

## Why Does U.S. Investment Abroad Earn Higher Returns Than Foreign Investment in the United States?

### Summary

At the end of 2004, foreigners owned \$12.5 trillion worth of assets in the United States, \$2.5 trillion more than the value of U.S.-owned assets abroad. That difference is a legacy of cumulative U.S. current-account deficits. Nevertheless, U.S. residents consistently earn more income from their foreign investments than foreigners earn from their larger U.S. investments, thereby holding down the size of the U.S. current-account deficit. That situation mainly reflects the fact that U.S. companies receive more earnings from each dollar's worth of direct investment abroad (ownership of foreign subsidiaries) than foreign companies earn from their subsidiaries in the United States.

Three factors may account for the difference in returns on cross-border direct investment. First, U.S. subsidiaries abroad have generally been in business longer than foreign-owned subsidiaries in this country, which contributes to their greater profitability. Second, in some cases, U.S. subsidiaries abroad face greater risks of political or economic disruptions than subsidiaries of foreign corporations face in the United States. U.S. investors may require higher returns because of that difference in risk; however, compensation for risk appears to explain a much smaller portion of the difference in returns than some analysts may believe. Third, some observers argue that U.S.-owned subsidiaries abroad appear to be more profitable because they overstate their profits—and foreign-owned subsidiaries in the United States understate their profits—for tax reasons. However, the extent to which such misstatements affect the difference in returns is unknown.

—*Douglas Holtz-Eakin*  
Director

When the United States or any nation runs a current-account deficit—that is, when its total receipts from abroad (from exports of goods and services, unilateral transfers, and international investment income) falls short of its total payments (for imports, unilateral transfers, and returns on foreign investment in the nation)—it must finance that deficit by either borrowing from or selling assets to foreigners.<sup>1</sup> Thus, foreign holdings of U.S. assets rise relative to U.S. holdings of foreign assets in each year that the United States runs a current-account deficit. After more than two decades of such deficits, the United States now has a smaller dollar value of foreign assets than foreigners have of U.S. assets. That difference (net U.S. liabilities to foreigners) reached \$2.5 trillion at the end of 2004.

Despite their smaller holdings, U.S. residents have persistently earned more income on their assets abroad than foreigners have earned on their assets in the United States. Such net U.S. investment income showed a total surplus of \$36.2 billion in 2004 and an annualized surplus of \$6.1 billion in the first half of 2005. In other words, the rate of return on U.S.-owned assets abroad (measured as the ratio of investment income to assets) has been higher than the rate of return on foreign-owned assets in the United States. As long as that advantageous gap in returns continues, it will help to slow the rise in the nation's current-account deficit.

### The U.S. Advantage Comes from Direct Investment

Both U.S. and foreign firms make direct investments outside their home countries. For example, U.S. automobile

---

1. International investment income, as measured in government statistics, includes income (interest and dividends, but not capital gains) earned on holdings of foreign stocks and interest-bearing assets as well as income from direct investment abroad (interest and dividends paid by foreign subsidiaries to their parent companies, plus those subsidiaries' reinvested earnings).

**Table 1.**

## Returns on Foreign and U.S. Cross-Border Direct Investment

	Amount at the End of 2004 (Billions of U.S. dollars)	Average Annual Return, 1982 to 2004 (Percent)
<b>Foreign-Owned Assets in the United States</b>		
Direct Investment	2,687	2.2
Portfolio Investment	9,828	5.2
<b>Total</b>	<b>12,515</b>	<b>4.5</b>
<b>U.S.-Owned Assets Abroad</b>		
Direct Investment	3,287	7.6
Portfolio Investment	6,685	4.9
<b>Total</b>	<b>9,973</b>	<b>5.7</b>
<b>Difference (Foreign minus U.S.)</b>		
Direct Investment	-600	-5.5
Portfolio Investment	3,143	0.3
<b>Total</b>	<b>2,542</b>	<b>-1.2</b>

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Notes: Rates of return are based on definitions used by the Bureau of Economic Analysis. BEA reports only the market value, not the purchase cost, of cross-border portfolio assets and excludes capital gains and losses (changes in the market value of assets) from its measure of income from portfolio investment and direct investment. The return on direct investment includes estimates of reinvested earnings, a fundamental component of changes in the market value of companies, whereas the return on portfolio investment does not.

Numbers may not add up to totals because of rounding.

companies have long owned subsidiaries in Europe, and European as well as Japanese automakers have set up subsidiaries in the United States.<sup>2</sup> In addition, U.S. and foreign investors hold investments in their portfolios (such as bonds, stocks, loans, and bank deposits) from outside their home countries. As a whole, cross-border portfolio investment exceeds cross-border direct investment (see Table 1). However, balance-of-payments data reported by

2. In U.S. government statistics, U.S. direct investment abroad is defined as U.S. parent companies' share of the market value of those foreign-located businesses of which U.S. residents own at least 10 percent. Foreign direct investment in the United States is defined analogously.

the U.S. Bureau of Economic Analysis (BEA) indicate that direct investment is largely responsible for the higher overall rate of return earned by U.S. investments abroad.

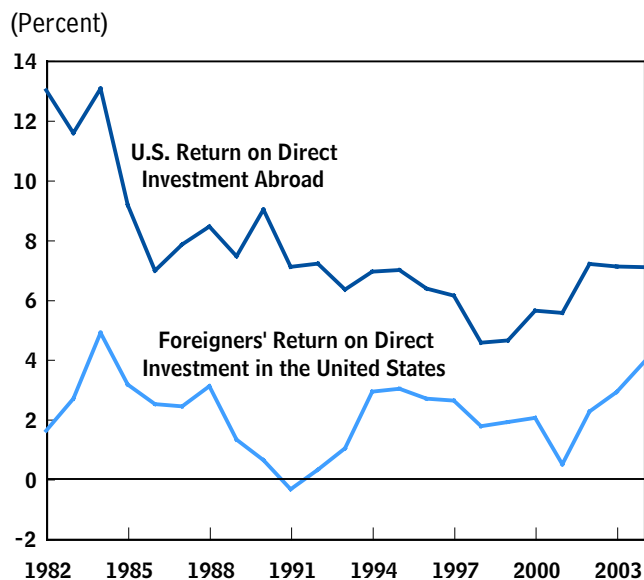
U.S. residents' direct investment in foreign countries has persistently yielded much greater returns than has foreigners' direct investment in the United States (see Figure 1). Between 1982 and 2004, U.S. direct investment abroad earned an average return of 7.6 percent per year, while foreign-owned direct investment in the United States earned only 2.2 percent. With portfolio investment, by contrast, little difference existed between the average rates of return earned by foreigners and U.S. residents on their investments abroad: 5.2 percent and 4.9 percent, respectively, over the 1982-2004 period.

As measured using BEA data, those rates of return do not include capital gains (changes in asset prices and currency valuation), which could make them a distorted indicator of true rates of return, especially during periods of large currency swings or relative movements in stock prices at home and abroad.<sup>3</sup> Any distortion should be less severe for rates of return on direct investment, however, because income from direct investment includes reinvested earnings, which, over time, should approximately equal cumulative capital gains.

## Why Does U.S. Direct Investment Earn Higher Returns?

The difference in returns on direct investment appears to stem partly from the longer presence of U.S. investments

3. Rates of return based on BEA data differ from those measured by some other researchers. For example, a recent analysis by Pierre-Olivier Gourinchas and Helene Rey—which measured rates of return using indexes of stock and bond prices in each country where assets are located and movements in the exchange value of the dollar relative to those countries' currencies—did not find a larger gap in returns for direct investment than for portfolio investment. Compared with the BEA-based measure, however, that measure potentially introduced new distortions, such as the use of broadly based stock-price indexes that may not be representative of the makeup of U.S. investments abroad or foreign investments in the United States. See Pierre-Olivier Gourinchas and Helene Rey, "From World Banker to World Venture Capitalist: The U.S. External Adjustment and the Exorbitant Privilege" (paper prepared for the National Bureau of Economic Research Conference on G7 Current Account Imbalances: Sustainability and Adjustment, June 1-2, 2005), available at [www.nber.org/~confer/2005/cas05/rey.pdf](http://www.nber.org/~confer/2005/cas05/rey.pdf).

**Figure 1.****Rates of Return on Direct Investment, 1982 to 2004**

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

abroad than of foreign investments in the United States. U.S. investments abroad may also earn higher returns because U.S. companies take greater risks by investing in some countries than do their foreign counterparts that invest in the United States. A third factor—that, for tax reasons, foreign-controlled multinational companies understate their profits in this country and U.S.-controlled companies overstate their profits abroad—might also be part of the explanation.

### Age of U.S. Investments

The number of years that an overseas subsidiary has been in existence appears to have an important and positive influence on its rate of return in several ways.<sup>4</sup> First, establishing a subsidiary in another country is challenging, and experience may pay dividends. Second, profits of newly acquired or established companies tend to be dampened

4. See, for example, L.A. Lupo, Arnold Gilbert, and Michael Liliestedt, "The Relationship Between Age and Rate of Return of Foreign Manufacturing Affiliates of U.S. Manufacturing Parent Companies," *Survey of Current Business* (August 1978), pp. 60-66; and Raymond J. Mataloni Jr., "An Examination of the Low Rates of Return of Foreign-Owned U.S. Companies," *Survey of Current Business* (March 2000), pp. 55-73.

by high startup costs, such as spending for capital equipment or advertising. Those costs may be particularly high for foreign firms that must get to know a market outside their home base. Third, returns on newly acquired companies may be depressed because mergers and acquisitions tend to increase the book value of assets before they affect operating profits.<sup>5</sup> Fourth, as unprofitable companies eventually exit a market, the average profitability of all subsidiaries begins to improve.

U.S. companies had been making significant direct investments in other countries for at least 20 years before the arrival of significant flows of foreign direct investment into the United States. New U.S. direct investment abroad consistently exceeded new foreign direct investment in the United States throughout the 1960s and 1970s (see Figure 2). By 1976, the total value of foreign subsidiaries in the United States amounted to only \$48 billion, about 20 percent of the \$222 billion value of U.S. subsidiaries abroad at that time. After 1980, however, new foreign direct investment in the United States increased and at times exceeded new U.S. direct investment abroad. By 2004, the value of foreign-owned subsidiaries in the United States had grown to \$2.7 trillion, about 82 percent of the \$3.3 trillion value of U.S.-owned subsidiaries elsewhere. The rapid rise in new foreign direct investment in the United States since 1980 may very well have depressed the average rate of return on all foreign-owned subsidiaries in this country.

As foreign-controlled companies become older, the pattern of returns on direct investment that has so far favored U.S. companies abroad could diminish. That development would erode the favorable returns and net inflows of income from direct investment and thus contribute to widening the current-account deficit.

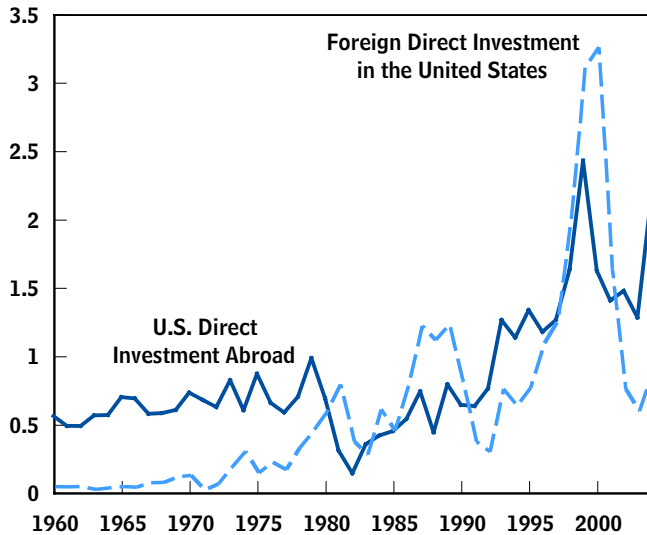
### Riskiness of Direct Investment

Some analysts argue that U.S. investments abroad may also earn higher returns because in some cases, U.S. companies take greater risks when they invest in foreign subsidiaries than foreign companies take when they invest in subsidiaries in the United States. Investments that involve

5. See David Laster and Robert N. McCauley, "Making Sense of the Profits of Foreign Firms in the United States," *Quarterly Review*, Federal Reserve Bank of New York (Summer-Fall 1994), pp. 44-75.

**Figure 2.****Flows of Direct Investment,  
1960 to 2004**

(Percentage of U.S. gross domestic product)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

higher risk will not be undertaken unless they also offer the potential for higher rewards.<sup>6</sup>

The major risks of cross-border direct investment include economic or political instability that could impair the ability of subsidiaries abroad to maintain operations, generate profits, repay debts, and repatriate earnings to their parent companies. One possible indicator of the level of risk in a country is the credit rating of its government. The lower that rating is, the higher may be the risk that subsidiaries operating in that country could see their business interrupted. The private rating company Standard & Poor's (S&P) gives the United States a rating of AAA, the highest credit rating it assigns.<sup>7</sup> The bulk of U.S. investments abroad are in other industrialized countries whose governments' credit ratings are comparable to that of the U.S. government (see Table 2). Only about 20

6. Just as investors typically require a higher expected return on a lower-rated bond to compensate for the higher risk being taken, they would also require a higher return for investing directly in countries with a lower credit rating. The correspondence between country-risk ratings and corporate-risk ratings is described in Richard Cantor and Frank Packer, "Determinants and Impacts of Sovereign Credit Ratings," *Economic Policy Review*, Federal Reserve Bank of New York, vol. 2, no. 2 (October 1996), pp. 37-53.

percent (by value) of U.S. subsidiaries abroad are located in countries whose credit ratings are significantly below that of the United States. Nevertheless, the Congressional Budget Office calculates that the average S&P rating for countries in which U.S. subsidiaries are located (weighted by the value of the subsidiaries) is BBB+, which is eight steps lower than the U.S. rating and not much higher than speculative status.

Countries with low ratings must pay comparatively higher rates of interest to borrow in international capital markets. U.S. companies presumably would not have committed their money to subsidiaries in those countries unless they expected returns on investments to be high enough to offset the higher risks. Over the past 10 years, the average yield on U.S. corporate bonds with a rating of BBB has exceeded the average yield on AAA-rated bonds by about 0.8 percentage points. Comparing that gap with the gap in returns between U.S. direct investment abroad and foreign direct investment in the United States—about 4 percentage points over the past 10 years—suggests, albeit roughly, that risk compensation is unlikely to account for more than one-fifth of the difference in returns in favor of U.S. direct investment abroad over the past decade or so.<sup>8</sup>

The riskiness of cross-border direct investment may depend on other factors as well, such as the industries being invested in. Differences in types of industry are not likely to cause much difference in the risks faced by U.S.-owned and foreign-owned subsidiaries, however—mainly because U.S. direct investment abroad is concentrated in roughly the same industries as foreign direct investment in this country.

Overall, it appears reasonable to infer that no more than a modest portion of the higher return that U.S. companies

7. S&P ratings have a maximum range of AAA to D. Ratings from AAA through BBB- are known as "investment grades," signifying very low likelihood of default; ratings from BB+ through CCC- are "speculative grades," with increasingly high likelihoods of default; D is the rating given to a country that is in default.

8. The bond calculation is based on the interest rates that the bonds are scheduled to pay. Riskier bonds are more likely to default, however, so the difference in actual returns between BBB-rated and AAA-rated bonds would probably be lower than 0.8 percentage points. Like the bond calculation, the gap of 4 percentage points between rates of return on cross-border direct investment excludes actual capital losses.

**Table 2.****Regional Risk of U.S. Direct Investment Abroad**

Location of U.S. Direct Investment	Standard & Poor's Country Rating <sup>a</sup>	Share of U.S. Direct Investment (Percent)
Canada	AAA	11
Europe	AA+	54
Asia and Pacific	A-	16
Middle East	A-	1
Africa	BBB-	1
Latin America and Other Western Hemisphere	BBB-	17
<b>Total (Weighted average)</b>	<b>BBB+</b>	<b>100</b>

**Memorandum:**  
Rating for Foreign Direct Investment Assets in the United States

	AAA	n.a.
--	-----	------

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Standard & Poor's.

Notes: Weighted-average ratings use the probabilities of default associated with the various letter ratings. For details of how those ratings were calculated, see Juann H. Hung and Angelo Mascaro, *Return on Cross-Border Investment: Why Does U.S. Investment Abroad Do Better?* CBO Technical Paper 2004-17 (December 2004).

n.a. = not applicable.

a. The rating for a region is the weighted average of the ratings for the countries that compose the region.

earn on direct investment abroad is compensation for their greater exposure to risk. Unlike the age effect, which can be expected eventually to lessen the U.S. advantage and thus widen the current-account deficit, the comparative-risk effect has no necessary implication for the direction of future returns—it could continue to favor the United States or diminish.

**Do Multinational Companies Shift Profits Out of the United States?**

Some analysts suggest that the returns to foreign-owned companies operating in the United States might be artificially low because those companies shift profits out of the country to minimize their worldwide tax costs. For the same reason, U.S.-owned companies might overstate their profits from direct investment abroad. U.S. and for-

eign governments direct considerable effort to uncovering and discouraging such profit-shifting activities. And researchers have detected some evidence that suggests that profit shifting probably occurs. Because of a host of difficulties, however, the large volume of research that has been conducted has found only indirect and weak evidence of profit shifting. As a result, the role of profit-shifting as an explanation for the U.S. advantage in returns on direct investment remains largely unknown.

Businesses always have an incentive to minimize their overall tax payments. Multinational corporations can do so by shifting profits into and out of the United States, or among their subsidiaries in countries with different tax rates, in various ways. One method is using “transfer pricing” schemes—that is, manipulating the price that a company charges for a product or service it supplies to an affiliated company. For example, a subsidiary in a high-tax country could sell its products at low (or even below-cost) prices to affiliates in low-tax countries, or it could buy products from those affiliates at artificially high prices.<sup>9</sup> Another way in which companies can shift profits from their higher-tax home countries to lower-tax countries is by licensing or selling their intellectual property to foreign subsidiaries at less than fair prices, after research and development costs have been incurred and claimed as expenses in the home country. In that case, the subsidiaries’ rates of return are artificially high because they underpay royalties and license fees or because they underpay to acquire intellectual property rights. In addition, multinationals can shift profits through third-party debt, intra-company debt, or tacit agreements with unaffiliated companies.<sup>10</sup> Such transactions can lower the taxable profits of subsidiaries in high-tax countries and increase the taxable profits of subsidiaries in low-tax countries.

The existence of foreign tax havens that impose virtually no taxes on corporate profits—and of countries (such as Ireland) that impose relatively low taxes on income of

9. Tax regulations generally require that transactions between subsidiaries of the same multinational company be conducted using “arms-length” prices (that is, prices charged between unrelated companies). However, cross-country differences in tax rates create incentives for foreign-controlled companies to deviate from that standard, particularly with goods and services that do not have well-established, or market-based, reference prices.

10. Given the methods that BEA uses to report international investment income, however, intracompany debt manipulations do not affect rates of return computed using balance-of-payments data.

foreign-owned companies—has led to the widely held view that multinational corporations have significantly understated their profits from operations in the United States through various schemes. That view is supported by the fact that the rate of return on U.S.-owned direct investment in Ireland was nearly three times higher than the rate on overall U.S. direct investment abroad from 1999 to 2003, and the rate on U.S. direct investment in Bermuda (a popular tax haven) was almost twice that overall rate. The combined average return on direct investment in those two countries accounted for about one-fifth of the overall return on U.S. direct investment abroad during the 1999-2003 period.

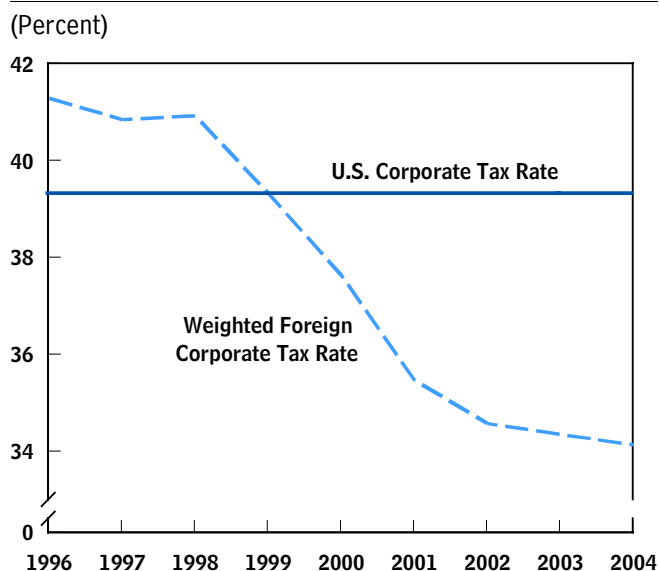
Nevertheless, the large number of empirical studies conducted so far have not been able to establish the degree to which profit shifting out of the United States explains the difference in returns that favors U.S. direct investment abroad. Researchers have found only indirect and weak evidence that foreign-controlled companies in the United States have been shifting profits elsewhere.<sup>11</sup> As for U.S. direct investment abroad, the evidence is stronger that U.S.-controlled multinationals have engaged in profit shifting through transfer prices or other methods.<sup>12</sup> However, such multinationals have been found to have shifted profits both into and out of the United States, perhaps because some U.S.-controlled companies abroad have nontax reasons to want to transfer profits to their parent companies in the United States (such as to avoid capital controls or in response to political instability). Overall, the balance of studies has fallen short of indicating the extent to which profit shifting has contributed to

11. See, for example, Laster and McCauley, "Making Sense of the Profits of Foreign Firms in the United States"; Mataloni, "An Examination of the Low Rates of Return of Foreign-Owned U.S. Companies"; and Harry Grubert, *Another Look at the Low Taxable Income of Foreign-Controlled Companies in the United States*, Working Paper No. 74 (U.S. Treasury Department, Office of Tax Analysis, October 1997), available at [www.treas.gov/ota/ota74.pdf](http://www.treas.gov/ota/ota74.pdf).

12. See, for example, Harry Grubert and John Mutti, "Taxes, Tariffs, and Transfer Pricing in Multinational Corporation Decision Making," *Review of Economics and Statistics*, vol. 73 (1991), pp. 285-293; David Harris and others, "Income Shifting in U.S. Multinational Corporations," in Alberto Giovannini, Glenn Hubbard, and Joel Slemrod, eds., *Studies in International Taxation* (Chicago: University of Chicago Press, 1993), pp. 277-302; and James R. Hines Jr. and Eric M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, Working Paper No. 3477 (Cambridge, Mass.: National Bureau of Economic Research, October 1990), available at [papers.nber.org/papers/w3477.v5.pdf](http://papers.nber.org/papers/w3477.v5.pdf).

**Figure 3.**

### Statutory Corporate Tax Rates in the United States and Foreign Countries, 1996 to 2004



Sources: Congressional Budget Office; KPMG International, *Corporate Tax Rate Survey* (various issues).

Notes: U.S. and foreign corporate tax rates include national and local statutory rates.

The weighted foreign corporate tax rate is the weighted average of the statutory tax rates of 21 countries (Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, South Korea, Spain, Sweden, Switzerland, and the United Kingdom), with each country weighted by its share of total foreign-owned direct investment assets in the United States.

the higher returns earned by U.S. direct investment abroad.

Two factors may help explain that (perhaps surprising) result. First, it is very difficult to measure the extent of mispricing, especially for services provided by intangible assets. Second, profit-shifting activities are influenced not only by differences in countries' tax rates but also by the distribution of profits and losses among parent and affiliated companies. Much of the research on profit shifting was conducted at a time when foreign-owned subsidiaries may have had little incentive to transfer income out of the United States, both because their average profits may have been low as a result of their "youth" and because the average corporate tax rate in some foreign countries was

higher than the U.S. rate (see Figure 3). Researchers may be able to get a more precise estimate of tax-related profit-shifting activities in the future, especially with data on how U.S. multinationals respond to a recently granted tax holiday on repatriated foreign profits.<sup>13</sup>

- 
13. Under the American Jobs Creation Act of 2004, repatriated foreign profits will be taxed at a maximum rate of 5.25 percent provided they are used to stimulate investment in the United States. Businesses have a one-year window (which closes in 2005 or 2006, depending on the company) to take advantage of the lower tax rate.

This brief summarizes the findings of Juann H. Hung and Angelo Mascaro, *Return on Cross-Border Investment: Why Does U.S. Investment Abroad Do Better?* CBO Technical Paper 2004-17 (December 2004). For more information about the current-account deficit, see Congressional Budget Office, *The Decline in the U.S. Current-Account Balance Since 1991* (August 6, 2004), and *Recent Shifts in Financing the U.S. Current-Account Deficit* (July 12, 2005), all available at [www.cbo.gov](http://www.cbo.gov).