://www.bloomberg.com/news/articles/2024-12-19/private-credit-looks-to-consumers-infrastructure-for-next-stage.

273 *See* Joern Block, Young Soo Jang, Steven N. Kaplan & Aaron Schulze, *A Survey of Private Debt Funds* 52 (Nat'l Bureau of Econ. Rsch., Working Paper No. 30868, 2023); BD. GOVERNORS FED. RSRV. SYS., FINANCIAL STABILITY REPORT 46 (2023).

largest private credit funds establish parallel offshore funds to facilitate investment by foreign investors.[274]

From a tax perspective, lending to U.S. borrowers creates a problem for foreign investors. Unlike the purchase of securities such as bonds in the secondary market,[275] loan origination—whether engaged in directly or indirectly through a look-through entity like a partnership—is treated as a trade or business, which means that income (including interest income) generated by lending activities is to be treated as "effectively connected" with that trade or business.[276] "Effectively connected income" is taxed to foreign taxpayers in the same manner, and at the same graduated tax rates, as if they were U.S. taxpayers.[277] Moreover, if the foreign investor is a corporation for U.S. tax purposes, then it is potentially subject to a "branch profits tax" of 30% (or a lower treaty rate) on that effectively connected income to the extent it is deemed repatriated rather than reinvested in the U.S. trade or business.[278] For foreign corporations, the effective federal income tax rate on effectively connected income from loan origination that is repatriated—or deemed repatriated—can reach 44.7%.[279] This tax rate would significantly reduce the after-tax return available to a foreign investor in a private credit fund.

274 For example, Ares Senior Direct Lending Fund III, at the time the largest private credit fund in history with nearly $34 billion in capital commitments, has multiple offshore funds. *See* Ares Senior Direct Lending Fund (Cayman) III, Notice of Exempt Offering of Securities (Form D) (July 26, 2023); Sonali Basak, Paula Seligson & Allison McNeely, *Ares Breaks Private Credit Record with New $34 Billion Fund*, BLOOMBERG (July 31, 2024, 6:00 AM), https://www.bloomberg.com/news/articles/2024-07-31/ares-breaks-private-credit-record-with-new-34-billion-fund.

275 I.R.C. § 864(b)(2)(A)(ii) establishes a safe harbor under which a foreign investor that trades in stocks, securities, and derivatives for its own account is not treated as engaged in a U.S. trade or business—even if the foreign investor has U.S. employees or relies on a U.S. dependent agent. *See supra* notes 76–79 and accompanying text.

276 According to the IRS, interest earned by a foreign investor on loans to U.S. borrowers is effectively connected income when an agent—dependent or independent—regularly and continuously originates loans in the United States on the foreign investor's behalf. *See* I.R.S. Gen. Couns., Mem. AM2009-010 (Sept. 22, 2009); *see also* I.R.S. Gen. Couns. Mem. 2015-01-013 (Sept. 5, 2014) (stating that the fund was engaged in a U.S. trade or business where its U.S. manager "actively solicited potential borrowers," "negotiated directly with borrowers concerning all key terms of the loans," and "conducted extensive due diligence on potential borrowers"). In *YA Global Investments, LP v. Commissioner of Internal Revenue*, the Tax Court held that a Cayman investment fund was engaged in a U.S. trade or business because of the lending and underwriting activities of its U.S. management company, though it did not squarely hold that the loan origination activities themselves were sufficient to establish a U.S. trade or business. 161 T.C. 173 (2023).

277 *See* I.R.C. §§ 871(b), 882(a).

278 *See* I.R.C. § 884(a).

279 This is equal to a 21% corporate tax rate plus a 30% dividend withholding tax (or branch profits tax) on the remaining after-tax income. *See* I.R.C. § 11(b) (corporate tax); *id.* §§ 871(a), 881(a) (dividend withholding); *id.* § 884(a) (branch profits). If the foreign corporation qualifies for a lower withholding rate under an applicable tax treaty, then the effective tax rate will be lower.

Foreign investors can avoid this problem by investing through a business development company ("BDC"), a type of entity created by Congress to facilitate lending to U.S. businesses.[280] BDCs are corporations for tax purposes, so their loan origination activities are not attributed to their foreign investors.[281] As a result, dividends paid by BDCs to foreign investors are not "effectively connected" with a U.S. trade or business.[282] Moreover, BDCs are eligible for treatment as regulated investment companies, so they can avoid entity-level income tax and can distribute to their foreign investor portfolio interest-related dividends that are exempt from U.S. withholding tax.[283] However, BDCs are subject to more onerous investment fund regulations than typical private funds, including the requirement to register and file reports with the Securities and Exchange Commission.[284] BDCs are also subject to borrowing limits, and—perhaps most importantly for fund managers—limits on management compensation.[285]

The result of these restrictions is that while some foreign investors originate U.S. loans through BDCs, most prefer workarounds that avoid tax on loan origination in other ways. Private credit funds that seek foreign investment have two primary structures that enable foreign investors to avoid the tax drag associated with loan origination.[286] The first workaround involves the use of a "season and sell" strategy in order to prevent attribution of loan origination to foreign investors.[287] In a season and sell structure, a fund manager will organize two parallel funds: one, a fund with only domestic investors that do not care about avoiding loan origination activities, and the other a fund with foreign investors.[288] The domestic fund will originate loans and then hold them for a specified period of time—typically at least 90 days—until they are "seasoned."[289] The domestic fund will then sell a portion of those seasoned loans to the parallel foreign fund. The premise underlying the "season and sell"

280 Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275.

281 *See* Miller, *supra* note 266, at 605.

282 *See id.*

283 *See* I.R.C. § 851(a)(1)(B).

284 15 U.S.C. § 80a-53 (setting forth registration requirement).

285 *See* 15 U.S.C. § 80a-60(a)(2) (providing leverage limitations); *id.* § 80b-5(b)(3) (management compensation).

286 Some investment funds take the position that periodic loan origination—of five or fewer loans per year—does not amount to a U.S. trade or business. *See* Miller, *supra* note 266, at 555–56 (describing "bullet" loans).

287 *See id.* at 596–600.

288 *See id.* at 596–97.

289 Although the sale generally is not completed until ninety days after loan origination, the domestic fund will typically wait only sixty days before offering to sell loans to the foreign fund. *See id.* at 596–97.

structure is that, because the foreign fund has no obligation to purchase the loan from the domestic fund and is doing so at its own discretion, the loan origination activities of the domestic fund are not attributed to the foreign fund.[290] The foreign fund is simply purchasing loans on the secondary market.[291]

The other major workaround—the "treaty fund" structure—involves reliance by investors on favorable bilateral income tax treaties that allow what would otherwise be effectively connected income to qualify for reduced (or zero) income tax rates.[292] U.S. income tax treaties follow the general rule that the business profits of a resident of one country are not taxable in the other country unless they are attributable to a "permanent establishment" in that other country.[293] In addition, carrying on a business in the other country through an "independent agent" will not give rise to a permanent establishment.[294] Although the term is undefined in income tax treaties, an agent is generally considered "independent" if they are both legally and economically independent of its principal. Legal independence requires that the agent not be subject to detailed instructions or comprehensive control of the principal. Economic independence means that the agent rather than the principal bears the entrepreneurial risk relating to the agent's activities.[295]

In the treaty fund structure, the fund manager that engages in loan origination activities, including discretionary decision-making on behalf of the fund, is intended to qualify as an independent agent of the fund.[296] To bolster the case for legal independence, treaty funds typically will have a general partner that is unaffiliated with the fund manager, unlike most

290 *See id.* at 598–600.

291 *See id.*

292 *See id.* at 558–88.

293 *See* United States Model Income Tax Convention, *supra* note 50, art. 7(1).

294 *See id.* art. 5(6).

295 *See* Taisei Fire & Marine Ins. Co. v. Comm'r of Internal Revenue, 104 T.C. 535, 548–51, 552–56 (1995); *see also* Memorandum, IRS, Field Serv. Advisory (Jan. 17, 1992) (listing eleven factors relevant to an agent's legal and economic independence: (1) the agent's activities are free from the foreign enterprise's detailed instructions and comprehensive control; (2) the agent decides whether to procure third-party services, and supervises and bears the cost of such services; (3) the agent and the foreign enterprise have separate business operations; (4) the agent is not required to submit regular reports to the foreign enterprise; (5) the agent bears the entrepreneurial risk of its activities; (6) the agent represents clients other than the foreign enterprise; (7) the agent regularly offers it services to the general public; (8) the agent is compensated at the market rate; (9) the foreign enterprise does not reimburse the agent for its business expenses; (10) the agent contributes a significant part of the resources necessary for its commercial activities; and (11) the agent makes long-term investments in the resources used in its commercial activities).

296 *See* RopesTalk, *Credit Funds: The Benefits, Challenges and Applications of Treaty Fund Structures When Investing in Credit*, ROPES & GRAY (Sept. 20, 2018), https://www.ropesgray.com/en/insights/podcasts/2018/09/podcast-credit-funds-the-benefits-challenges-and-applications-of-treaty-fund-structures [https://perma.cc/KJZ2-4CBB].

investment funds where the fund manager or its affiliate serves as the general partner of the fund.[297] The unaffiliated general partner will often be empowered to terminate the fund manager without cause.[298] In order to substantiate their economic independence, fund managers will bear their own expenses and, in some cases, will structure their compensation so that they are paid a performance fee rather than the standard carried interest paid to most private fund managers.[299]

If the fund manager qualifies as an independent agent, neither the fund nor its foreign investors will be treated as having a permanent establishment in the United States. There are two variations on the treaty fund structure. In the "bring-your-own-treaty" variant, the investment fund is transparent for tax purposes and fund investors rely on their home country tax treaties with the United States.[300] Since the fund does not have a permanent establishment in the United States, interest income earned by the investors through the fund will be taxed at the rates applicable to those investors under the terms of their home countries' tax treaties with the United States.[301] Under many of those treaties, interest income generated by those loans will be subject to no U.S. federal income tax.[302] The other variant of the treaty fund structure involves the use of a pooled investment vehicle, typically located in either Ireland or Luxembourg, that is itself eligible for the benefits of the tax treaties that the United States has with Ireland or Luxembourg.[303]

Both the "season and sell" and "treaty" workarounds lack any coherent basis in law or policy. They rely on "very technical readings of authorities, principles developed decades ago in different contexts, or arbitrary distinctions" to avoid attribution of loan origination activities

297 *See id.*

298 *See id.* Others disagree and argue that it is unnecessary—and may undermine the fund manager's independence—if the fund has power over the manager in these ways. *See* Miller, *supra* note 266, at 571–74.

299 *See id.* at 573.

300 *See id.* at 558–60, 568–69. In practice, the requirement for transparency means that these funds are typically structured as limited partnerships (which most treaty jurisdictions recognize as transparent) and not limited liability companies (which they do not). *See id.* at 569.

301 *See id.* at 558.

302 *See* United States Model Income Tax Convention, *supra* note 50, art. 11(1). This structure does not eliminate all taxes on foreign investors, for several reasons: (1) some tax treaties allow the United States to impose withholding tax on interest of 10% or higher; (2) most tax treaties do not eliminate withholding on dividends; and (3) tax treaties do not necessarily provide exemptions for state-level taxes. *Id.*

303 *See* Miller, *supra* note 266, at 575–88. Under these treaties, the investment vehicle is only eligible for treaty benefits if more than half of its shares, by vote and value, are held by residents of the treaty jurisdiction (Ireland or Luxembourg) and U.S. residents (for the Luxembourg treaty, U.S. for-profit corporations only count if they are publicly traded). *See id.*

to foreign investors.[304] "Season and sell" structures depend on the absence of an agency relationship between the foreign and domestic funds.[305] "Treaty" funds rely on the purported independence of the investment manager who negotiates and originates loans on behalf of an investment fund.[306]

Both structures involve "relational" tax planning, in which one party (the domestic fund, the investment manager) takes on formal counterparty risk while relying on informal understandings to minimize the actual risk involved.[307] Whatever formal relationship between the two funds in a "season and sell" structure exists,[308] they are both managed by the same investment manager and operated with the implicit understanding that the foreign fund will purchase a pro rata portion of the loans originated by the domestic fund.[309] On paper, a "treaty" structure may give a fund broad authority to terminate the fund manager and structure the manager's compensation in a manner that suggests an arm's length contractual relationship.[310] In practice, the fund manager not only selects and negotiates the fund's investments but also solicits investors—it runs both the asset and liability sides of the operation. Termination of the fund manager will amount to the end of the fund (as well as the unaffiliated general partner's compensation for serving as a stand-in) and significantly harm the manager's business and reputation.

The IRS could raise the tax cost of foreign investment in private credit by challenging the characterization of these workarounds, on the ground that both amount to the conduct of a U.S. trade or business of loan origination on behalf of foreign investors. If the IRS were to succeed, foreign investors in private credit funds would be subject to tax on their income from credit funds on a net basis, at the graduated rates applicable to U.S. taxpayers. The IRS has already challenged foreign funds that lend to U.S. borrowers without relying on either of these structures and has

304 *Id.* at 606.

305 *See id.* at 598–600.

306 *See supra* notes 283–295 and accompanying text.

307 *Cf.* Alex Raskolnikov, *Relational Tax Planning Under Risk-Based Rules*, 156 U. PENN. L REV. 1181 (2008).

308 Investment managers typically adopt some nominal restrictions to avoid characterization of the domestic fund as the foreign fund's agent. For example, there may be a formal review process before the foreign fund purchases loans as well as a valuation mechanism to establish that the foreign fund pays fair market value for the loans it purchases from the domestic fund after the "seasoning" period. *See* Miller, *supra* note 266, at 596–97.

309 *See id.* at 600.

310 *See* RopesTalk, *supra* note 297.

won.[311] And it has announced its intention to actively audit offshore investment funds that engage in loan origination to determine whether they are engaged in a U.S. trade or business.[312] If the IRS were to challenge the "season and sell" or "treaty" fund structures directly, it could force foreign investors to pay tax on private credit investments or deter those investors from investing in private credit entirely.

2. Taxing Foreign Interest Income

Eliminating other tax preferences for foreign investors to deter foreign financial inflows would require statutory changes. Prior to 1984, U.S. source interest paid on most types of debt obligations was subject to a 30% flat tax collected through withholding. Under the current rules, foreign investors' "portfolio interest" is exempt from U.S. tax, so long as it is not "effectively connected" with the conduct of a U.S. trade or business.[313] Interest on foreign taxpayers' bank deposits is also exempt from U.S. tax.[314] These exemptions effectively eliminate U.S. income tax on much of the return to passive foreign investment in the United States if it takes the form of debt. In 2021, the most recent year for which data is publicly available, interest income paid to foreign recipients accounted for more than 40% of all U.S.-source income paid to foreign taxpayers.[315] The reintroduction of withholding tax on portfolio interest and bank deposits would increase the cost to foreign investors of buying U.S. debt.

Estimating the revenue that would be raised by imposing U.S. tax on foreign investors' interest income is difficult. In 2021, foreign taxpayers earned $398 billion of U.S.-source interest income.[316] But the elimination of the tax exemptions for foreign investors' portfolio and deposit interest would not subject all that income to U.S. tax. If the imposition of tax on interest income leads foreign investors to hold less U.S. debt, then they will earn less interest income. Even if they continue to invest in U.S. debt,

311 *See* YA Glob. Invs., LP v. Comm'r of Internal Revenue, 161 T.C. 173 (2023) (finding that a Cayman investment fund was engaged in U.S. trade or business due to lending and underwriting activities of its U.S.-based agent). *But see* David H. Shapiro & Rebecca E. Lee, YA Global: *Bad Facts Make Bad Law?*, 182 TAX NOTES 451, 453–58 (2024) (noting that the Tax Court did not accept the IRS's explanation of why the fund was engaged in a U.S. trade or business).

312 *See* Michael Rapoport, *IRS Sees Noncompliance in Foreign 'Financial Service Entities,'* BLOOMBERG TAX (Aug. 10, 2021, 6:01 PM), https://news.bloomberglaw.com/daily-tax-report-international/irs-sees-noncompliance-in-foreign-financial-service-entities.

313 *See* I.R.C. §§ 871(h), 881(c).

314 *See* I.R.C. §§ 871(i), 881(d).

315 *See Foreign Recipients of U.S. Income Statistics*, IRS (Nov. 26, 2024), https://www.irs.gov/statistics/soi-tax-stats-foreign-recipients-of-us-income-statistics [https://perma.cc/L35D-DY9Z].

316 *See id.*

many foreign investors reside in treaty countries, and benefit from treaties that reduce or eliminate U.S. tax on interest income. But not all: The jurisdiction that received the most U.S.-source interest income (nearly $61 billion) in 2021 was the Cayman Islands, which does not have a tax treaty with the United States.[317]

Before it was repealed, the withholding tax on portfolio interest did not raise much revenue, for several reasons. As now, recipients of interest income in treaty countries benefited from tax treaties that reduced or eliminated the tax rate on interest income.[318] More significantly, a series of IRS rulings enabled U.S. corporate borrowers to avoid the withholding tax on interest by establishing finance subsidiaries in the Netherlands Antilles, whose tax treaty with the United States eliminated U.S. tax on interest paid by U.S. residents to Antilles residents.[319] The subsidiary would issue a U.S. dollar-denominated bond in a European financial center, free of Antilles tax, to foreign investors, and then funnel the bond revenues to its U.S. parent corporation.[320] This financing channel, which allowed foreign investors from countries without favorable U.S. tax treaties to hold U.S. debt without facing any U.S. tax, became the preferred method for U.S. corporations seeking to borrow from foreign investors. By 1983, bond issues through the Netherlands Antilles made up nearly all new U.S. corporate bond issues abroad.[321] The main impediment to U.S. corporate borrowing from foreigners was not the tax drag, but the cost of setting up a finance subsidiary.[322]

It would be mistaken, however, to conclude that a reimposed withholding tax on interest income would suffer from the same problems. For one, the United States no longer has a "one-way treaty with the world": The Treasury terminated the Antilles tax treaty in 1987, after several failed efforts to renegotiate the treaty to incorporate anti-abuse and exchange of information provisions.[323] In addition, many U.S. tax

317 *Id.* Cayman Islands corporations accounted for more than 90% of that income. *See id.*

318 *See* Margaret P. Lewis, *Foreign Recipients of U.S. Income and Tax Withheld, 1984*, 6 SOI BULL. 61 (1986).

319 *See, e.g.*, Rev. Rul. 73-110, 1 C.B. 454 (1973). The IRS's solicitous approach to finance subsidiaries was motivated in part by the "scarce capital assumption": The U.S. government wanted to encourage foreign financial inflows in order to prevent devaluation of the U.S. dollar. *See Tax Treatment of Interest Paid to Foreign Persons Hearing*, *supra* note 87, at 61–64. After repeal of the withholding tax on portfolio interest, the IRS reversed its position and challenged the finance subsidiaries as mere conduits. *See* Rev. Rul. 84-152, 2 C.B. 381 (1984).

320 *See* Papke, *supra* note 94, at 298–99.

321 *Id.* at 300.

322 *See* Wells, *supra* note 4 at 224–25.

323 *See* JESSE HELMS, S. COMM. ON FOREIGN RELS., PROTOCOL AMENDING ARTICLE VIII OF THE 1948 TAX CONVENTION WITH RESPECT TO THE NETHERLANDS ANTILLES, S. REP. NO. 104-35, at 9

treaties now include "limitation on benefits" clauses that restrict treaty benefits to residents who have a real economic connection with the treaty jurisdiction.[324] And Treasury regulations, adopted at the direction of Congress, permit the IRS to disregard intermediate entities (such as a finance subsidiary) in a financing arrangement if they are acting as mere conduits for financial flows from one entity to another.[325]

3. Taxing Foreign Capital Gains

Another tax policy measure that the United States could adopt to discourage financial inflows would be to tax foreign investors' capital gains on financial assets.[326] In the mid-1930s, for both administrative and policy reasons, the United States abandoned the taxation of non-residents on capital gains realized on the sale of U.S. securities.[327] Under current law, that approach is embodied in the rule that treats income from the sale by non-U.S. residents of personal property—including securities—as foreign-source income.[328]

There are already several exceptions to the general rule that capital gain from sale of property by foreign investors is treated as foreign-source income. In response to concerns about foreign investment in U.S. real property, for example, Congress enacted the Foreign Investment in Real Property Tax Act (FIRPTA) of 1980.[329] Among other things, FIRPTA added a rule that treats gain or loss realized by foreign taxpayers on the disposition of a "U.S. real property interest" as if it were effectively connected with an active U.S. trade or business (even if it was a purely

(1996). In addition to allowing foreign investors to eliminate tax on interest income, the treaty also made it easier for U.S. taxpayers to evade taxes they would otherwise owe. Even after the treaty was eliminated, debt that had been issued through finance subsidiaries before the elimination of withholding on portfolio interest was grandfathered into the treaty exemption. *See id.*

324 *See* United States Model Income Tax Convention, *supra* note 50, art. 22.

325 *See* I.R.C. § 7701(l); Treas. Reg. § 1.881-3(a) (2021).

326 Others have advocated for reconsideration of this rule, albeit on different grounds. *See, e.g.*, Amanda Parsons, *The Shifting Allegiance of Capital Gains*, 26 FLA. TAX REV. 308 (2023) (arguing that changes in the nature of corporate activities and income have undermined the justification for granting tax jurisdiction over capital gains to the investor's residence); Stanley Veliotis, *Equating U.S. Tax Treatment for Dividends and Capital Gains for Foreign Portfolio Investors*, 56 AM. BUS. L.J. 345 (2019) (arguing that portfolio dividends and capital gains are economically equivalent and should be taxed in the same manner).

327 *See supra* notes 54–63 and accompanying text; Stanford G. Ross, *United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments*, 22 TAX. L. REV. 279, 294–95 (1967).

328 *See* I.R.C. § 865(a).

329 Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, 94 Stat. 2682.

passive investment).[330] "U.S. real property interests" include a wide variety of possessory and beneficial interests in U.S. real property, as well as corporations that primarily hold U.S. real estate.[331] Tax on foreign taxpayer's capital gain from the sale of a U.S. real property interest is collected by requiring buyers to withhold and remit to the IRS a portion (currently 15%) of the sales price.[332] This history suggests that, at the very least, the taxation of foreign taxpayers' capital gains is administratively feasible.[333]

The notion that foreign taxpayers should be taxed on at least some of their capital gains from U.S. investment—even if indirectly—has motivated recent changes to U.S. tax law. In 2022, Congress added a 1% excise tax on stock buybacks by publicly traded companies.[334] The buyback tax was motivated in part by the fact that corporations prefer stock buybacks to dividends because the gain realized by their foreign investors on buybacks is not subject to U.S. income tax.[335] More recently, the Biden administration proposed to increase the buyback tax to 4%.[336]

Taxing foreign investors' capital gains may also enhance the stability of the U.S. financial system. Because of the realization rule, which requires a realization event such as a sale or disposition before capital gains can be taxed, a tax on foreign investors' capital gains would operate like a transaction tax.[337] Transaction taxes do not affect all investments

330 *See* I.R.C. § 897(a). Under current rules, a U.S. real property interest does not include a debt "interest solely as a creditor . . . in real property." Treas. Reg. § 1.897-1(d)(1) (2024). But a loan in which the lender has a direct or indirect right to participate in the increase in value or the proceeds or profits from the sale of property will not be regarded as an interest solely as a creditor. *Id.* § 1.897-1(d)(2)(i).

331 *See* I.R.C. § 897(c)(1)–(2).

332 *See* I.R.C. § 1445(a).

333 Real property is not the only exception to the general sourcing rule for the sale of property. I.R.C § 871(a)(1)(D) imposes the 30% flat rate tax applicable to most passive income on foreign taxpayers'

> gains from the sale or exchange . . . of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property, or of any interest in any such property, to the extent such gains are from payments which are contingent on the productivity, use or disposition of the property or interest sold or exchanged.

That tax is collected through imposing a withholding obligation on the payor. *See* I.R.C § 1441(b). Likewise, foreign taxpayers are required to pay tax on the sale of an ownership interest in a partnership that is engaged in a U.S. trade or business. That tax is also collected through requiring the buyer to withhold a portion of the sale price. *See* I.R.C §§ 864(c)(8), 1446(f).

334 *See* I.R.C. § 4501(a).

335 *See* Veliotis, *supra* note 326, at 368–73.

336 *See* Steven M. Rosenthal & Thomas Brosy, *Stock Buyback Excise Taxes: What We Know and Don't Know*, TAX POL'Y CTR. (Mar. 10, 2023), https://taxpolicycenter.org/taxvox/stock-buyback-excise-taxes-what-we-know-and-dont-know [https://perma.cc/D628-C7NT].

337 *See* Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1 (1992).

equally: They fall more heavily on short-term investments than those with longer holding periods.[338] Taxing foreign investors' capital gains may result in diverting foreign investment in the United States away from short-term, speculative inflows—which potentially increase financial instability—and toward long-term, productive investments.

4. Limiting the Foreign Sovereign Tax Exemption

Because of the tax preferences generally available to foreign investors, the foreign sovereign tax exemption is only relevant to specific types of income that would not otherwise qualify for a U.S. tax exemption. If those tax preferences were eliminated, however, the sovereign tax exemption would loom large. Foreign sovereigns—more specifically, their instrumentalities such as foreign central banks and sovereign wealth funds—account for a significant share of foreign financial inflows into the United States, although that share has declined in recent years.[339]

Foreign official institutions, including central banks and sovereign wealth funds, hold more than $7 trillion of U.S. financial assets, or more than 13% of all such assets held by foreign residents as of 2023.[340] More than half of the financial assets held by foreign official institutions are Treasury and agency-backed debt.[341] Foreign central banks buy dollar-denominated assets, especially Treasury debt to prevent currency appreciation while maintaining persistent trade surpluses.[342] Sovereign wealth funds have increased in number and size over the past two decades as foreign countries have run persistent trade surpluses and have sought to invest their excess savings in assets beyond the highly liquid, safe assets typically held by central banks.[343] In addition to safer, fixed-income

338 *See* Joseph E. Stiglitz, *Using Tax Policy to Curb Speculative Short-Term Trading*, 3 J. FIN. SERVS. RSCH. 101, 105–07 (1989).

339 Brad W. Setser, *Mapping Capital Flows into the U.S. Over the Last Thirty Years*, COUNCIL ON FOREIGN RELS. (Feb. 16, 2018, 5:17 PM), https://www.cfr.org/blog/mapping-capital-flows-us-over-last-thirty-years [https://perma.cc/EGY6-ZP7N].

340 *See* BUREAU ECON. ANALYSIS, TABLE 1.1 U.S. NET INTERNATIONAL INVESTMENT POSITION AT THE END OF THE PERIOD (2024); BUREAU ECON. ANALYSIS, TABLE 3.1. U.S. INTERNATIONAL INVESTMENT POSITION FOR LIABILITIES TO FOREIGN OFFICIAL AGENCIES AT THE END OF THE PERIOD (2024).

341 *See* BUREAU ECON. ANALYSIS, TABLE 3.1., *supra* note 340.

342 *See* Joseph E. Gagnon, *Global Imbalances and Foreign Asset Expansion by Developing Economy Central Banks* (Bank for Int'l Settlements, BIS Papers No. 66J, 2012).

343 *See* Esplen Klitzing, Diaan-Yi Lin, Susan Lund & Laurent Nordin, *Demystifying Sovereign Wealth Funds*, *in* ECONOMICS OF SOVEREIGN WEALTH FUNDS: ISSUES FOR POLICYMAKERS 3 (Udaibir S. Das, Adnan Mazarei & Han van der Hoorn eds., 2010).

assets, they invest in equities and other risky assets, largely through hedge funds and private equity funds.[344]

Limiting the foreign sovereign tax exemption would raise the cost to foreign governments of foisting their excess savings on the United States. While the tax exemption is rooted in the common law doctrine of sovereign immunity, the scope of that exemption has been historically contested, and would not preclude the taxation of income earned by foreign central banks and sovereign wealth funds. Indeed, although U.S. income tax law has included some form of tax exemption for foreign sovereigns almost since its inception, for decades the IRS and Joint Committee on Taxation took the position that that exemption did not apply to entities that had a separate legal personality from the sovereign.[345] As part of an effort to increase the tax cost of holding U.S. financial assets, Congress could therefore revise the existing exemption to clarify that it does not apply to income earned by entities, such as central banks or sovereign wealth funds, that are formally distinct from a foreign sovereign.

C. *Other Efforts to Use Tax Policy to Reduce the Trade Deficit—And Why They Do Not (or Will Not) Work*

The proposals outlined in this Section would not be the first attempts to use tax policies to reduce the U.S. trade deficit. Previous tax policy proposals to reduce the trade deficit, however, have been shaped by the conventional account of the trade deficit. According to that account, the U.S. imports more goods and services from foreign countries than it exports abroad because U.S. demand for consumption and investment outstrips the productive capacity of the U.S. economy. As a result, earlier proposals have taken two general forms: proposals to reduce domestic consumption or to increase domestic production. The rationale behind these kinds of proposals has been that if tax policy can be used to induce greater domestic production or less domestic consumption, then that will reduce the need for imports, mechanically reducing the size of the U.S. trade deficit and the need for the United States to rely on foreign borrowing to finance domestic demand.[346]

One class of proposals intended to reduce the U.S. trade deficit—and the perceived need to borrow abroad to finance that deficit—aims at reducing domestic demand. These proposals take as their starting point that Americans—whether at the household, business, or government

344 *See id.* at 6–7.

345 *See* S. REP. NO. 87-163 (1961).

346 *See, e.g.*, Klitzing et al., *supra* note 343, at 6–7.

level—save too little relative to the amount that they consume and invest. The objective of these proposals is to increase national savings (or reduce dissaving). Often, they are targeted at increasing government savings by shrinking the federal deficit.[347] According to these proposals, the way to narrow the gap between what Americans use and what they produce is to reduce the amount they use. Depending on the political persuasion of its source, these proposals might call for reduced government spending (which would reduce government consumption) or increased taxation (which would reduce private consumption).[348] Still other proposals of this kind have aimed at increasing private savings. Since the 1970s, tax policy has also been used to try to increase private savings through the introduction of tax-favored vehicles for retirement savings.[349] If Americans can get a higher after-tax return on their retirement savings, they will spend less now and save more for later.[350] One of the justifications offered for providing tax incentives for private saving has been to reduce the need to borrow abroad to finance investment, thereby bringing down the trade deficit.[351]

Another class of tax policy proposals has attempted to increase domestic production. In 2004, Congress enacted a special tax deduction based on income derived from domestic manufacturing and other production activities.[352] The deduction was intended to compensate for the concurrent repeal of export tax incentives, which had been found to violate World Trade Organization rules against export subsidies and to encourage domestic manufacturing activities.[353] The deduction, which was widely panned by tax experts, was ultimately repealed in 2017.[354]

347 *See, e.g.*, Shultz & Feldstein, *supra* note 184.

348 *See id.* ("Control that [federal] spending and you will control trade deficits . . . ."); Sachs, *supra* note 184 ("Most of the decline in the US saving rate is due to a decline in the government saving rate. . . . Every president since Ronald Reagan has promised "middle-class tax cuts" and other tax breaks, undermining revenues and leaving the federal budget in chronic deficit.").

349 *See* Sarah Holden, Peter Brady & Michael Hadley, *401(k) Plans, A 25-Year Retrospective*, RSCH. PERSP., Nov. 2006, at 1, 2–6.

350 *See id.*

351 *See* Jason Furman, *Worry About the Trade Deficit—A Bit*, WALL ST. J. (May 2, 2018, 6:51 PM), https://www.wsj.com/articles/worry-about-the-trade-deficita-bit-1525215114. *But see* Eric M. Engen, William G. Gale & John Karl Scholz, *The Illusory Effects of Saving Incentives of Saving*, 10 J. ECON. PERSPS. 113 (1996) (arguing that tax incentives for saving do not increase national saving).

352 *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 102, 118 Stat. 1418, 1424.

353 *See* MOLLY F. SHERLOCK, CONG. RSCH. SERV., R41988, THE SECTION 199 PRODUCTION ACTIVITIES DEDUCTION: BACKGROUND AND ANALYSIS 1–3 (2017).

354 *See, e.g.*, Kimberly A. Clausing, *The American Jobs Creation Act of 2004: Creating Jobs for Accountants and Lawyers*, URB.-BROOKINGS TAX POL'Y CTR., Dec. 2004. The deduction was repealed as part of the Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13305(a), 131 Stat. 2054, 2126.

More recently, tax scholars have proposed the use of tax policy sticks to encourage U.S. corporations to engage in more domestic production. For example, James R. Repetti has proposed eliminating tax loopholes that allow U.S. multinational enterprises to defer income from foreign manufacturing activities indefinitely through the use of contract manufacturers or hybrid entities—entities that are transparent for U.S. tax purposes but treated as separate taxable entities for foreign tax purposes.[355] Repetti argues that these loopholes have contributed to the decline of manufacturing in the United States by encouraging U.S. multinationals to offshore their manufacturing activities.[356]

What these proposals share is the underlying premise that the reason why the United States runs a trade deficit is because of domestic decisions about production and demand. Instead of U.S. multinationals deciding to base their manufacturing operations abroad, they can be encouraged to onshore their operations through tax breaks for domestic production or by repealing tax preferences for foreign manufacturing. Alternatively, Americans can be induced to consume less in the form of fewer government programs or through forced savings (taxation). Either way, these proposals treat the U.S. financial account surplus—the fact that the United States takes in more financial flows than it sends abroad—as a mere residual of domestic production and consumption decisions. Those financial inflows are needed to fill the gap between the amount of output that Americans use and the amount that they produce.

If the U.S. trade deficit is indeed driven by domestic demand and production decisions, then tax policies targeted at those decisions might succeed in rebalancing the trade ledger. But if the U.S. trade deficit is driven by foreign demand and production decisions—in particular, by the flow of excess savings from surplus countries into U.S. financial markets—then those tax policies will not have the desired effect. Measures that reduce the fiscal deficit by cutting government spending or raising taxes will increase government savings but will not affect the U.S. trade deficit. The increase in government savings will be matched by a decline in private savings as household savings decline (due to increasing unemployment) or consumer debt increases to offset the financial inflows no longer being absorbed by the federal government.[357]

355 *See* James R. Repetti, *International Tax Policy's Harm to Manufacturing and National Interests*, 2023 WIS. L. REV. 1309, 1361–76.

356 *See id.* at 1328–34; *see also* J. Clifton Fleming Jr., Robert J. Peroni & Stephen E. Shay, *The U.S. Tax System's Curious Embrace of Manufacturing Job Losses*, 185 TAX NOTES FED. 35 (2024) (arguing that the subpart F and global intangible low-taxed income regimes incentivize offshoring of manufacturing activity by U.S. multinationals).

357 *See supra* notes 212–229 and accompanying text. Indeed, foreign financial inflows may even rise—and the trade deficit may increase—if a shrinking fiscal deficit leads foreign investors to have more confidence in the U.S. government and economy. *See* Pettis, *supra* note 209.

Likewise, tax measures that discourage foreign production or remove existing incentives for foreign production will not necessarily affect the trade deficit. Whether the offshoring affects the trade balance in the first place depends on how that production is consumed. If offshore production is consumed abroad, then offshoring does not affect the trade balance—it just shifts both consumption and production abroad. If that production is exchanged for goods and services produced in the United States, then any rise in imports will be offset by an increase in exports. Offshoring only affects the trade deficit when foreign workers—due to the regressive distribution of income in the countries to which production is outsourced—consume less of what they produce than American workers would. In that case, consumption that would have occurred in the United States is replaced not by foreign consumption but by foreign savings, leading to a buildup of excess savings abroad. When that happens, offshoring will increase the trade deficit. But what drives the increase is not offshoring itself but the policies that shape consumption and savings decisions abroad, as well as the policies—including the tax policies—that encourage those savings to be channeled back into the United States.

CONCLUSION

U.S. tax policy toward foreign investment must reflect current economic realities, particularly the global forces driving financial flows into the United States. Historically, the U.S. tax treatment of foreign investment has been premised on the notion that financial capital is scarce: To attract scarce capital, the United States must offer favorable tax treatment to foreign investors. However, this framework ignores the role that global economic conditions, including regressive policies that shift income from spenders to savers, play in pushing financial capital into the U.S. regardless of domestic need. These inflows distort the U.S. economy by displacing domestic production, inflating debt-driven demand and exacerbating financial instability and unemployment. The distortions created by foreign financial inflows should lead U.S. policymakers to look for ways to increase the tax burden on foreign investment in the United States. Of course, there are other ways that the United States can deter financial inflows, including by eroding the structural advantages that make it an attractive destination for financial capital in the first place. Yet dismantling those advantages would carry severe collateral consequences—undermining long-term growth and stability—in ways that more targeted tax reforms avoid. So long as financial flows into the United States are primarily driven by foreign imbalances rather than

domestic need, tax preferences for foreign investment should be eliminated.