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U. S. MULTINATIONAL CORPORATIONS AND THE BALANCE OF PAYMENTS

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A MONOGRAPH

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ABSTRACT

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The basic question is whether or not Multinational Corporations (MNC) have the potential for helping solve the US balance of payments problem. Of particular interest is the solution of that part of the problem that relates to the NATO imposed foreign exchange deficit. This paper examines the balance of payments problem from 1950-on, and shows how the NATO deficit relates to the overall problem. It examines the NATO costs and foreign exchange expenditures. It discusses the NATO offset arrangements and the problems with them. It then examines the economic activities of MNC with specific emphasis on how these activities impact the balance of payments. The opposing views of labor and management are discussed with regard to how MNC affect exports, imports, and employment and how US tax laws affect foreign investment and the balance of payments. The Burke-Hartke proposed legislation and its impact on foreign investment is discussed. The paper concludes that there is no equitable way for MNC to directly defray the NATO foreign exchange costs, but that these enterprises appear to have the potential for improving the balance of payments through a change in US tax rules, thereby indirectly helping defray the NATO inflicted deficit.

PREFACE

This paper was written to sort out some of the issues and facts in a very volatile, intricate problem area, aspects of which in some way touch the lives of most Americans. I wish to thank Dr. Sidney L. Jones, Minister-Counselor for Economic Affairs, United States Mission to the North Atlantic Treaty Organization, for his guidance on approaching this project and in suggesting sources. Even as this paper was being written the situation was changing rapidly. However, in viewing the latest developments, I do not believe they have changed any essential aspects of the paper.

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CHAPTER I

INTRODUCTION

The purpose of this paper is to investigate the potential that US Multinational Corporations (MNC) have for helping solve the US Balance of payments problem. Of special interest is the part of the problem that relates to the foreign exchange deficit imposed on the US by maintenance of US NATO forces in Europe. Any solution to this problem seems worthy of exploration because of the paramount role a stable dollar plays in the world economy and because balance of payments more and more impacts the stability of the dollar.

The US has run a net deficit in its international balance of payments account for most years since 1950. In spite of this overall deficit, the part of the account that dealt with trade reflected a surplus until 1971. In 1971 the US had a trade deficit for the first year in this century. This deficit increased in 1972. The overall deficit which we ran prior to 1971, in spite of the favorable trade balance, was due in large part to direct defense expenditures abroad. Even though the war in Vietnam has been responsible for a large part of this deficit, expenditures for maintenance of US NATO forces in Europe have been significant and have become an area of increasing concern. Many feel that in Europe, unlike Vietnam, the US is "picking up the tab" for helping defend countries that are financially and otherwise capable of defending themselves.

Every year since the NATO command was organized in 1951, the US has spent dollars in Europe in support of its military forces there.

These dollars have continuously enlarged the foreign exchange reserves of US European Allies and could, in theory at least, have been cashed for gold (some of which were, until suspension of convertibility on 15 August 1971). During the 1960s this situation became increasingly worrisome to the US Treasury. Since 1961 there have been arrangements with West Germany, the main area of US expenditures, to help offset the dollar outflow by various devices.[1] Offset arrangements have entailed frequent negotiations which have strained relations between the US and West Germany, and remain a problem in search of a solution with some degree of permanency.

The multibillion dollar economic activities of US MNC could conceivably become part of this solution. The purpose, then, is to look at the MNC to determine how their economic activities might serve to help offset the US NATO dollar deficit. In theory this could be accomplished by taking advantage of the activities of only those MNC operating in Europe, which is about 30 per cent to the total.[2] Another way would be to take advantage of the activities of all US MNC to help improve the balance of payments, in general, thereby, indirectly alleviating the NATO exchange situation. The best solution might be some combination of the two.

The ramifications of this subject are extensive, and any facet of it could be developed at great length. However, in order to place some reasonable bounds on our discussion, only the basic aspects will be addressed in any detail. Other aspects that are not of primary concern to the central issue will not be addressed except briefly, as immediately follows.

With respect to US MNC, security, transfer of technology and management skills, infringement on sovereignty, and MNC as instruments of foreign policy are all issues, in themselves, that have excited considerable attention and controversy in recent years. Labor is critical of all of these. Host countries (countries in which affiliates are located), particularly developing countries, seem to show some concern in the areas of sovereignty and foreign policy. However, benefits to the host countries, in the way of improving their gross national product, seem to outweigh any adverse impact the countries might feel that the presence of these enterprises have.

Regarding the overall balance of payments account, there are several things that could be done that might eliminate or greatly diminish the causes of our deficits that are not concerned specifically with MNC. One is international monetary reforms recently proposed by the US.[3] Another is the reduction of the price of our exports through some sort of tax rebate to exporters, thereby making US goods more competitive on the world market. The former is new and untried and we cannot be sure at this time just how it might work. The latter is a technique used by a number of foreign countries, including Western European countries, to make their exports more competitive in world trade.

Another thing that should not be overlooked in passing, is the economic activities of foreign MNC in the US. These are extensive and increasing. By 1971 the book value of foreign direct investment in this country amounted to about $13.5 billion.[4] This is a situation that should be recognized because it impacts the net balance of payments.

With reference to the way this paper is developed, the following should be noted. Assessment of the economic activities of the MNC and the options these activities pose for helping solve the balance of payments problem will be more qualitative than quantitative, because precise statistical data to support any in depth quantitative analysis is not available. The reasons are that companies are generally reluctant, for any variety of reasons, to divulge such data, and countries in which subsidiaries operate are equally reluctant to cooperate with the US in obtaining such data.[5] Further, such statistical data as annual amounts of foreign investment, total book value, production worth, etc. are not intended to represent exact, precise, officially published information. The figures are believed to be generally "in the ball park", since, even though only one reference may be cited, most have been checked against at least two sources that generally agree. Surplus and deficit figures, however, are taken from the Survey of Current Business, an officially published Department of Commerce document.

Having qualified our purpose and approach, let us first discuss balance of payments. We will then, in turn, discuss the NATO imposed foreign exchange deficit, the economic activities of MNC, and finally, possible options for helping solve our foreign exchange problems.

CHAPTER I

FOOTNOTES

1. Strategic Survey 1971 (London: The International Institute for Strategic Studies, 1972), p. 24.

2. National Association of Manufacturers, US Stake in World Trade and Investment, 1972, p. 2.

3. "Common Market Taking Monetary Stance," The Wall Street Journal, 17 January 1972, p. 9.

4. Ralph C. Dean, "Multinational Companies," Editoral Research Reports, 5 July 1972, p. 512.

5. Lawrence B. Krause and Kenneth W. Dam, Federal Tax Treatment of Foreign Income (Washington: The Brookings Institution, December 1964), p. 95.

CHAPTER II

US BALANCE OF PAYMENTS

SIGNIFICANCE

Every nation has a balance of international payments. Simply defined, balance of payments is a system of accounting which shows flows to and from foreigners. To extend this somewhat, it is the difference between the inflow and outflow of capital to and from a country resulting from trade, travel, investments, grants, military expenditures, etc. It relates directly to the foreign exchange available to a country to conduct international financial transactions. The primary difference between US balance of payments and that of most other nations is that US money is commonly held and used by foreigners as a means of international exchange. Therefore, a deficit in the balance of payments for the US is significant not so much because the US is lacking in foreign exchange, since the dollar is the US's own foreign exchange, but because of the increase in the amount of dollars in foreign hands. The danger, then, in the deficit is that excessive dollars held by foreigners have a tendency to cheapen our currency and cause a loss of confidence in it. This is exemplified by recent "runs" on the dollar. Foreign confidence in the dollar will continue only as long as foreigners believe that US liabilities are not too great in comparison to US monetary assets and the US overall economic position.

Balance of payments here will be understood to mean the Balance on Current Account and Long Term Capital, as listed in the Survey of Current Business, published monthly by the US Department of Commerce.[1] This balance reflects broad, persistent forces or underlying trends. Hence, it is frequently termed the "basic balance".[2]

DEFICIT

The significant thing about the basic balance has been the almost continuous deficit run by the US for over two decades. To better understand the relationship between the basic balance, the deficit, foreign direct investment,* and US NATO costs, it appears appropriate to discuss some key factors in the balance of payments and a little of the history of the deficit.

In the decade of the 50s, the deficit primarily reflected heavy government expenditures to maintain US military forces in Western Europe, mainly Germany, Korea, and a number of other countries; grants and loans to rebuild Europe and Japan, and to assist less developed countries; and an outflow of capital to other countries to acquire, establish, and expand business enterprises.

In the early 1960s, we enjoyed an annual surplus of $3 to $7 billion in our trade account, however, private capital outflow continued to mount through the sale of foreign bonds and other securities in this country, private bank loans to foreigners, and a stepped up pace in foreign direct investment, especially in Europe.

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*Throughout this paper the terms, foreign direct investment, foreign investment, investment abroad, etc., will all have the same meaning, which is: investment abroad with US capital by US corporate enterprises. This is different from portfolio investment.

Military expenditures in Europe and Asia continued. Our earnings did rot offset our expenditures and the deficit remained chronic.[3]

Growing concern over the deficit prompted the enactment in 1962 of new tax legislation designed to discourage foreign direct investment.[4] This was followed in 1963 by the Interest Equalization Tax, which imposed a tax on foreign stocks and bonds sold in the US, roughly equivalent to the difference in low interest rates here and the higher rates abroad.[5]

In the 1963-1965 period the country operated what is generally considered to have been a non-inflationary economy. The fact that during this period the US continued to run a balance of payments deficit was evidence to many economists that the dollar was overvalued and should be devalued. The government was unwilling to consider devaluation, however.[6] Instead, in 1965 it instituted a voluntary program of controls; these became mandatory in 1968. This program placed restrictions on loans and investments abroad by US businesses, banks, and other financial institutions.[7] Along with these controls on capital outflow was a requirement that a share of overseas earnings be repatriated. Even though these measures have effected balance of payments savings, they have required US businesses to do their investment borrowing abroad, often at higher rates of interest. Obviously this results in the return flow on their overseas earnings being diminished by the amount they are paying for increased use of foreign capital.[8] The exact amount of capital involved is not known: however, some appreciation for the amount might be obtained from the following. In 1966, capital invested in US manufacturing affiliates abroad amounted to $9.1 billion, of which $7.2 billion was either borrowed abroad or was reinvested income.[9] A 1968 estimate made by Chase Manhattan Bank indicated that MNC were at that time financing 35 per cent of their foreign direct investments by borrowing abroad (40 per cent was from reinvested income and 25 per cent from the US).[10] With foreign direct investment (capital from the US) up from $3.2 billion in 1968 to $4.8 billion in 1971,[11] one can see that the total amounts involved are significant. So in the short run, though controls may have decreased the deficit, in the long run, their effect may be deleterious.

In the late 1960s, large expenditures in Vietnam added to the outflows. The situation was further aggravated by the war-sparked domestic inflation, which sharply reduced the merchandise trade surplus.[12] The situation would have been worse had it not been for the controls, just discussed, and for the US government inducing foreign governments to convert some of their dollar holdings to various "nonliquid" securities in the US. The latter had the effect of improving the appearance of the official balance of payments statistics for a few years, but it placed long term claims on the US economy.[13]

To add to the continuing balance of payments problem, there was a sharp decline of interest rates in the US beginning in 1970. This started a massive flight of capital from dollars into several other currencies. This continued on into 1971 and contributed to a worsened balance of payments, which was compounded in that year by the first deficit in the US trade account in this century.[14]

One thing that should be recognized, in order to make any discussion on balance of payments more complete, is the continuing net effect generated by tourism. In the decades of the 60s it added to the deficit an average of over $1.3 billion annually.[15]

To sum up, from 1950--on, net earnings from goods and services exports were not large enough to counter US capital exports and foreign grants, with the result that the US generated a chronic balance of payments deficit. One explanation was overvaluation of the dollar. Another was the very high level of US military spending abroad that began, as the deficits did, in the early 1950s. Both together probably best explain it. Unlike foreign direct investment, which is expected to generate a return flow of funds at some future date, military spending abroad acts as a one way drain of dollars out of the country. During this period, military spending abroad was more than the private sector of the economy could earn abroad at existing exchange rates. It is still too early since the recent devaluation of the dollar or even since the one a year earlier to know exactly how and to what extent the long run situation will change as a result of these devaluations. With respect to the short range situation, however, balance of trade figures recently released show that the earlier devaluation has not helped, since trade ran a deficit of $6.4 billion in 1972.[16]

IMPACT ON RESERVES

The continual deficit of the last twenty years has had a considerable impact on US official reserves. In 1950, US official reserves were $24.3 billion, nearly one-half of the world's holdings of gold and convertible currencies. By August of 1971, US reserves had decreased to $12 billion, scarcely 10 per cent of the total. Since 1950, Western European reserves rose from 13 per cent of the world's holdings, equivalent to about $6.3 billion, to 37 per cent, equivalent to about $44.4 billion. Part of this increase resulted from the flow of gold from the US.[17]

NATO AND THE DEFICIT

The dollar/gold drain, especially to Europe, and the late 1960s sharply increasing expenditures on the war in Vietnam, and its contribution to the deficits, caused mounting pressures for decreasing or offsetting our NATO inflicted costs and associated balance of payments deficits. These deficits were a primary target since they had been long-standing and since it was generally felt that our NATO allies were in a position to give us some relief. Let us then consider the cost of US NATO forces, the impact on the balance of payments in maintaining these forces, and what is being done in the way of offset to alleviate the NATO associated foreign exchange deficits.

CHAPTER II

FOOTNOTES

1. "US Balance of Payments Summary," Survey of Current Business, US Department of Commerce, June 1971, p. 30.

2. Arthur M. Okun and George L. Perry, (eds.), Economic Activities 1:1971 (Washington: The Brookings Institution, 1971), p. 222.

3. Robert Warren Stevens, A Primer on the Dollar in the World Economy (New York: Random House, 1972), p. 114.

4. Krause and Dam, p.5.

5. Stevens, p. 132.

6. Ibid., p. 114.

7. Ibid., p. 132.

8. Editorial, The Wall Street Journal, 18 October 1972, p. 14.

9. Robert B. Stobaugh, "How Investment Abroad Creates Jobs at Home," Harvard Business Review, September-October 1972, p. 124.

10. Christopher Tugendhat, The Multinationals (New York: Random House, 1972), p. 151.

11. "US Balance of Payments Summary," Survey of Current Business, US Department of Commerce, June 1972, p. 26.

12. Stevens, p. 114.

13. Ibid., p. 115.

14. Okun and Perry, p. 224.

15. Survey of Current Business, June 1971, p. 30.

16. Carole Shifrin, "Trade Deficit Worst in History," The Washington Post, 25 January 1973, p. 9.

17. Thomas W. M. Smith, The Strategic Implications of International Monetary Reform (Washington: The National War College, 10 July 1972), p. 2.

CHAPTER III

THE NATO FOREIGN EXCHANGE DEFICIT

FORCES

The US NATO forces actually stationed in Europe or the surrounding waters consist of more than four Army divisions (virtually all in Germany), seven tactical air wings, two attack carriers and several Polaris submarines deployed in the Mediterranean, and other naval forces assigned to NATO in the Mediterranean and Atlantic Fleets.[1] Altogether, approximately 300,000 US troops are stationed in Europe, including those afloat on NATO assigned naval missions. Accompanying them are approximately 225,000 civilians.[2]

COSTS

The costs to the US of maintaining this contingent in Europe are difficult to determine. These costs are not clearly identified in the budget; official sources do not regularly publish them; and when they are publicized, one might suspect that it is for political reasons and, therefore, the amounts stated might be equally suspect. The figures used here are those published by the Brookings Institution.

The approximate annual cost in 1972 dollars of the total NATO-oriented force, is estimated at about $25 billion. This includes not only those forces stationed in Europe, but forces in the US and elsewhere marked for a NATO contingency.[3] The annual cost of the forces stationed in Europe is estimated at something over $9 billion, of which $3 billion plus is for operations (personnel pay and allowances, supplies, maintenance, and transportation) and $6 billion plus is for annual investment (military equipment and construction) and direct support (such as administration and training).[4]

FOREIGN EXCHANGE COSTS

In bearing its share of the NATO cost, the US has a problem which is either not shared or shared to a much less extent by its NATO allies, that is the problem of foreign exchange costs. These costs arise mainly from three types of expenditures: (1) payments for local goods and services required to maintain and operate military facilites, (2) military capital investment in Europe (building, equipment, and US share of NATO infrastructure costs), and (3) local purchases by US military personnel and their dependents stationed in Europe. All three categories produce windfall foreign exchange receipts for the host country.[5] During most of the 1960s, expenditures for these purposes averaged $1.5 billion annually. In 1971 it rose to around $2 billion. Since relocation of US forces from France in 1967, a growing proportion of these expenditures has been in Germany.[6]

OFFSET

Since the NATO military command was organized, the US has added annually to its balance of payments deficits through its military expenditures in Europe. In the late 1950s, this deficit began to cause increasing concern. The issue came to a head in late 1960 so far as US-German relations were concerned, and from 1961-on resulted in a series of formal offset arrangements.

The first group of offsets covered the period 1961-1966. They consisted of German purchases of US military equipment, or advanced payments for such equipment, to the full amount of US foreign exchange expenditures, these agreements resulted in substantial build-up of German advance payments to the US Treasury on which interest is still being earned.[7]

The second group covered the period 1967-1969. They consisted of a combination of purchases of military equipment and medium-term US Treasury securities, along with an agreement that Germany would not convert dollars for US gold.[8]

In the 1970-1971 agreement, the major change was Germany's buying of ten-year US Government securities at approximately half the market rate of interest and some US Export-Import Bank and Marshall Plan loans to other countries, instead of buying US medium-term securities at commercial interest rates. The 1972-1973 agreement is essentially the same as the previous one with the additional arrangement for Germany to help pay for renovation of American barracks and airfields and to make a cash payment to the US government of about $.2 billion.[9] These figures obviously make the deficit look a bit more palatable, but still leave a lot to be desired.

The build-up in the US Treasury of German advance payments for military equipment and the German purchase of US securities is essentially "window dressing," which improves the short term balance of payments statistics but places long term claims on the US economy. Such transactions, if prolonged, could become meaningless because of the amount of interest earned.[10]

Similar arrangements as those discussed above have been made between the US and other NATO countries but on a catch-as-catch-can basis.

Some feel that the military sales to NATO countries are not, in part at least, a true offset, since a portion would have been made in any event. If, however, we consider these sales as part of the net, the US NATO forces military expenditures foreign exchange deficits averaged close to $.9 billion from 1966 to 1970.[11] This figure increased to around $1.3 billion in 1971.[12]

PROBLEMS WITH OFFSET

Past measures, though perhaps a necessary stopgap, cannot meet the political and financial requirements of a strong and lasting US-European defense relationship. Two major deficiencies are apparent. First, past measures have not solved the problem. Their failure has caused a mounting concern about the "dollar drain" to Europe and a feeling of resentment toward our European Allies on the basis that inequities are involved. Second, past measures required the US to consistently suffer foreign exchange deficits through their NATO obligations, while Germany and other European surplus countries received foreign exchange gains. Though this perverse situation was mitigated by Germany's cooperation in holding dollar reserves and by revaluation of the mark, this cooperation did not receive the political credit it deserved in the US and it also created political problems in Germany.[13]

These deficiencies would disappear if an efficient and politically neutral process existed to adjust chronic surpluses and deficits among industrial countries. The US government has proposed such measures.[14] Pending their enactment, however, the issue of the NATO inflicted deficit could still probably be greatly deflated if the private sector of the US economy were able to offset the foreign exchange deficit created by government spending abroad. One way in which this might be done is through the economic activities of the MNC. We will now take a look at these enterprises and some of their economic activities.

CHAPTER III

FOOTNOTES

1. John Newhouse with Melvin Croon, Edward R. Fried, and Timothy W. Stanley, <u>US Troops in Europe, Issues, Costs, and Choices</u> (Washington: The Brookings Institution, 1971), p. 106.

2. <u>Strategic Survey 1971</u>, p. 22.

3. Charles L. Schultze, Edward R. Fried, Alice M. Rivlin, Nancy H. Teeters, <u>Setting National Priorities The 1972 Budget</u> (Washington: The Brookings Institution, 1971), p. 55.

4. Newhouse, p. 106.

5. <u>Ibid</u>., p. 126.

6. <u>Ibid</u>., pp. 126-129.

7. <u>Ibid</u>., pp. 129-130.

8. Stevens, p. 115.

9. Newhouse, p. 131.

10. Stevens, p. 115.

11. <u>Strategic Survey 1971</u>, p. 24.

12. Newhouse, p. 128.

13. <u>Ibid</u>., p. 132.

14. <u>The Wall Street Journal</u>, 17 January 1972.

CHAPTER IV

MULTINATIONAL CORPORATIONS

DEFINITION

Raymond Vernon, of the Harvard Business School, has defined MNC as companies operating in at least six countries, with sales of over $100 million per annum, and for which subsidiaries or branches account for at least 20 per cent of total sales, assets, and labor force.[1] This definition is good to keep in mind so as to have a feel for the international corporate enterprises that impact most heavily on US balance of payments. As an example of such enterprises, note that out of the top 200 US companies, 80 do 25 per cent or more of their business abroad.[2] Hence, 80 US companies impact quite heavily on our balance of payments. For our purposes here, we are interested not so much in Vernon's somewhat restrictive definition as in US based international corporate enterprises, in general, because all such organizations, regardless of size, impact US balance of payments.

The subsidiaries and branches, to which Vernon referred, are located in countries other than where the parent is incorporated. The difference between these affiliates is that subsidiaries are incorporated in the country of their operations and branches are not, being merely extensions of domestic corporations' operations. Branches are more generally used by extractive industries and subsidiaries by manufacturing industries. The distinction is important for US tax purposes, an aspect which will be discussed more later.

BOOK VALUE AND PRODUCTION WORTH

It is estimated that the book value of all MNC investments, US and foreign, outside their own countries totalled at least $150 billion by 1971, and is growing at a rate of about 12 per cent a year.[3] It is further estimated that these investments resulted in production of over $300 billion of goods in 1971, more than the total value of world trade for that year. The US share of all MNC is variously figured to be between 40 and 60 per cent.[4] The US Department of Commerce estimated that US foreign direct investments totalled approximately $86 billion by the end of 1971.[5] During that year, these investments produced goods and services approaching $200 billion.[6] Of this amount, an estimated $65 billion was produced in Europe by US owned manufacturing facilities.[7] This is significant, particularly in that investments and follow-on productions in Europe have a unique potential for causing balance of payments problems--more on this later.

One recent estimate of the annual international production of the world's MNC is $450 billion.[8] With a gross world product estimated at around $3 trillion for 1972, it is easy to appreciate the impact that the economic activities of these corporations have on the world economy. Considering that US businesses control in the vicinity of 50 per cent of these corporations, one can appreciate the impact that US foreign investments have on the world economy.

What impact, then, do these investments have on the US economy? In answering this, two things must be considered: the drain on the economy in financing these investments and the accompanying contribution to a balance of payments deficit, and the profits for the economy and their contribution to a balance of payments surplus.

FOREIGN INVESTMENTS, CAUSE-AND-EFFECT FACTORS

US investments abroad increased from $1.7 billion in 1960 to $4.8 billion in 1971, averaging about $3 billion per year. This does not include reinvested earnings of foreign affiliates. From 1960 to 1971, returns on foreign investments in the form of dividends, branch earnings, fees, royalities, and interest increased from $2.9 billion to $9.5 billion, averaging in excess of $5.5 billion per year.[9] These figures are clear and evident pluses and minuses in the balance of payments account. They indicate that the net effect of US investments abroad for the twelve year period considered was a profit exceeding $31 billion. This, however, is not the complete picture with respect to the effect of foreign investments on balance of payments, since there are other cause-and-effect factors which impact the returns on these investments. Only by considering these other factors collectively with the evident pluses and minuses can we hope to assess the overall effect of US investments abroad on the balance of payments. Some of these other factors are:

1. 1965/1968 controls.

2. Effect of US foreign investments on US exports, imports, and, in turn employment.

3. Impact of the US tax system on the economic activities of US MNC.

4. Impact on the world economy of the currency exchange activities of the MNC.

CONTROLS

As was pointed out above, net earnings increased from 1960 to 1971. This is a trend that is expected to continue over the coming years. However, these earnings are expected to be diminished by the amount US firms are paying for the increased use of foreign capital, necessitated by the 1965/1968 controls. The Wall Street Journal states that this increased borrowing abroad puts great pressure on foreign capital, helping run up interest rates and making the capital more expensive than it might be in the US. It further states that higher interest rates abroad also attract foreign investment capital that might otherwise come to the US, which would help improve our balance of payments.[10] So it appears that controls and their ramifications impact the economic activities of MNC, affecting the overall balance of payments. This, however, occurs in ways that are not easy to assess. This is generally true, also, for the other factors discussed below, since analysis requires estimating alternative actions that did not, in fact, come to pass.

EXPORTS, IMPORTS, AND UNEMPLOYMENT

The impact of US investment abroad on US exports and imports is something about which labor is particularly critical. Labor's main criticism is that production by US foreign based affiliates cuts into US exports, thereby reducing production in this country and, in turn, increasing unemployment. It further argues that US foreign affiliates flood US markets with imports, thereby eroding US jobs, since goods produced here cannot compete with lower priced foreign made goods.[11] In considering these allegations, Robert Stobaugh of the Harvard Business School estimated in 1971 that US foreign direct investment accounted for one-fourth of all US exports and one-half of US exports in manufactured goods.[12] Instead of being critical of this, however, he feels that foreign direct investment is an integral part of a manufacturer's worldwide strategy for growth, and that in many industries, to survive, let along grow, a company is virtually forced into such investment at some time.[13] The reasons for this are several, the primary ones being to get around trade barriers and reduce production costs. Others are that local managers understand customers, labor-management contracts require that supplies be made locally, locally produced goods receive preferential treatment over imports, requirement to work patent rights within country, etc.[14] The National Association of Manufacturers (NAM) states that the decision to invest is not whether to export or invest abroad, but rather to invest abroad or stop selling to the foreign market.[15] These arguments tend to indicate that foreign direct investments do not replace exports. Stobaugh further states that these investments have the effect of expanding exports.[16] Both NAM and labor agree that between 25 and 35 per cent of total exports go to subsidiaries of US corporations.[17] NAM sees this as an increase and labor as a replacement of the US exports. Some recent statistics seem to support NAM's view. These statistics cover the period 1966-1970 and survey 298 US based MNC with about 5200 foreign affiliates. They indicate that exports of these companies rose from $12.7 billion in 1966 to $29 billion in 1970, a faster rate of growth than the nation's total exports. These companies also showed a growth in imports, but their surplus of exports rose from $5.3 billion in 1966 to $7.6 billion in 1970--a time when the nation's overall trade surplus declined almost one-half.[18]

How do foreign direct investments affect imports? Statistics indicate that in 1968 most production of US affiliates abroad served local markets. Only 14 per cent were imported into the US. When transportation equipment from Canada, which came under the 1965 US-Canadian auto agreement, is excluded, foreign affiliates accounted for only eight per cent of US imports.[19] Data after 1968 is limited. However, the NAM feels that such imports have not increased as a percentage of total US imports.[20] Labor addresses these statistics by pointing out that the 14 per cent figure does not include imports from joint ventures, from licensees or from foreign companies of which a US company is a significant though not dominant part. As a result, some Labor statistics are as high as 25 per cent.[21]

The AFL-CIO claims that between 1966 and 1969 about 400,000 US jobs were dropped by US companies shifting their production to foreign plants.[22] Stobaugh admits that investment abroad inevitably causes shifts within the domestic job market, but disagrees that there is an overall increase in unemployment. On the contrary, he estimates that by 1971, 600,000 jobs in the US that would not have otherwise existed derived from overseas investments.[23] Other statistics indicate that between 1960-1972, home employment of the 86 heaviest foreign investors rose 32.8 per cent, while for all US manufacturers, the increase was only 14 per cent.[24] Statistics on the 298 companies discussed above indicate that domestic employment of these companies rose 2.7 per cent per year from 1966-1970, while the national average rose by only 1.8 per cent.[25] Stobaugh says that elimination of foreign affiliates would result not in increased US employment, but in replacement of the affiliates' output by production of foreign competitors. Further, he feels that investment abroad helps US employment by encouraging US exports. This occurs in at least three ways: (1) by the manufacture of capital equipment to be used in foreign affiliate plants, (2) by the production of components to be processed in foreign affiliate plants, (3) by manufacture and export of US goods that would not be sold abroad unless a US company was established there.[26]

Exports and imports result in conspicuous pluses and minuses in the balance of trade and, in turn, the larger balance of payments account. To the extent that foreign investments affect imports and exports, these investments affect the balance of trade account. Exports and imports affect employment. So, to the degree that foreign investment affects exports and imports, it, too, affects employment. The impact of unemployment on balance of payments is somewhat subtle. It is closely related to the cause-and-effect of inflation, with inflation, itself, affecting balance of payments. There is some optimum balance--perhaps a delicate one--between foreign investments, exports and imports, employment, and balance of payments. No one can assert that we are at the optimum balance now, but certainly the present balance should be carefully weighed by government, labor, and industry before altering it.

US TAX SYSTEM

Another factor about which labor is particularly vocal is the US tax system for foreign-source income. Labor views the system as encouraging foreign investment at the expense of domestic investment. Perhaps no aspect of MNC is more revealing of their unique nature than the interaction of the economic activities of these enterprises with US tax laws. This interaction is particularly significant, since much of the monetary activities (manipulations, if you will) of these corporations impact upon or are impacted by the US tax system. These activities and the tax rules which impact them affect the balance of payments. To understand how, let's briefly discuss first the basic rules, which were set forth in a 1954 law, and modified, somewhat, in 1962.

Domestic corporations are taxed on their worldwide income at corporate tax rates; foreign corporations are taxed only on their income earned in the United States. If a domestic corporation operates directly in a foreign country, through a branch, it is subject to US taxation on the income derived from the foreign source as part of the overall income of the corporation. Taxes are due on profits as they are earned, however, credit is allowed, on a dollar-for-dollar basis, for any foreign tax paid on the foreign-source part of the overall income. If, instead, a domestic corporation conducts its foreign operations through a subsidiary incorporated in a foreign country, the subsidiary is considered to be a foreign corporation as far as US tax laws are concerned, even though it may be wholly owned by a US parent. Income of that subsidiary is exempt from US taxation until profits are repatriated to the United States. This is known as deferral. On repatriation from a developing country, the profits are not taxed at the corporate rate. Instead they are treated as some form of receipt to the parent corporation, the nature depending on whether they are distributed as dividends or in some other form.[27] From a developed country, income (dividends) from a subsidiary plus foreign taxes paid by the subsidiary are figured into the gross income of the corporation for tax purposes, but, as was true with the branches, the parent, here, is allowed a credit against US taxes for any tax paid to a foreign government.[28] The Revenue Act of 1962 singles out certain tax avoidance transactions of tax haven corporations for inclusion in the taxable income of the parent in the year in which income is earned. Though deferral is eliminated for these specific cases, the basic deferral provisions are unchanged.[29]

The government faces several problems in taxing foreign-source income, the solutions to which inevitably seem to create loopholes and still other problems. Among the problems that the government faces are:

1. Foreign vs. domestic tax neutrality.
2. Deferral of taxes on foreign corporate earnings.

3. Unreasonable accumulation of profits in foreign countries, delaying repatriation of funds to US.

4. Making proper allocation of income between parent and subsidiary.

5. Tax avoidance by taking advantage of different rates applicable to branches and subsidiaries.

DOMESTIC NEUTRALITY

The issue of foreign vs. domestic tax neutrality is one about which labor has strong feelings. The laws as they are written generally favor foreign neutrality, which means generally that the US treats its foreign subsidiaries the same way foreign governments treat their corporations. It is argued that if foreign neutrality is not recognized, American businesses operating abroad will be at a disadvantage compared to foreign owned businesses. This argument supports deferral and insists that higher corporate income taxes would result from elimination of deferral, hurting the competitive position of US businesses abroad. It is noted that all foreign countries allow the deferral of taxes on foreign source income.[30]

Much of the foregoing is disputed by those, including labor, who support domestic neutrality (treating foreign subsidiaries identically to domestic producers). They argue that low foreign tax rates may place American firms operating at home at a disadvantage in competing with American-owned foreign subsidiaries. They feel that this situation is aggravated when deferral is combined with a low foreign tax rate in the country of operations. This could be important in competition for foreign markets where subsidiaries are operating, for third country markets, or even for the domestic market if foreign subsidiaries export back to the US. They further argue that this situation tends to inhibit domestic investment and attract American capital abroad, intensifying the balance of payments problem.

Labor, specifically, pushes the argument for domestic neutrality even further by supporting the elimination of credit, to be replaced by deduction, for foreign taxes paid on foreign-source income. It argues that the foreign credit system puts domestic firms at a competitive disadvantage since income taxes paid to a state (as opposed to a foreign government) can be applied only as a deduction against US taxes owed. An example used by labor is that of two US firms with taxable incomes of $1 million each, one operating in Pennsylvania and the other in Japan. The Japanese affiliate pays $63,000, or 12 per cent, less total taxes than that paid by the domestic firm.

DEFERRAL

Deferral of taxes is an issue closely connected to that of tax neutrality. It is important for several reasons--reasons that are generally difficult to assess. First, if it creates an incentive to make foreign investment at the expense of US exports and investment in the US, it departs from standards of tax neutrality. This situation could also contribute to weakening the US balance of payments position by encouraging an undesirable outflow of capital.[31] Labor's position is that it does, in fact, create a situation that both departs from standards of tax neutrality and weakens US balance of payments position.[32] Second, if it delays repatriation of earnings, it could reduce total tax revenues by several hundred million dollars per year.[33] If these earnings of foreign subsidiaries are reinvested to become part of the permanent capital transactions of foreign operations, they might never be repatriated and US taxes, in turn, never paid.[34] As will be pointed out below, there is at least some trend in this direction. Third, if foreign earnings are growing over time, postponing the tax liability by deferral amounts to interest free loans, here again departing from tax neutrality.

UNREASONABLE ACCUMULATION

Closely related to deferral is unreasonable accumulation of profits. When the foreign tax rate is substantially below the US rate, deferral of taxes on foreign-source income enables American-controlled foreign corporations to accumulate capital at a much faster rate than would otherwise be possible. This may induce retention of foreign funds not currently needed for the foreign business operations, rather than repatriate the funds and pay taxes. Retained funds would be invested in some sort of securities to draw interest.[35] In a recent article on this matter, the Wall Street Journal stated that many companies prefer to leave their profits abroad indefinitely to invest in securities or to expand their foreign operations.[36]

A closely related problem is one of the "disguised dividend". Some US parents attempt to disguise as investments made by their foreign subsidiaries in the US what are actually dividends to the parent in order to avoid taxes. An example would be a long-term loan by a foreign subsidiary to its US parent.[37]

ALLOCATION OF INCOME

An abuse that is encouraged by deferral and the propensity for unreasonable accumulation is the manipulation of pricing of transactions among subsidiaries across national boundaries. Such manipulation is sometimes referred to as transfer pricing. The Wall Street Journal reports that siphoning profits into subsidiaries located in countries where taxes are lowest is common with international corporations. It states further that tax havens on remote islands, dummy subsidiaries in Switzerland, loopholes in the tax laws of various lands, all permit companies to avoid, more or less legally, large sums in taxes.[38] For example, on sales between a US manufacturing parent and a foreign sales subsidiary located in a low tax area, there is a strong incentive to stipulate a price as low as possible so that both the selling and manufacturing portion of the profit becomes the income of the subsidiary.[39] In a similar operation, a US parent might sell its products, perhaps component parts and capital equipment, to its foreign subsidiaries at very low prices, reducing its own US taxable profits and boosting its modestly taxed profits abroad. This manipulation is a useful device for keeping down the overall corporate tax liability. Firms can get by with such manipulations, since the Internal Revenue Service cannot effectively tamper with such pricing policies, if only because it is often difficult to determine a fair market price.[40] Here again deferral comes into play, since that is the thing that makes such manipulation worthwhile.

BRANCHES VS. SUBSIDIARIES

There is also a strong incentive to take advantage of the different tax rates applicable to branches and subsidiaries. It is often possible for US companies to open a new foreign operation as a branch, deducting its initial losses for US tax purposes, then later converting the operation to a subsidiary whose profits are taxed at a lower rate than the 48 per cent US maximum.[41] By use of deferral, such conversion can also mean avoiding US taxes altogether.

CURRENCY EXCHANGE ACTIVITIES

In shifting from consideration of the taxing system, we will consider a factor involving the currency exchange activities of MNC that can have considerable impact on the world economy, including balance of payments of several countries at once, depending on the nature and extent of the countries' international economic activities. This factor concerns the transferring of funds between currencies as a defensive hedge against the vagaries of the currency markets. Vast sums of money are controlled by MNC. Their funds may be in several currencies at one time. These enterprises employ economists/money experts who keep abreast of strengths and weaknesses of important national currencies, as well as interest rates in various countries.[42] They are particularly concerned about devaluation of a currency in a country in which they have investments, since devaluation can mean losses in corporate accounts measured in the millions. When they sense that devaluation is imminent, they commonly shift funds from the currency concerned and do not allow their subsidiaries in that country to accumulate surplus cash. At such times, it is common for them to require that imports be paid for immediately and that extended credit be given on exports.[43] Parents may also require subsidiaries to borrow locally, increasing interest rates, thereby increasing the credit squeeze.[44] These very actions can compound the money crisis they are trying to circumvent. Other currency dealings routinely involve the converting of liquid assets into currencies that offer higher rates of interest or into "undervalued" currencies. This relates to deferral and unreasonable accumulation, discussed above, in that excess money on hand makes such transactions possible.

These transactions are all perfectly legal and, perhaps, even morally defensible, since a company owes it to its stockholders to protect their interests. But such actions, if they occur on a wide enough scale, can have a considerable impact on the international money market. It is estimated that about 4000 MNC were involved in such transactions in the tense weeks prior to August 15, 1971.[45] It is felt among some authorities that these monetary dealings contributed, maybe significantly, to the money crisis that ensured.[46] Not necessarily out of any malice aforethought, the companies involved in these dealings became part of the "evil speculators" that helped bring on the crisis.

It is difficult to assess the effect that such dealings have on balance of payments. But since they can affect the rate of exchange, and rate of exchange is at the very heart of the balance of payments account, it is not hard to be convinced that these dealings can impact the balance of payments. For instance, when the rate of exchange of other currencies changed with respect to the dollar, upon the recent devaluations of the dollar, certain things happened. US goods became cheaper on the world market, which should in time help improve our export trade account. Imports became more costly. However, the net effect on the import trade is not so obvious. The increased cost of foreign goods may discourage some imports, which will help our balance of payments. The goods that do come in, however, are costing more, perhaps offsetting the effect of any decrease in volume.* Goods which we are required to buy from abroad have become more expensive, thereby hurting that particular aspect of the balance of payments account. This includes our required military expenditures in NATO. What, then, does this tell us? Perhaps it is this: we go from a mounting international currency crisis, brought on by many diverse factors, to the defensive currency transactions by the MNC, to culmination of the crisis resulting in devaluation of the dollar and the accompanying impact on the exchange rate, to an effect on the balance of payments account, part of which is increased cost in our commitment to NATO.

There is no attempt here to make MNC the culprit in whatever effect the devaluation of the dollar is having on our military

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*The trade deficit increased to $6.4 billion in 1972, almost three times the 1971 deficit. It appears to have resulted in the volume of imports not decreasing because of the economic resurgence in this country. There are some optimistic **predictions** that this trend will be reversed in 1973 as a result of the 12 February 1973 devaluation because this most recent devaluation was accompanied by certain under-priced currencies being allowed to float.

expenditures abroad. The point being made is that the international monetary resources of these enterprises are so vast that they do, in fact, have the potential for causing, or at least compounding, monetary crises.

BURKE-HARTKE BILL

These vast resources reflect the size and rapid growth of MNC, making them highly "visible". This adds to their being a target for criticism of real or imagined abuses of their powers and positions. Organized labor is one of their major protagonists. Labor's major criticism centers around the following points:[47]

1. MNC are a major cause of US unemployment because they export capital which could have been invested at home; produce goods abroad which could have been produced at home and exported; increase imports, cutting into US production.

2. MNC contribute to the balance of payments deficit by weakening the balance of trade.

3. MNC are a primary channel of technology transfer abroad, undermining US technology lead.

4. MNC manipulate transfer pricing and take advantage of tax and tariff loopholes, thereby being encouraged to invest abroad at the expense of investing at home.

In order to counter what it considers abuses by MNC, labor is sponsoring a Foreign Trade and Investment Act, commonly known as the Burke-Hartke Bill. This bill is designed to discourage American business investment abroad and limit the flow of imports into this country. Its stated purpose is to promote full employment, restore a diversified production base, and stem the outflow of US capital, jobs, technology and production.[48] Among other things, it would eliminate the deferral of taxes on profits held abroad and wipe out the US tax credit on taxes paid to foreign countries; such payments would be treated as expenses or reduction in taxable income rather than reductions in the amount of federal taxes owed.[49] This should be recognized as application of the principle of domestic tax neutrality, which was discussed above. As implied in this bill, elimination of these privileges would be primarily for reasons not associated with the balance of payments. There are other aspects of this bill that impose considerable restrictions on foreign trade. Many feel that it is too extreme in many of its provisions. Be that as it may, it does identify many of the problems and abuses associated with the economic activities of the MNC.

CONCLUDING MNC

It is conceptually possible to measure the benefits and costs of foreign direct investment. With respect to balance of payments effects, benefits include the MNC's returns of interest and dividends to the parent company and US citizens, royalties and management fees, host country imports of US capital goods and intermediate products, and export of US goods not directly associated with foreign affiliates but affected by their operations. Cost include capital outflows, possible replacement of US exports by sales of affiliates in host countries and third countries, and possible US imports from foreign affiliates.[50] The difficulty in reaching conclusions on the effect of foreign investments on the US balance of payments results from the theoretical problem of comparing the actual situation of having foreign investments to a hypothetical situation without them.

Clearly, the investments that could cause difficulty for the US are those that expand the manufacturing capacity for the production of goods competitive with US domestic output. This is especially so for goods from Europe, where, as was noted earlier, our investments produced $65 billion worth of goods in 1971. Another problem with Europe, is that unlike a developing area, Europe has foreign exchange and capital goods, therefore, dollars invested in Europe are not as likely and as quickly to be spent back in the US as they would be were they invested in a developing area.[51] This creates a foreign exchange "overhang".

Even in Europe, though, foreign subsidiaries once established should in the long run be a net exporter of capital, providing there is not a growing stream of investments over an extended period with capital from the US. Between 1960 and 1965 US subsidiaries in Europe exported 25 per cent over import of capital. This ignores initial investments, but, on the other hand, it does not include royalries and other services, which can be substantial.[52] Stobaugh states that original capital investment appears to be recovered, usually, between three and six years.[53] The time may be less for follow-on investments in on-going operations.[54]

Even without the continuous outflow of capital from this country our economic strength abroad is growing. Some growth estimates are as high as $8 billion per year.[55] This has the potential for a good long range effect on our balance of payments.

Labor sees no favorable aspects to foreign investment and advocates restrictive measures for curtailing it. The Burke-Hartke Bill, which labor is sponsoring, seems to be least concerned with the balance of payments, and, therefore, if enacted in its present form might degrade our foreign exchange situation. It does, however, identify certain abuses, which if eliminated, might have a favorable effect on balance of payments.

CHAPTER IV

FOOTNOTES

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2. "On the Way: Companies More Powerful than Nations," US News and World Report, 19 July 1971, p. 38.

3. Tugendhat, p. 3.

4. Dean, p. 512.

5. What's News. "Direct Investments Abroad," The Wall Street Journal, 3 November 1972, p. 1.

6. Gus Tyler, "Multinationals: A Global Menace," AFL-CIO American Federationist, July 1972.

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9. Survey of Current Business, June 1972.

10. The Wall Street Journal, 18 October 1972.

11. Tyler, p. 5.

12. Stobaugh, pp. 119-120.

13. Ibid., p. 118.

14. Tugendhat, p. 13.

15. National Association of Manufacturers, p. 28.

16. Stobaugh, p. 118.

17. National Association of Manufacturers, p. 38.

18. Edwin L. Dale, Jr., "No U.S. Job Losses Found at Multinational Concerns," New York Times, 20 November 1972, p. 59.

19. Stobaugh, p. 121.

20. National Association of Manufacturers, p. 29.

21. US News and World Report, p. 41.

22. *Ibid*.

23. Stobaugh, pp. 118-119.

24. Dean, p. 506.

25. *New York Times*.

26. Stobaugh, pp. 119-120.

27. Krause and Dam, p. 7.

28. Joseph A. Pechman, *Federal Tax Policy* (Washington: The Brookings Institution, September 1966), p. 131.

29. *Ibid*., p. 132.

30. Krause and Dam, pp. 88-89.

31. *Ibid*., p. 11.

32. National Association of Manufacturers, p. ii.

33. Krause and Dam. p. 11.

34. *Ibid*., p. 42.

35. *Ibid*., p. 19.

36. William M. Carley, "Land of Opportunity," *The Wall Street Journal*, 16 October 1972, p. 1.

37. Krause and Dam, p. 20.

38. Carley, p. 1.

39. Krause and Dam, p. 26.

40. Carley, p. 15.

41. "Global Companies: Too Big to Handle?," *Newsweek*, 20 November 1972, p. 97.

42. Dean, p. 513.

43. Tugendhat, p. 134.

44. *Ibid*., p. 154.

45. *Newsweek*, p. 96.

46. Dean, p. 512.

47. Elizabeth R. Jager, "The Conglomerate Goes Global," AFL-CIO American Federationist, January 1970.

48. U.S., Congressional Record, 92d Cong., 1st Sess. (1971), Vol. 117, Senate, 28 September 1971.

49. Carley, p. 15.

50. Direct Investment Task Force. "Report to the Council on International Economic Policy," 1972, C, p. 5.

51. Krause and Dam, p. 71.

52. Tugendhat, p. 152.

53. Stobaugh, p. 132.

54. Krause and Dam, p. 95.

55. Stobaugh, p. 119.

CHAPTER V

SUMMARY, OPTIONS, AND CONCLUSIONS

SUMMARY

The US has run an almost continuous deficit in its Balance on Current Account and Long Term Capital, or Basic Balance, for over two decades. From 1960 to 1970, this deficit averaged $1.98 billion per annum. It jumped considerably in 1971 to $9.37 billion, bringing the annual average from 1960 to 1971 to $2.72 billion.[1]

During the 1960s, the annual military expenditures in NATO affecting US foreign exchange averaged about $1.5 billion. In 1971 it rose to about $2 billion.[2] These figures show that throughout most of this period our NATO foreign exchange deficit amounted to about three-fourths of our total deficit on Basic Balance. (This should not be confused with being three-fourths of the total outflow of dollars and other reserves.)

In making these comparisons, offset is not considered. Its real contribution in helping counter the NATO inflicted deficit is minimal, at best, for the following reasons. The purchase of US military equipment would probably have been made without offset. The advanced payment for equipment and the buying of US securities places long term commitments on the US economy that outweigh the short term benefits. The most recent arrangements between the US and Germany have included some true offsets. These are the German buying of some US Export-Import Bank and Marshall Plan loans. The German payment of a $.2 billion to the US and payment for renovation of barracks and airfields reduce US expenditures and, thereby, not only reduce foreign exchange costs but budget outlay as well. Unfortunately, these latter arrangements are limited in scope and the impact is relatively small. So for the most part, offset has been a "finger in the dike" and "something is better than nothing" type remedy by the US Treasury, which has been able to arrive at no other solution that is economically and politically acceptable to all parties. It is largely window dressing. It does, however, help deflate NATO critics. Whether or not it is a short term solution or a long range problem, itself, is debatable. One thing about which all will agree is that no good solution as yet has been devised. There seems to be reason to believe that if the balance of payments deficit could be eliminated or substantially reduced, the NATO foreign exchange expenditures might well cease to be a major issue.

MNC appear to have the potential for helping, perhaps significantly, in this regard. Though their overall contribution today is hard to assess with a high degree of accuracy, there is good argument to be made for the case that our balance of payments situation might be considerably worse were it not for the economic activities of these enterprises.

It is often incorrectly assumed that investors have an option between exporting and investing abroad and that investments abroad displace US exports.[3] There appears to be a reasonably good argument that foreign investment is in some measure, perhaps a large one, a defensive move. For as consumption of a product increases abroad, production of it begins in other advanced industrial nations by foreign companies. At this time, US companies stand to lose their export market unless they produce locally.[4] And in many cases the option of exporting or investing abroad does not exist since a firm may be unable to export because of foreign trade barriers or relative production costs.[5]

Assuming, then, that investments abroad have a net beneficial effect on the US economy and the balance of payments, how can this effect be increased without "killing the goose that lays the golden egg"? (This is not assuming that the egg is 24K, but any egg may be better than no egg at all.) What follows is a discussion of some of the possible options. None are "sure fire", and each with its apparent benefits undoubtedly has its drawbacks, which may not be as readily apparent as the benefits.

DOMESTIC NEUTRALITY

US tax laws generally favor foreign neutrality, the most favorable aspects of which are deferral and tax credit. These two aspects together permit US MNC to pay less in total taxes, both US and foreign, than required of their domestic counterparts. Whether or not this actually encourages investment abroad at the expense of US exports is debatable, but it does discriminate against domestic firms (that perhaps do not have the capital or management resources to invest abroad) in competing for third country and domestic markets. If deferral were eliminated in developed areas, like Europe, subsidiaries in these areas would then be treated as all foreign branches are now.

If tax credit were replaced by a deduction for foreign taxes paid, both foreign subsidiaries in developed areas and foreign branches would then be treated more like domestic branches are now and domestic neutrality would then hold sway. If domestic neutrality is not sought in US tax laws, some critics feel that low foreign tax rates may place American firms operating at home at a disadvantage in competing for foreign markets with American-owned foreign subsidiaries.[6] If this be the case, investment abroad would replace US exports and hurt US balance of payments. Only developed areas are considered here, since it might be desirable to let the law remain as currently written for developing areas in order to continue encouraging investment in these areas. Developing areas cause us little or no balance of payments problems, for reasons pointed out above.

If deferral were eliminated, this would eliminate unreasonable accumulation and the concomitant encouragement to invest funds abroad in foreign securities. This should cause, assuming the law is complied with or enforced, a repatriation of more profits to the parent corporation. If credit were replaced by deduction, this would increase the tax rate. More repatriated income and a higher rate of taxation would help improve both the balance of payments and Treasury receipts. To get a general feel for what this might mean, consider what was pointed out above: in 1971, US foreign investment produced about $200 billion worth of goods and services. More than one-half of these derived from developed areas. It is not hard to imagine, then, that if domestic neutrality applied, the increased foreign exchange from these areas might well offset our NATO deficit.

Admittedly, all would not be perfect in applying the principle of domestic neutrality. One cannot ignore the problems arising from revaluation of currencies and in balancing the foreign and domestic tax systems to achieve equity. These are among several problems that would have to be considered, and depending on how they are solved would determine the effectiveness of applying this principle.

A proposal for applying domestic neutrality is not new. When the 1962 tax law was being drafted, the US Treasury Department assiduously pushed for domestic neutrality.[7] The business community raised a determined assault against the Treasury, with the result that foreign neutrality retained its favored position. There is little doubt that business would still take the same stand, arguing that application of the principle of domestic tax neutrality would hurt their competitive position abroad. That it would impact their competitive position is true. But it would by no means destroy it, since their competitive position abroad is based primarily on their capital resources, technology base, and management skills. The community's position, however, is not hard to understand, since it is easy to conclude that deferral and the credit system either saves or makes money (depending on how one looks at it) for the MNC; accordingly these enterprises will obviously push for retention of these privileges. The status of these privileges, however, is something that does not appear to be an overriding consideration of businesses in deciding whether or not to invest abroad, since taxes, in general, do not appear to be a primary determing factor in foreign investment. In support of this, the Brookings Institution states in a report: "Many other factors appeared to be more important than taxes in influencing the decision of businessmen to produce abroad. Conversely, it was noted that taxes were rarely mentioned by businessmen as a reason their foreign ventures failed to prosper."[8] Though tax rules may not be a primary factor in deciding whether or not to invest abroad, once the decision has been made to invest, however, tax rules might influence where investment is made. It appears that elimination of certain privileges for developed areas would have little effect on companies already established in these areas, while it might considerably improve US balance of payments. For new ventures, however, it might encourage more investment in developing areas, where investments have a more favorable impact on our balance of payments.

Another thing that can be said about deferral is that if it were eliminated this would reduce the amount of funds on the currency market and therefore reduce the impact of manipulation of these funds during a currency crisis. In addition, there would be little cause for transfer pricing since it is primarily deferral that makes such manipulations profitable.

DIVIDEND EXEMPTION

A driving purpose behind the Revenue Act of 1962 was to improve balance of payments by discouraging foreign direct investment.[9] The resulting change in the tax rules, which now generally require MNC to pay more in both foreign and domestic taxes than they had previously, did not accomplish this purpose. Foreign direct investment has continued at an increasing pace. Therefore, further changes in the direction of requiring these companies to pay more taxes, as would be the case through application of the principle of domestic neutrality, may not accomplish the intended purpose. (This could obviously be the case with any proposed action.) Recognizing this, we might consider an action that extends the application of the principle of foreign neutrality by decreasing the amount of US taxes paid on repatriated foreign-source income. For instance, the parent might be granted the 85 per cent dividends-received deduction presently available on intercorporate dividends among domestic corporations. Then under the present top corporate rate of 48 per cent, the effective rate on dividends would be 7.2 per cent.[10]

The advantage is that it might encourage repatriation of more income thereby improving the balance of payments. Obvious disadvantages are: (1) it would decrease Treasury receipts; (2) it might encourage foreign direct investment at the expense of domestic investments; (3) it would discriminate against domestic firms that do not have the resources to invest abroad. Of course, if domestic neutrality applied, as discussed above, companies would be "required" to repatriate income instead of just "encouraged" to do so. Yet, if balance of payments is the primary consideration, "encouraging" repatriation might be more effective than "requiring" it, because of loopholes that inevitably seem to develop, permitting circumvention of any requirement.

FOREIGN SECURITIES

Another option would be to prohibit or attempt to discourage MNC from investing in foreign securities with foreign-source income. Such a law might be an extension of the 1963 Interest Equalization Tax Law, which imposed a tax on foreign stocks and bonds sold in this country. Such a system would be designed to discourage unreasonable accumulations abroad, by either not allowing foreign-source income to be invested in foreign securities or if it were, to impose a tax that would make it no less profitable to repatriate funds to the US. However, it would be almost impossible to enforce such a law without the cooperation of the foreign countries concerned, in whose interest it would be not to cooperate. Since we permit and encourage foreign investments in US securities, no matter what the source of funds used, we can hardly expect other countries to discourage it or to cooperate in prohibiting it. It should be noted that if domestic neutrality were applied, this, in itself, would discourage investing in foreign securities.

SPECIAL TAXES

Two other options would be a special host country or US tax on MNC in NATO countries to be utilized for paying for maintenance of NATO forces. Either tax would be discriminatory and on this basis alone would be undesirable. A foreign tax, which the host country would utilize, by treaty agreement with the US, for paying NATO imposed US foreign exchange costs, would, in all likelihood, decrease repatriated income to the US, and, therefore, not improve the balance of payments at all. A US tax, without elimination of deferral, might encourage an accumulation of earnings abroad and hurt balance of payments; with elimination of deferral, it would only increase receipts to the treasury but not affect the balance of payments.

PROHIBITION OF IMPORTS

Prohibition of US imports from foreign-based US affiliates, a move that Labor would undoubtedly support, is another option that might be considered. With only about eight per cent of our imports being from such affiliates, this move would probably be of little help to our balance of payments. Such action would constitute erection of a trade barrier against which the countries effected would probably retaliate. If they did, this would decrease our exports, with a net effect that might hurt our balance of payments.

EXTENSION OF CONTROLS

Some sort of broadening of the controls of 1968 should not be overlooked as an option. This might mean complete curtailment of foreign investments with US capital. All foreign investments would then have to be made with foreign capital. The arguments against extensive and long term use of foreign capital were entered above. Simply stated, it is this: inflow of US foreign exchange is decreased by the amount of interest that US MNC are paying abroad. If foreign investments do not replace US exports (there are persuasive arguments that, for the most part, they do not) and if they are a necessary means of entering foreign markets (it appears that they may be), then it appears to be to our long term interest not to discourage them, which any broadening of the 1968 controls might do. Even with the controls as they stand, there are those who are seriously concerned about a possible adverse effect that these controls are beginning to have on the balance of payments.[11]

There are other options that could be considered, but it is not apparent that they have sufficient validity to be worthwhile pursuing.

CONCLUSIONS

There appears to be no policy that the US could pursue unilaterally or in cooperation with our NATO allies requiring US MNC in NATO countries to pick up the burden of NATO foreign exchange costs that would not be discriminatory against the MNC concerned. Therefore, it appears that any equitable solution involving MNC for solving our balance of payments problem would have to relate to both MNC and balance of payments in general. It would obviously involve exacting more foreign exchange from MNC. This, of course, would improve the balance of payments and, therefore, would indirectly help offset the NATO imposed deficit. The solution that appears to be most equitable and exhibits the best likelihood for improving the balance of payments is the application of the principle of domestic neutrality in taxing foreign-source income.

If this principle were applied to foreign investments in developed areas, this would include the countries of Western Europe with which we have most of our NATO foreign exchange problems. The MNC in this areas would then be contributing more (than they do today) to improving the balance of payments, and, thereby, indirectly offsetting the NATO deficit. It would not be politic, of course, to associate domestic neutrality for developed areas, or any other policy for exacting more foreign exchange from enterprises in these areas, with the NATO deficit. Otherwise, this course of action could hardly be considered discriminatory, since it would be applied to developed areas, in general, and not just to Western Europe. Even today the tax laws are different for developed and developing areas, giving advantages to US investors in the latter. (Recall that income from subsidiaries in developing areas is taxed at the dividend rate, whereas income from developed areas is taxed at the higher corporate rate.)

There are those that would question whether or not it is appropriate or possible to regulate balance of payments through tax legislation, particularly since the current deficit is an economic phenomenon of unknown duration that will require different solutions at different times. However, it should be recognized that tax rules for foreign-source income affect the balance of payments, regardless of intent. The problem here is to insure that maximum advantage is derived from new rules, a situation which the current rules do not seem to be affording.

The balance of payments problem exist for many reasons, some of which are far more subtle than those addressed here. There are solutions to this problem if our government is willing to exercise the political clout to impose them. The economic activities of MNC have the potential for being part of the overall solution, specifically through the application of the principle of domestic tax neutrality. The US Treasury advocated application of this principle in 1962 and its basic tenets are currently recommended in the Burke-Hartke Bill. However, the Burke-Hartke Bill is less concerned with balance of payments than with restricting foreign investments and trade in general. Any changes to the laws affecting foreign investments should attempt to optimize a favorable balance of payments situation while giving due consideration to social and other economic factors. In making these changes we must be careful not to "kill the goose that lays the golden egg".

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CHAPTER V

FOOTNOTES

1. *Survey of Current Business*, June 1972.
2. Newhouse, pp. 128-129.
3. Direct Investment Task Force, p. 16.
4. Stobaugh, p. 121.
5. Direct Investment Task Force.
6. Krause and Dam, p. 89.
7. *Ibid.*, pp. 86-87.
8. *Ibid.*, p. 92.
9. *Ibid.*, p. 5.
10. *Ibid.*, p. 22.
11. *The Wall Street Journal*, 18 October 1972.

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