Funding the Future

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Kenneth Thomas researched the following blog and posted it first on his blog, the Middle Class Political Economist. The insight it provides is enormously significant. True, it's US focussed, but the day after the UK revealed its worst ever trade deficit it's enormously telling to realise that this could, in no small part, be due to the way in which intra-group trading works and the rigidities inherent in the wholly outmoded Organisation for Economic Cooperation and Development arm's length pricing system.

To put it another way: our tax system, profit shifting for tax reasons and transfer mispricing could be impacting our economic well being.

Anyway, this is what Kenneth said:

The vast majority of the U.S. $727 billion trade deficit in goods for 2011 is due to "intra-firm" or "related party" trade, that is, trade between two units of the same corporation, according to the U.S. Census Bureau. This is significant because such trade is the most open to companies manipulating the prices between subsidiaries to minimize tax liabilities, usually known as abusive transfer pricing. Moreover, as Stuart Holland argued in 1987, intra-firm trade is also less responsive to changes in exchange rates than is trade between independent businesses, since within an individual multinational corporation each subsidiary will have a specific role to play in its supply chain, which won't be quickly changed.

U.S. goods trade and related party trade (billions of dollars), world and selected countries, 2011:

Country	*Exports from US*	*Imports to US*	*Balance*
World	*$1480.4*	*$2707.8*	*- $727.4*
World (RP)	*$ 365.0*	*$1056.2*	*- $691.2*
Canada	*$ 280.9*	*$ 315.3*	*- $ 34.5*
Canada (RP)	*$ 98.1*	*$ 162.0*	*- $ 64.1*
Ireland	*$ 7.6*	*$ 39.4*	*- $ 31.7*
Ireland (RP)	*$ 1.5*	*$ 34.6*	*- $ 33.1*
Mexico	*$ 196.4*	*$ 262.9*	*- $ 64.5*
Mexico (RP)	*$ 60.5*	*$ 155.7*	*- $ 95.2*

Sources: Total trade, U.S. Census, Trade in Good with World, Not Seasonally Adjusted; Related party (RP) trade, U.S. Census, NAICS Related-Party, select all NAICS2, 2011, all countries, variables "imports related trade" and "exports related trade" and layout by country. Canada, Ireland, and Mexico as linked.

As we can see, related party trade (which can mean trade within either a U.S. or foreign multinational corporation) is 27.6% of goods trade, but it represents a whopping 95.0% of the trade deficit. Moreover, in countries where the U.S. has heavy foreign direct investment, such as Canada, Ireland, and Mexico, the trade deficit for intra-firm trade actually exceeds the country's overall trade deficit.

In fact, virtually all U.S. imports from Ireland take the form of intra-firm trade. This is no doubt due to Ireland's status as a tax haven and low corporate income tax rate of 12.5%.

These data suggest that much of the U.S. trade deficit is due to U.S. corporations offshoring production and exporting the products back home. As the related-party data does not distinguish between U.S. and foreign multinationals, there is no way to know exactly how big the share of U.S. multinationals is in intra-firm, but is surely much more than half. Moreover, not counted in the data are imports that come from subcontractors (Wal-Mart's many suppliers, Foxconn producing Apple products, etc.).

The bottom line is that we need to reverse the incentives in the tax code that encourage the offshoring of jobs. (Why does Apple have $64 billion in cash abroad?) However, to emphasize the point I made last time about what Americans want out of tax reform and the "reform" that has actually happened, it's worth pointing out that Robert Gilpin of Princeton University, author of the seminal U.S. Power and the Multinational Corporation(1975), made the same policy recommendation almost 40 years ago, and it hasn't happened yet. We've got our work cut out for us.

UPDATE: Following the Mitt George Romney rule ("one year might be a fluke"), I went back and collected the data for all years back to 2002 (the earliest for which the related party trade info was available). While 2009-11 were all 95%, previous years were generally between 70% and 80%. I'm not sure yet what to make of that.

Year	Goods trade deficit	Related party trade deficit	% Related party
2011	727.4	691.2	95.0%
2010	634.9	607.7	95.7%
2009	503.6	479.2	95.2%
2008	816.2	647.9	79.4%
2007	808.7	619.1	76.6%
2006	828.0	582.9	70.4%
2005	772.4	530.0	68.6%
2004	654.8	478.9	73.1%
2003	532.4	389.3	73.1%
2002	468.3	352.1	75.2%