Asian Shadow Financial Regulatory Committee

A New Perspective on Global Imbalances: the Role of MNCs

Statement No. 8
Hong Kong, July 5, 2007

Abstract

The global imbalances that threaten to provoke major international trade conflicts may be a statistical artifact, arising from an outmoded accounting for international trade that ignores its present domination by multinational corporations. Regional governments should update their international accounting; the first step would be to mandate the disclosure of data on the ownership and control of multinational corporations and the terms of their transactions amongst subsidiaries.

STATEMENT

Public discussion of global trade imbalances is based on an outdated model of international trade that ignores multinational corporations (MNCs). That outdated model postulates firms owned and located in one country, i.e., with clear national identities, which export goods to other countries. A country's current account would then indicate its ability to sustain its living standards.

However, international trade today is largely a by-product of MNC operations. Since the 1980s, MNC affiliate sales have been a more important way to penetrate export markets than traditional cross-border exports. Sales of MNC affiliates in their host countries are about 2 times their exports of goods and services. For US MNCs, affiliate sales in host countries are about 3 times their exports. About half of all international trade in goods and services is by MNCs. More than half of MNC international trade is internal: affiliates in one country trade finished and unfinished goods, services and intangibles with the parent and sister affiliates (Zeile, 2003).

The core of an MNC is a set of soft skills in management, sourcing, branding, marketing, technology, logistics and finance. These skills have no clear national identity, or legal domicile. Ownership and capital structures are flexible and respond to local political and business conditions. Tax differentials alone do not drive investment decisions, although tax and legal expertise is mobilized to ensure global tax efficiency by booking profits in low-tax jurisdictions. This is achieved by manipulating the terms of trade and of loans amongst affiliates, and the fees charged for intellectual property, trademarks and brands. Ownership of these intangibles is located in affiliates domiciled in tax havens to minimize exposure to tax and litigation. Profits booked there are typically recycled into new investments in other countries.

The following issues are raised by the role of MNCs in international trade.

The Country Running a Large Trade Surplus May Derive Little Benefit From It

Today, MNCs coordinate complex supply chains that pass through many countries. Consequently, the exports of final products often embody the value added by many different countries. Under current trade accounting practices, the entire value of the finished product is included in the exports of the nation of the final-stage producer, which might add the least value. Case in point: China, the last stop in a multi-stage pan-Asian production system that dominates global manufacturing. Since the 1990s, China has been importing advanced components from Japan and South Korea; other components from Hong Kong, South Korea, and Taiwan; yet other components and subassemblies from Southeast Asia. So China runs a trade surplus with the West but a trade deficit with the rest of Asia. In effect, China aggregates the trade surplus of East Asia with the U.S. and Western Europe, takes the political heat, but captures relatively little of the value that it adds to final products.

MNC Activity Distorts the Meaning of International Trade Accounts

MNC affiliate sales within their host countries are not included in trade balances, but are counted in host country GDP. MNC affiliate sales from the host country to other countries are counted as exports of the host country. This accounting practice overstates the current account surplus of a country like China with heavy inward foreign direct investment (FDI). This surplus would be reduced if sales outside China by affiliates of foreign-owned MNCs were excluded from its exports and sales within China by affiliates of foreign-owned MNCs were included in its imports. The trade accounting system overstates the current account deficit of a country like the US, with heavy outward FDI. This deficit would be greatly reduced if sales outside the US of overseas affiliates of US MNCs were included in US exports and sales back to the US of overseas affiliates of US MNCs were excluded from US imports.

A nation's international accounts should record changes in its capacity to deliver future income to citizens and to meet international obligations. So, it should include the income of overseas branches of US-owned MNCs in US national income and their sales abroad from US exports, but exclude their sales to the US from US imports. It should exclude the income of US branches of foreign-owned MNCs from US national income and their sales abroad from US exports, but include their sales to the US in US exports. These arguments assume that foreign branches of US MNCs are taxable by the US government and are thus part of its capacity to meet its international obligations. However….

Transfer Pricing and Corporate Tax Avoidance

If an MNC earns profits in a foreign jurisdiction that deducts taxes, then those profits are not subject to US taxes until repatriated. This is an incentive for "transfer pricing": setting prices for transactions within the MNCs to shift profits out of the US to subsidiaries in low-tax jurisdictions, followed by complicated offshore transactions that defer the US tax burden indefinitely (Desai *et. al*., 2003). The vitiation of corporate taxation by transfer pricing was confirmed by the US General Accounting Office (2004), which reported that, of those US-controlled corporations with assets of at least $250 million (representing 93 percent of all corporate assets reported to the IRS), more than 60 percent paid no federal taxes between 1996 and 2000. Those untaxed corporations received $3.5 trillion of revenues. 71 percent of foreign-based firms operating in the U.S. during that period paid no U.S. taxes.

Christian and Schultz (2005) estimate that MNCs are shifting $87 billion of pre-tax income out of the U.S. each year - net of income shifted into the country. Pak and Zdanowicz (2002) conclude that MNCs used transfer pricing to avoid $53.1 billion in taxes during 2001, up from $35.7 billion in 1998. Sullivan (2004) inferred that US-based MNCs have shifted about $75 billion a year to foreign subsidiaries. Over the preceding 12 years, their profits booked to foreign jurisdictions more than tripled — from $89 billion in 1993 to $298 billion in 2004. Such bookings surged from $8.5 billion to $25.2 billion in no-tax Bermuda and from $13.4 billion to $26.8 billion in low-tax Ireland.

China, today the largest recipient of FDI, is another major victim of transfer pricing. Li and Paisley (2007, p. 26) report that "the tax revenue statistics show that 35 percent to 40 percent of foreign investment enterprises were in a loss-making position from 1988 to 1993. For 1994 and 1995, the percentage increased to between 50 percent and 60 percent. Between 1996 and 2000, 60 percent to 70 percent of foreign companies reported losses. The Chinese Government estimates that 60 percent of the reported losses by these companies is attributable to transfer pricing maneuvers." The high and rising percentage of firms reporting losses over the period 1988-2000 invites skepticism, given the flood of FDI into China over the same period. We conjecture that one major attraction was the high profits that could be siphoned out untaxed via transfer pricing: China's State Administration of Taxation has only 20 transfer pricing specialists to oversee 330,000 foreign invested enterprises (Chung (2007)).

Worldwide, the scope for transfer pricing within MNCs is vast. The US Census Bureau reports that in 2005, related party trade accounted for 47 percent ($776 billion) of US imports and 31 percent ($283 billion) of US exports. Related party trade accounts for increasing shares of US trade with Pacific Rim Countries such as Taiwan, China and Korea. However, even these figures may understate the phenomenon, given the obscure ownership of many international trading companies. The tax havens of Hong Kong, British Virgin Islands, the Caymans and Samoa accounted for 50.18 percent of investment into China in 2005, 55.70 percent in 2006 and 61.95 percent in the first quarter of 2007. [1] Much of this is Chinese capital on a "round trip" via the tax havens to exploit China's tax concessions to foreign enterprises. The related parties have every incentive to use transfer pricing to shift profits out of China.

Aggregating National Trade Current Accounts Implies World Trade with Mars

Another indicator of the limitations of BOP accounting is the large discrepancies reported by the IMF Committee on Balance of Payments Statistics when it aggregates the current accounts reported by all countries. For example, the first line of the table below indicates that in 2005, the world as a whole ran a current account surplus in goods of US$53 billion, which would require interplanetary trade!

2005 world current account balance	US$ (billion)
Goods	+53
Transportation	-84
Travel	+40
Government services	-39
Other services	+95
Reinvested earnings	+115
Portfolio and other investment income	-130
Other direct investment income	-47
Current transfers	-24
Aggregate	-27

Some Conjectures

The above considerations point to the following conjectures:

(i) The trade imbalance between the US and China is largely a statistical artifact, and has little bearing on the capacity of the US to sustain its standard of living.

[1] See http://www.mofcom.gov.cn/aarticle/tongjiziliao/v/200704/20070404572808.html, the website of China's Ministry of Commerce

(ii) Appreciation of the yuan would not have a significant impact on China's current account surplus. Such appreciation would have little effect on a MNC's overall profitability, given the reduced yuan costs of their inputs from the rest of Asia. The MNC could readily offset the effects of the yuan appreciation by cutting the yuan prices of internal sales to their US subsidiaries.

(iii) If international transactions were booked at arms-length prices and MNCs refrained from tax arbitrage, then the US Treasury could collect substantial additional revenue to reduce its budget deficit — and indirectly its current account deficit.

(iv) The recent surge in China's current account surplus is largely the byproduct of MNC transfer pricing to book profits in China to speculate on a yuan appreciation, on China's stock market and on real estate. The resulting rise in China's reported current account surplus raised expectations of further yuan appreciation, which led to more manipulation of transfer prices in a destabilizing feedback loop.

(v) The possibility of booking profits to offshore subsidiaries in jurisdictions with weak disclosure requirements exposes minority shareholders to massive expropriation by controlling shareholders via related party transactions.

(vi) Reported growth rates in a country's GDP and trade balance do not indicate the growth of economic opportunities for its citizens; that would require identifying who owns the income generated.

More Transparent International Trade Accounts

While the above propositions would re-orient major debates in international economics and finance, the statistical basis for evaluating them is weak. US law now mandates the collection of relevant data by its Bureau of Economic Analysis (BEA), a unit of the US Department of Commerce. This has allowed the BEA to develop an ownership-based framework for the current account, which indicated that the 2003 US trade deficit was overstated by $118.9 billion or 24 percent. Another finding was that in 2004, US MNCs earned $315 billion profits overseas, an increase of 24% over the previous year and about half the current account deficit of the US.

Asian countries should emulate the US drive for transparency in MNC operations in order to clarify the distribution of the gains from international trade and investment. Greater transparency would also allow a more realistic, and more constructive, view of MNC operations. For example, countries could better evaluate the likely impact of tax incentives and weigh the benefits against the foregone tax revenue. They might well find that the key to attracting FDI is not tax concessions, but improvements in their infrastructure, workforce, managerial skills and business environment.

We recommend that Asian governments update their international accounts; the first step would be to mandate the disclosure of data on the ownership and control of MNCs, and the terms on which they book internal transactions in trade and finance and payments for intangibles located offshore. MNCs ought to willing to provide such data for research purposes, as researchers can help dispel hostile speculation, pinpoint weaknesses in corporate governance and highlight the critical skills that MNCs bring to their host countries.

References

Christian, Charles W. and Thomas D. Schultz (2005), "ROA Based Estimates of Income Shifting by U.S. Multinational Corporations." http://www.irs.gov/pub/irs-soi/05christian.pdf

Chung, Olivia (2007), **"**How foreign firms dodge taxes in China". *Asian Times*, April, 11.

Desai, Mihir A., C. Fritz Foley and James R. Hines Jr. (2003) "Chains of Ownership, Regional Tax Competition, and Foreign Direct Investment." In *Foreign Direct Investment in the Real and Financial Sector of Industrial Countries*, edited by Heinz Herrmann and Robert Lipsey, 61–98. Heidelberg: Springer Verlag, 2003.

Li, Jiang and Allan Paisley (2007), *Transfer Pricing Audits in China*, Palgrave MacMillan.

Pak, S.J. and J. S. Zdanowicz (2002), "US Trade with the world: An Estimate of 2001 lost US Federal Income Tax Revenue due to Over-Invoiced Imports and Under-Invoiced Exports", Executive Summary of presentation to the US Senate, October 31, 2002.

Sullivan, Martin (2004), "Shifting of Profits Offshore Costs U.S. Treasury $10 Billion or More." *Tax Notes*, Sep. 27.

US Census Bureau News, (2006) "US goods trade: Imports & Exports by related parties; 2005" May 12.

Zeile, William J. (2003), "Trade in Goods Within Multinational Companies: Survey-Based Data and Findings for the United States of America", paper prepared for OECD Committee on Industry and Business Environment Working Party on Statistics, Session on Globalisation Paris, France, November 3-4, 2003.