OFFSHORE MACROECONOMICS

Leslie Young
Professor of Finance
Executive Director, The Asia-Pacific Institute of Business
The Chinese University of Hong Kong

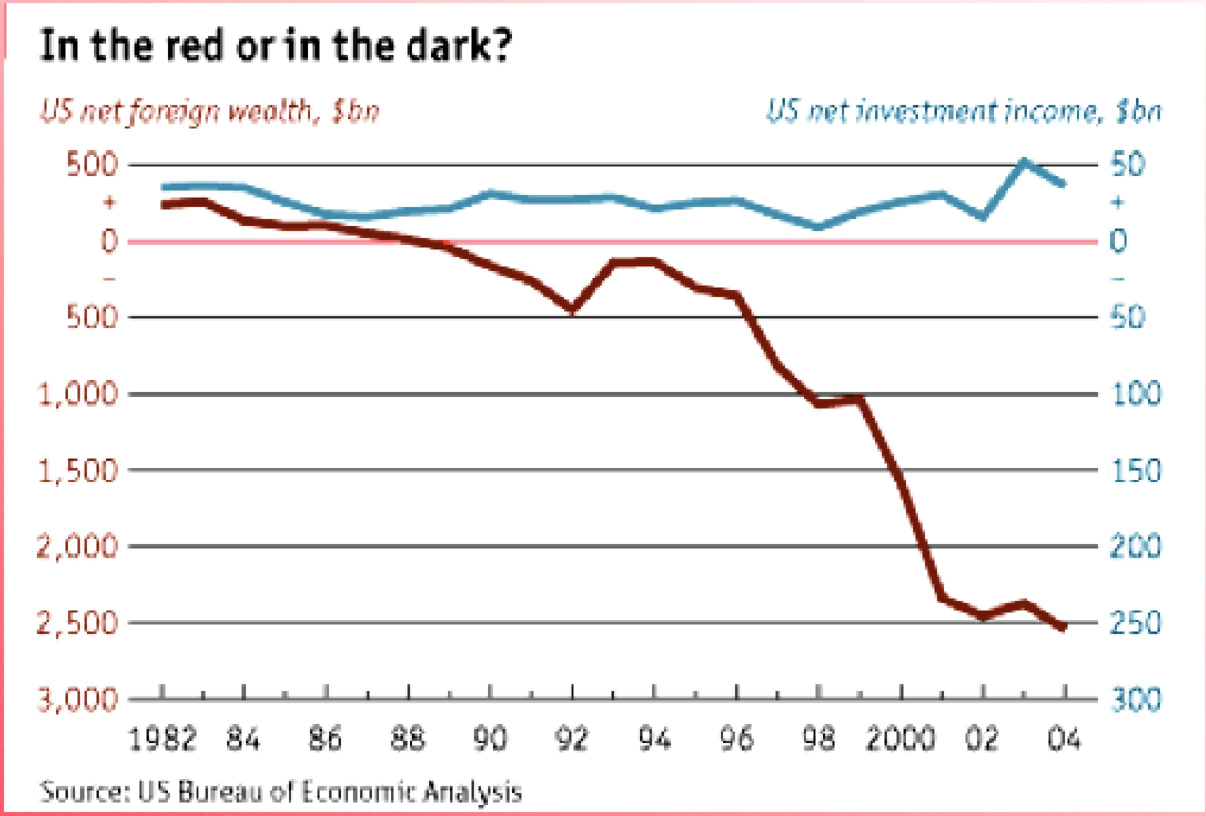
US Balance of Payments

	1960	1970	1980	1990	2000	2001	2002	2003	2004	2005 H1
A. Current account										
Exports										
Goods	19.7	42.5	224.3	387.4	772.0	718.7	682.4	713.4	807.5	874.8
Services	6.3	14.2	47.6	147.8	299.5	288.4	294.9	309.1	343.9	372.7
Income receipts	4.6	11.7	72.6	171.7	350.9	288.3	270.8	309.8	379.5	440.6
Imports										
Goods	14.8	39.9	249.8	498.4	1 224.4	1 145.9	1 164.7	1 260.7	1 472.9	1 621.3
Services	7.7	14.5	41.5	117.7	225.3	224.0	233.7	256.7	296.1	318.9
Income payments	1.2	5.5	42.5	143.2	329.9	263.1	260.8	263.5	349.1	440.2
Unilateral current transfers, net	-4.1	-6.2	-8.3	-26.7	-58.8	-51.9	-64.0	-71.2	-80.9	-96.3
Balance on:										
Goods	4.9	2.6	-25.5	-111.0	-452.4	-427.2	-482.3	-547.3	-665.4	-746.5
Services	-1.4	-0.3	6.1	30.0	74.1	64.5	61.1	52.5	47.8	53.8
Goods and services	3.5	2.3	-19.4	-80.9	-378.3	-362.7	-421.2	-494.8	-617.6	-692.8
Income	3.4	6.2	30.1	28.6	21.1	25.2	10.0	46.3	30.4	0.4
Current account	2.8	2.3	2.3	-79.0	-416.0	-389.5	-475.2	-519.7	-668.1	-788.6
Share of GDP (%)	0.5	0.2	0.1	-1.4	-4.2	-3.8	-4.5	-4.7	-5.7	-6.4
B. Financial account[1]										
US-owned assets abroad, net	-4.1	-8.5	-85.8	-81.2	-560.5	-382.6	-294.0	-328.4	-855.5	-664.6
Official reserve assets, net	2.1	3.3	-7.0	-2.2	-0.3	-4.9	-3.7	1.5	2.8	9.1
Other government assets, net	-1.1	-1.6	-5.2	2.3	-0.9	-0.5	0.3	0.5	1.2	9.5
Private assets, net	-5.1	-10.2	-73.7	-81.4	-559.3	-377.2	-290.7	-330.5	-859.5	-683.2
Direct investment	-2.9	-7.6	-19.2	-37.2	-159.2	-142.3	-154.5	-140.6	-252.0	-121.2
Foreign securities	-0.7	-1.1	-3.6	-28.8	-127.9	-90.6	-48.6	-156.1	-102.4	-149.4
Foreign-owned assets in the United States, net	2.3	6.4	62.6	141.6	1 046.9	782.9	794.3	889.0	1 440.1	1 273.0
Official assets, net	1.5	6.9	15.5	33.9	42.8	28.1	115.9	278.3	394.7	215.2
US Treasury securities	0.7	9.4	11.9	30.2	-5.2	33.7	60.5	184.9	272.6	74.1
Other foreign assets, net	0.8	-0.6	47.1	107.7	1 004.1	754.8	678.4	610.8	1 045.4	1 057.8
Direct investment	0.3	1.5	16.9	48.5	321.3	167.0	80.8	67.1	106.8	105.3
US Treasury securities	-0.4	0.1	2.6	-2.5	-70.0	-14.4	100.4	104.4	107.0	161.6
Other US securities	0.3	2.2	5.5	1.6	459.9	393.9	283.3	226.3	369.8	390.6

Dark Matters in International Macroeconomics

- The US enjoys a surplus on investment income, although foreign holdings of US assets exceed US holdings of foreign assets.
- The US enjoys only a small percentage surplus in its balance of payments in services, even though it has the most advanced service economy and dominates world research, technology commercialization, and mass consumer brands .
- The US savings rate has collapsed, despite a massive shift of wealth and income from the lower and middle income groups to the very rich - who save at a higher rate.
- The US$ has retained its value through a succession of massive current account deficits.

Dark Matter: US Wealth Hidden Abroad?



Services

- The US National Science Board (2004) in its Science and Engineering Indicators annual report estimates that the US commanded 32% of global high technology goods and services (as a percentage of global industry shipments) in 2001, followed by the EU at 22.8% (France 5.5%; Germany, 5.0%, UK 4.1%) and Japan at 12.9%.
- In 2001, balance of payments data indicate that together these 5 countries received royalty and fee payments of US86bn. The USA received just under half (47.8%), followed by the UK (19.9%), Germany (16.6%), Japan (11.9%) and France (3.7%) (OECD, 2005).
- Ratio of global technology US/(Fr+Ge+UK) = 32/14.6 =2.2
- Ratio of royalties US/(Fr+Ge+UK) = 47.8/40.2% = 1.17

Light Explanations of Dark Matters

- Shifting profits offshore via transfer pricing understates exports and overstates imports. This worsens the trade balance dollar for dollar.
- Shifting trademarks and intellectual property offshore allows recurring payments of royalties and fees. These payments worsen the current account balance for services dollar for dollar.
- Shifting assets offshore shifts their income offshore. This has a recurring dollar-for-dollar impact on the current account balance for investment income.
- Lending to foreign subsidiaries at low interest rates and borrowing from them at high interest rates has a recurring dollar-for-dollar impact on the current account balance for investment income.

Light Explanations of Dark Matters

- A current account deficit reflects a deficit in personal savings and/or a deficit in public savings.
- US residents consume more in the US when they accumulate wealth and income offshore - both directly and by owning shares that have appreciated because they are claims on high-yielding offshore assets. This shows up in personal onshore consumption that exceeds personal onshore income.
- The accumulation of wealth offshore generates income that avoids US taxes. The taxes avoided show up in:
  - higher personal onshore consumption
  - a larger US government deficit.

  Both worsen the current account deficit.

Light Explanations of Dark Matters

- The key strategists in foreign exchange markets are aware of all of the above: their personal wealth is offshore also.
- They foresee ongoing transactions demand for US dollars as investors rotate offshore wealth onshore for investment and consumption.
- They also foresee an ongoing offshore demand for US dollars and dollar-denominated assets for portfolio diversification and exchange rate hedging by
  - US nationals who consume mostly in the US and value their portfolios in US dollars
  - Corporations and institutions whose income statements and balance sheets are reported in US dollars.

Estimates of Wealth Offshore

- The Bank for International Settlements (June 2004) estimate that offshore bank deposits totaled US$2.7 trillion offshore out of $14.4 trillion total bank deposits.
- This excludes other financial assets such as stocks, shares and bonds, and the value of tangible assets such as real estate, gold and even yachts held offshore as well as shares in private companies. These assets are typically controlled through offshore companies, foundations and trusts, the latter not even being registered let alone required to furnish annual statements of account. The value of these assets is therefore unknown and harder to determine.

Estimates of Wealth Offshore

- In 1998, Merrill Lynch / Cap Gemini's 'World Wealth Report' estimated that one third of the wealth of the world's high net-worth individuals (HNWIs) is held offshore.
- Their most recent wealth report estimated that HNWIs with liquid financial assets of $1 million or more held $27.2 trillion in 2002/3, of which $8.5 trillion (31%) was offshore.
- This figure is increasing by about $600 billion annually, which brings the current figure to about $9.7 trillion.

Estimates of Wealth Offshore

- The global consulting group McKinsey estimated that the total global financial capital was $118 trillion in 2003.
- This figure includes the balances that banks owe to each other, which are not included in the BIS data quoted above. So the BIS data reflects the sums held by individuals, non-banking corporations and trusts and is therefore more accurate for these purposes.

Estimates of Wealth Offshore

Asset type	Value $ trillions	percent of total
Quoted Equities	32	27
Private bonds	30	26
Gov't bonds	20	17
Bank deposits	35	30
Total	118	100

Estimates of Wealth Offshore

McKinsey's estimated that the ratio of cash to total financial assets has ranged between 3.3 to 3.85 over the past 4 years. Applying an average of 3.5 to the BIS offshore holdings yields an estimate for total financial assets held offshore of $9.45 trillion. This provides a third estimate within the range $9 to $10 trillion.

This estimate does not include real estate and other tangible assets, the ownership of private businesses held offshore, or other intangible assets such as the rights to receive royalties and licence fees. Suppose that they add $2 trillion to the value of offshore holdings (which in view of the value of real estate may well be very modest indeed). This implies that the value of assets held offshore is about $11 - $12 trillion.

By comparison, in 2001 the US stock market = 16.6 trillion; all international debt securities = 5.6 trillion; Japan stock market = 4.6 trillion.

Income from offshore wealth

- According to the above wealth reports, wealth holders currently expect their assets to grow at between 7 and 8 percent annually. US$11.5 trillion invested at 7.5 percent yields a return of about US$860 billion a year. This is a reasonable measure of the offshore investment income each year.

Tax lost on offshore income

- In 2003 Cap Gemini stated that 7.7 million people around the world held more than US$1 million in financial-asset wealth. Forbes magazine in 2004 stated that the average marginal tax rate for a person earning €100,000 that year was 37.5 percent. However, this figure would be too high an estimate of overall tax losses since some assets held offshore will have been invested in ways that involve taxes being withheld from payments. Suppose that the average withholding on a Cap Gemini type portfolio is 7.5 percent. So we use an average tax rate of 30 percent to calculate the overall tax loss.
- $860 billion at 30 percent yields an annual tax loss of approximately $255 billion resulting from wealthy individuals holding their assets offshore. This estimate does not include tax losses arising from: tax competition and corporate profit-laundering.

Estimates of Wealth Offshore

- Offshore tax havens used by the wealthy cost U.S. taxpayers $40 billion to $70 billion a year and should be shut down, a Senate panel said in a report naming specific wealthy people as tax haven abusers.
  WASHINGTON (Reuters) -- August 1 2006: 6:57 AM EDT
- At a marginal tax rate of 35%, the income sheltered offshore is up to $200 billion
- At 5% return, the capital sheltered offshore by wealthy US taxpayers is up to $4 trillion.

Corporate Taxation GAO

- The General Accounting Office (GAO) is the investigative arm of Congress. In 2003 it reported that most corporations owed no taxes from 1996 to 2000, a boom period for corporate profits.Those untaxed corporations earned $3.5 trillion of revenues.
- More than 60% of U.S. controlled corporations with at least $250 million in assets (representing 93 percent of all corporate assets reported to the IRS) reported no federal tax liability each year between 1996 and 2000, while the economy boomed and corporate profits soared.
- 71% of foreign-based firms operating in the U.S. during that same period paid no U.S. income taxes.

Corporate Taxation GAO

- According to Citizens for Tax Justice, 82 of 275 top U.S. corporations paid zero taxes between 2001 and 2003, although they earned $102 billion in pre-tax profits. 46 companies with a combined profit of $42.6 billion paid no federal income taxes in 2003 alone. Instead they received rebates totaling $5.4 billion.
- In 2003, the Internal Revenue Service conducted face-to-face audits of only 29 percent of the largest firms - those with assets of more than $250 million. That compares with 34.7 percent in 1999. Report by Transactional Records Access Clearinghouse, a government watchdog group.

Tax havens GAO

In 2004, the GAO reported:

- "59 out of the 100 largest publicly-traded federal contractors in 2001, with tens of billions of dollars in federal contracts in 2001, had established hundreds of subsidiaries in offshore tax havens,"
- "Exxon-Mobil Corporation, the 21st largest publicly traded federal contractor in 2001, has some 11 tax-haven subsidiaries in the Bahamas
- Halliburton has 17 tax-haven subsidiaries, including 13 in the Cayman Islands, which have no corporate income tax.
- Enron Corporation had 1,300 different foreign entities, including 441 in the Cayman Islands."

Setting up in a tax Haven

- The ownership of a trade name like Coca-Cola can be located anywhere. You assign your valuable trade name or patents on drugs or other knowledge to the offshore entity, and then you have that entity charge the U.S. company a big royalty to use it.
- Multinationals need not set up offices, hire staff or build factories in the tax havens. Luxembourg, (population 437,000 with an effective corporate tax rate of 1 percent) saw profits from subsidiaries of U.S. corporations rocket from $4 billion in 1999 to $18.4 billion in 2002 [Martin Sullivan Tax Notes.]
- A five-story building on Church Street in the Cayman Islands capital of George Town is the "official address of 12,748 companies. George Town is home to subsidiaries of more than 150 U.S. corporations, including Coca-Cola Co., Intel Corp. and 10 more of the 30 companies in the Dow Jones Industrial Average," David Evans in the June 21, 2004 issue of *Bloomberg Markets* magazine

Corporate Taxation

- As a percentage of all federal tax revenues, corporate tax payments have declined from 23 percent in 1960 to 13 percent in 1980 and 8 percent today.
- The average effective tax rate was 12 percent in 2002, down from 15 percent in 1999, and 18 percent in 1995, John Graham, Duke University, using data from the financial statements of publicly-traded companies.

Corporate Taxation EU vs. US

- In 1996 the U.S. corporate tax rate was 3.7% *below* the EU average. By the end of 2004 the U.S. rate was 6.9% *above* the EU average.
- The current U.S. corporate tax rate is higher than the corporate tax rate in *all* 25 EU countries. Only Japan has a fractionally higher tax rate.
- EU corporate tax revenues increased slightly from 2.8% of GDP during the five years from 1995 to 1999 to an average 2.9% of GDP during the years 2000 through 2004.
- In the United States the five-year average for 1995-99 was 2.5% of GDP; for 2000-04 the average dropped to 1.9% of GDP.

Corporate Taxation and Transfer Pricing

- Factors reducing the corporate taxes in recent years include more tax shelters, new tax breaks, and the transfer of profits by multinational companies to low-tax foreign nations.
- Profit-shifting out of the United State to Ireland, cost the U.S. Treasury at least $2 billion in 2002. “The IRS Multibillion-Dollar Subsidy for Ireland,” Martin Sullivan

  Tax Notes, July 18, 2005, p. 287.

Corporate Taxation and Transfer Pricing Sullivan

- In low-tax Ireland, for instance, profits of subsidiaries of US multinationals have doubled in four years, from $13.4 billion to $26.8 billion.
- Profits from operations of U.S. multinationals in no-tax Bermuda have tripled, from $8.5 billion to $25.2 billion.
- Those two tax havens rank as the number one and number two locations in terms of profitability for U.S. corporations operating abroad-surpassing long-time leading investment partners like the United Kingdom and Canada. Tax Notes 2004:

Corporate Taxation and Transfer Pricing Sullivan

- "Shifting of Profits Offshore Costs U.S. Treasury $10 Billion or More." Tax Notes study by Martin Sullivan based on U.S. Commerce Department data to conclude that U.S. corporations have shifted approximately $75 billion a year to foreign subsidiaries.
- Over the last 12 years, foreign profits have more than tripled -- from $89 billion in 1993 to $298 billion. The domestic share of profits has declined significantly -- from 83.6 percent in 1993 to 74.4 percent in June" of 2004.
- Sullivan applies that 6.6 percent drop in domestic U.S. profits to U.S. annualized profits of $1.166 trillion. and comes up with an income-shifting estimate of $75 billion.

Corporate Taxation and Transfer Pricing Sullivan

- Pak and Zdanowicz studied U.S. import and export data produced by the U.S. Department of Commerce and contained in the U.S. merchandise trade database, the same data used to determine the U.S. balance of trade. They determined that multinational corporations used transfer pricing to avoid $53.1 billion in taxes during 2001, $44.6 billion in 2000, $42.7 billion in 1999 and $35.7 billion in 1998.
- US corporations imported from their foreign subsidiaries tweezers at $4,896, toilet tissue at $4,121.81 per kilogram and plastic buckets at $972.
- U.S. companies exported to their foreign subsidiaries missile launchers at $52.03 and prefabricated buildings at $1.20 per unit.

Corporate Taxation and Transfer Pricing

- In research commissioned by the Internal Revenue Service, Christian and Schultz, estimate that multinational corporations are shifting $87 billion of pre-tax income out of the U.S. each year - net of income shifted into the country.They reached their conclusions by comparing the effective tax rates and the returns on assets for 6,212 multinational corporations.
- They observed how much companies were earning in a foreign jurisdiction relative to their assets there.Then they observed the same thing domestically then assumed that if companies hadn't manipulated transfer prices, after-tax return on assets would have been equal between a parent company and the foreign subsidiary."

Corporate Taxation and Transfer Pricing

- Among 686 firms shifting income out of the U.S., they found that, on average, foreign return on assets was 11.3 percent compared to domestic return on assets of 2.4 percent. For those same companies, average foreign effective tax rates were 22.2 percent compared to U.S. tax rates of 32.9 percent. They conclude that $62 billion of pre-tax income was shifted abroad. "ROA Based Estimates of Income Shifting by U.S. Multinational Corporations." Christian and Schultz *IRS Research Bulletin*

Selected 2004 FDI Recipients (Source: UNCTAD)

Destination	Amount	Percent Change
CHINA	**$61 Billion**	Up 13%
HONG KONG	$34 Billion	Up 143%
INDIA	$5 Billion	Up 25%
USA	$96 Billion	Up 68%
EUROPEAN UNION	$216 Billion	Down 36%
ASIA	$148 Billion	Up 47%
LATIN AMERICA	$68 Billion	Up 45%
AFRICA	$18 Billion	No Change
WORLDWIDE	$648 Billion	Up 2%

JONES DAY

Dark Matters in Foreign Direct Investment

- The US attracts so much international investment because corporations do not have to pay taxes there.
- China attracts so much international investment because corporations do not have to pay taxes there
- Where are the profits going? Why does Hong Kong get half as much DIRECT investment as the whole of China? There is no room in HK for 34 Billion dollars worth of factories!