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The wealth puzzle: There's a lot of money someplace, but where?

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The IRS estimates, from records obtained from credit card companies, that one to two million U.S. citizens have offshore bank accounts. If they are using them to avoid taxes, it's at least in part because the government encourages them.

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Q. New, startling fortunes exist but are very well hidden. For example, North Americans are said to hold $1.6 trillion in offshore assets. Is that figure reliable, and how much of it is placed there to illegally evade taxes?

Q. Why has the U.S. government made it especially easy for the wealthy to hide their money?

Q. What's the IRS doing, if anything, to tap into all this wealth?

Any effort to understand economic inequality in America runs into an anomaly. While the last two decades or so have seen a massive shift in income to the very top of the economic ladder (usually described as the top 0.05%), this shift appears to have resulted in no significant increase in wealth for this top fraction. Wealth includes all of the assets that people own, homes and other real estate, cash, financial assets, minus any debts owed. One would expect that as income increases, wealth would also, at least to some extent, increase.

What makes this so puzzling is that the size of the income gain realized by the top fraction is literally of historic proportions. Its scale is breathtaking. It is so large that the failure to find a comparable shift in wealth seems, at least to an ordinary observer, improbable. Yet some of the best research on the question has found that between 1986 and 2000 top wealth shares "did not increase significantly".

In part, the explanations offered for this apparent anomaly are related to the fact that a large part of the increase in income to the top fraction seems to come from wages and salaries. It appears to be more a matter of corporate management compensation than a return on investments or capital gains. In broad terms, therefore, it is a relatively new development. These explanations are:

1) The very rich do not have the same propensity to save as they used to; i.e., they spend a lot more of what they make. Just imagining what this could entail could be

great fun, but, alas, could the leaders of American business really be *that* profligate?

2) There is a lot of turnover among the very rich. There has to be some truth to this since the role of wages and salaries in creating extremely high incomes is relatively new. On the other hand, it is not that new; the increasing income of the very top fraction is now well into its third decade. And it is worth remembering that Americans in general, and economists in particular, have a long history of overestimating economic mobility.

3) There hasn't been enough time. It is possible that the shift in income has benefited those who do not yet hold the greater amounts of wealth, and there has not been enough time for them to build up large fortunes. It does take time to build up a real fortune, even for the aggressively greedy. But the fantastic gains at the top, again as noted, have been going on for some time and the gains have been enormous. In any case we will know more about this after the next triennial Consumer Finance Survey by the Federal Reserve Board.

And most seriously of all,
4) The data are bad. Indeed. The income data from the IRS have a great deal of credibility behind them. The wealth data are another matter. This is not the place for a detailed discussion of the issue, but it is worth noting that data derived from voluntary interviews or samples collected from dead people (i.e. estates) to estimate the wealth of the living have problems. Nevertheless, it is not the needle we are looking for; it's the haystack.

None of these explanations can be easily dismissed; in fact there may well be some truth in all of them. But one is still left with a strong suspicion that altogether they do not dispose of the issue. The idea that this huge shift in income does not show up in the best estimates of wealth held by those with the largest incomes is hard to accept. One is left with an almost unavoidable suspicion that the wealth/income anomaly has something to do with taxes. It does not require a tax lawyer to figure out that it is easier to hide assets (and income from assets) than wages and salaries. The IRS is good at keeping track of income; wealth is another matter.

What we do know is that there has been a large movement of assets to offshore tax havens. It is, of course, impossible to know with certainty how much wealth has slipped away, not just from the IRS's, but from anyone's, ability to keep track of it. But there is troubling evidence that there might be enough of it to explain some of the wealth/income anomaly. Tax Justice Network, an organization headquartered in the U.K., has used data published by banking interests to come up with an estimate of assets held offshore. Their recent report cited estimates by the Boston Consulting Group that $1.6 trillion in offshore assets were held by wealthy North Americans – out of about $9 trillion in offshore assets worldwide.

In October of 2000, the IRS asked the major credit card companies for their records of accounts in Caribbean tax havens that were routinely used for transactions in the United States. The intent was to uncover taxpayers who were evading taxes by hiding assets in the tax havens and using credit cards to access their accounts. The IRS was surprised by results. From the records obtained from the credit card companies the Service estimated that one to two million U.S. citizens may be using such accounts.

Most were thought to have incomes that would put them in the top one percent. There is nothing illegal about having an offshore account as such; failure to report it is a felony. The IRS admitted that it was overwhelmed by the results of the credit card investigation; it simply lacked the resources to pursue all of the likely tax evasion. The *Financial Times* (January 14, 2003) quotes tax experts as saying that as much as $70 billion in taxes may be lost each year due such offshore schemes. To date the IRS has collected about $3.7 billion from an amnesty program.

The same investigation turned up dozens of companies involved in the promotion of offshore tax avoidance schemes. In April of this year the IRS announced that it had obtained over 100 injunctions against the promoters of such schemes.

The most significant case against a promoter of abusive tax shelters was brought against KPMG. The Justice Department alleged that the fraudulent tax shelter designed by the accounting firm cost the United States at least $2.5 billion in evaded taxes. KPMG agreed to a fine of $456 million.

The IRS has also pursued the use of tax avoidance schemes involving the transfer of stock options or restricted stock to family controlled entities. Under these schemes corporate executives, sometimes assisted by the corporations, transfer stock options to related entities created for the purpose of receiving the options and avoiding taxes on compensation income. In February the IRS announced the settlement of cases involving 42 corporations, a large number of corporate executives, and over $700 million in unreported income.

Again, presumably because of a lack of resources, the IRS is resorting to an amnesty program. There have been no published estimates of how much the other purveyors of such schemes may have cost the United States.

The limited ability of the IRS to deal with large complex cases is not an accident. And it certainly is not a matter of laziness, stupidity, or the inherent ineptitude frequently attributed to the government by a certain type of politician. Rather, it is a matter deliberate policy. In his book, "Perfectly Legal," David Cay Johnston describes the deliberate measures taken to gut the IRS's enforcement powers, including hearings on IRS "abuses" that were simply a hoax.

Efforts on this scale, involving a major Senate committee, do not come out of nowhere. One must ask, for whose benefit was this elaborate fandango performed? One thing for certain is that it was not done on behalf of the average middle class taxpayer. The notion that ordinary citizens organized themselves and marshaled vast amounts of political influence in a cause that facilitated tax evasion by the very rich defies good sense. It had to have been inspired by people who had a very great deal at stake.

After all this, financial reporters are still left with more questions than answers, questions fueled more by doubts and suspicions than credible data. There is a lot of digging to do. Does the apparent wealth/income anomaly really exist? Have the fantastic income gains at the very top come from an overreaching corporate management? Where is the growth in offshore assets coming from? Are the tax consequences of holding assets offshore enough to really matter? Does all of this tax avoidance and evasion activity add up to an explanation for the wealth/income mystery? Is it enough to actually affect the distribution of wealth – indeed, affect it on a grand scale?

It is possible to argue that the answers to these questions do not matter. After all, there are those who believe that we would all be better off if the very rich were even richer, that the "supply side" investment drives the economy, even that tax evaders are public heroes – of the same ilk as those who threw tea in Boston Harbor. Private greed equals public good. There is only a problem when the issue is viewed from the social and political perspective of the far left.

Important as this argument may be, it should not be the center of our concerns. Our immediate concern must not be with the ideological issues. Rather it must be focused on the economic risk created by the huge shift of income to a tiny fraction of the population and the accompanying stagnation of middle class income. And this risk must be seen in the context of a whole panoply of risky policies, particularly federal tax policy. The risk is in underestimating the potential downside presented by this situation.

One way or another, all economic policy is a bet. There are always risks, foreseen and unforeseen. But we seem to be tempting the gods with a huge bet that offers no real gain for any but a small class of very rich. If consumer demand, which by definition comes from the middle class, should falter for whatever reason – gasoline prices, falling real estate values, or something we cannot predict – the damage could be terrible.

The declining fortunes of the middle class has received both scholarly and media attention. Most notable is the work of Clair Brown of Berkeley who has focused not only on the middle class wage stagnation but also on the decline in the quality of life.

Even a relatively remote risk of a major catastrophe should be a matter of concern. Who would have thought that a little local corruption in a levee commission, a bit of bad engineering, some reckless environmental policies, and a dash of global warming would have cost us a major city? Rotten luck is not unknown.

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