The U.S. Stake in U.S. Foreign Investment

Proceedings of a Tax Foundation Seminar
THE U.S. STAKE IN U.S. FOREIGN INVESTMENT

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FOREWORD

Investment abroad plays an important role in the U.S. economy, not just for the earning statements of firms doing business overseas, but because it creates markets for U.S. manufactured products and provides capital for domestic economic growth. Currently, national policy regarding foreign investment is marked by a great deal of confusion, and too little thought has been given to a tax policy that could best further U.S. competitiveness in overseas markets.

To increase understanding of the critical role of U.S. direct investment abroad, the Tax Foundation held a seminar in Washington, D.C., on September 13, 1988. Leading representatives of the business community, the media, Congress and the Executive Branch, and academia explored this important issue and offered specific recommendations for a more enlightened policy in foreign investment.

The seminar was a follow-up to publication by the Tax Foundation of a study entitled "The Competitive Burden: Tax Treatment of U.S. Multinationals." This incisive study, authored by Raymond Haas, International Tax Partner, Arthur Young and Company, documents the serious disadvantages that U.S. firms now face when competing in world markets because of our own national tax policies.

The presentations at the seminar and our precis of each are contained in these proceedings.

Robert C. Brown
President
Tax Foundation
Conference Participants

O. Donaldson Chapoton was confirmed as Assistant Secretary of the Treasury for Tax Policy on October 1, 1987. He joined Treasury in 1986 as Deputy Assistant Secretary for Tax Policy. He was with the law firm of Baker & Botts from 1963-1986, following service in the Judge Advocate General’s Corps of the U.S. Army.

Sam M. Gibbons has represented the 7th District of Florida in the United States Congress since 1962. He is Second Ranking Member of the Committee on Ways and Means and also serves on the Joint Committee on Taxation. He served in the Florida House of Representatives from 1952-58 and in the Florida Senate from 1958-62.

Raymond Haas has been an international tax partner of Arthur Young & Company since 1978. He is principal author of “The Competitive Burden: Tax Treatment of U.S. Multinationals,” published by the Tax Foundation in January 1987. Mr. Haas is both a lawyer and a certified public accountant.

Gary Hufbauer is Wallenberg Professor of International Finance, Georgetown University. Mr. Hufbauer was formerly Senior Fellow, Institute for International Economics; Deputy Director, International Law Institute, Georgetown Law Center; Deputy Assistant Secretary for International Trade and Investment Policy, Department of the Treasury.

Kenneth N. Kermes is Executive Vice President, Corporate Finance, SmithKline Beckman Corporation. He came to the company in January 1987 from Black & Decker, where he served as Executive Vice President, Finance and Corporate Development. Earlier he had been with the Ralston Purina Company as Senior Vice President and Chief Financial Officer.

Leonard E. Kust is a retired partner and counsel to Cadwalader, Wickersham & Taft and former Vice President and General Tax Counsel of Westinghouse Electric Corporation. He has served on the Advisory Group to the Commissioner of the Internal Revenue Service, as well as Tax Foundation’s Advisory Council.

Robert Z. Lawrence is a Senior Fellow in the Department of Economics, The Brookings Institution. He has been a consultant to the Federal Reserve Bank of New York, the OECD, the World Bank, and the Coalition for Advancement of Industrial Technology. He is the author of three books and many articles on international issues.

Robert L. McNeill is Executive Vice Chairman of the Emergency Committee for American Trade after having served as Director of International Affairs of the Ford Motor Company. As Deputy Assistant Secretary of Commerce for Trade Policy, he helped negotiate the Kennedy Round and played a principal role in the U.S.-Canada Auto Agreement.

Walter S. Mossberg, now Senior Correspondent, has been with the Wall Street Journal’s Washington Bureau since 1973, three years after he joined the paper. He has covered labor, energy, the Pentagon, and international issues. He served from 1973-1977 as co-editor of the Journal’s “Labor Letter” column.

David R. Milton recently retired as Vice President and Director of SPNV Holdings. Earlier, he served as Vice President and General Tax Counsel of Shell Oil Company. Mr. Milton is a member of the Tax Foundation’s Advisory Council.

James Q. Riordan is Director, Vice Chairman and Chief Financial Officer of Mobil Corporation. He joined Mobil Oil in 1957 as Tax Counsel and has held major posts both in the U.S. and overseas. He is a director of Dow Jones & Co., Inc., and a trustee of the Tax Foundation.

Joel B. Slemrod is Associate Professor of Business Economics and Public Policy at the University of Michigan. He was formerly Associate Professor of Economics, University of Minnesota; Senior Staff Economist for Tax Policy, Council of Economic Advisers; and National Fellow at the Hoover Institution.

Hans W. Wanders is Vice Chairman of The Wachovia Corporation; and President and Chief Executive Officer of First Wachovia Corporate Services, Inc. He is Chairman of Tax Foundation’s Executive Committee.
Good Morning ladies and gentlemen and welcome to the Tax Foundation Seminar on "The U.S. Stake in U.S. Foreign Investment." I sense an exciting day ahead, with a most important subject. We can clearly see the trend toward globalization of trade and commerce in the world, and we can see increasing pressures to accelerate that trend. We see, on the other hand, fear of protectionism and double taxation and other nationalistic policies which can hinder harmonization of the differing taxing systems of trading partners.

You recall that in the 1930s the League of Nations developed or recommended a model bilateral income tax treaty to deal with the double taxation issue and the diverse tax systems then in existence. Mitchell Carroll of the United States, a man whom many of you knew, who came out of the Commerce and State Departments and was a major actor in that. Eldon King, then Deputy Commissioner of the Internal Revenue Service, was prominent in negotiating the first U.S. income tax treaties, the first of which was with France. Following that, in the 1940s, the United States pushed a new comprehensive commercial treaty for use with countries that had different legal and tax systems. These were called Treaties of Friendship, Commerce and Navigation. The first of these was with China in 1946.

Now, today, we see an erosion in all of these historic bases. Congress has started to routinely override tax treaties. Treaties and the articles may well be ignored or interpreted extremely rigidly. Indeed, it appears that our Internal Revenue Code's foreign tax provisions were changed in 1986 mainly to raise revenue. Foreign economic policy was not often a criteria. So, today, we have much uncertainty and turmoil about U.S. foreign investment, its place in global commerce, and how the U.S. will stack up in world competition. What is certain is that today's subject, "The U.S. Stake in U.S. Foreign Investment," will be at the cutting edge of important issues facing the United States.
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stimulating greater R&D effort.

Slemrod maintains that the tax treatment of foreign source income always has been controversial, but now because of its implications for competitiveness, the stakes are much higher. He mourns the lost goal of tax simplification, especially as it applies to international transactions.

Finally, Slemrod describes a major research project under the auspices of the National Bureau of Economic Research. The project will attempt to measure the effect of U.S. and foreign country taxation on the magnitude and location of U.S. direct investment abroad, the effect of such taxation on corporate financial policy including transfer pricing, and the cross-border "spillover" effects of tax policy, such as that of the U.S. Tax Reform Act of 1986, on other countries' structures.

One way that things really have changed in the past ten years and more is the exploding internationalization of economic activity. The dollar value of U.S. imports today is twenty times what it was in 1965, and the value of U.S. exports is, well, nearly ten times what it was then. Note, though, that the share of world exports of manufactures by U.S. multinationals in 1983 is about 17 percent, not much different than it was in 1966. This steady share masks what has been a slight fall in the share of exports from U.S. parents, made up by an increasing share of exports from U.S. majority-owned foreign affiliates.

Foreign investment, both into the U.S. and from the U.S., has also seen large growth. Foreign direct investment in the U.S., which averaged under $1 billion per year in the early 1970s, was $25 billion in 1986. Foreign investment abroad by U.S. corporations has also risen phenomenally. The annual flow of direct investment abroad, including transfers of funds by corporations and retained earnings, was $2.9 billion in 1960, $7.6 billion in 1970, $19.2 billion in 1980 and, after a period of no growth from 1980 to 1984, has increased since at double digit rates until it stood at $44.5 billion in 1987. This amounts to 6-1/2 percent of gross private domestic investment in the U.S. The stock of direct investment abroad, evaluated at book value, is as of 1987, $309 billion. In 1986, the total employment of multinationals' foreign affiliates was 6.3 million, or nearly 8 percent of total private sector employment. Profits earned by foreign affiliates in recent years have comprised as much as 20 percent of all after-tax corporate profits. As U.S. investment abroad has grown over the past thirty years, its composition has shifted, with a decrease in the importance of investment in the production of goods, especially primary products, and an increase in investment in trade and services, especially finance.

Of course, the U.S. is not the only country whose businesses have rapidly increased their foreign presence. In fact, the U.S. share in worldwide direct investment abroad has been shrinking. Japan, whose direct investment abroad in 1960 totaled less than $100 million, in 1986...
invested nearly $15 billion abroad. West Germany and the United Kingdom, whose combined foreign investment in 1960 was less than $1 billion, in 1986 had more than $25 billion invested abroad. The U.S. share of total outflows of foreign direct investment from 13 large developed countries was 61 percent during the early 1960s, but is now less than 30 percent. A fair summary of the last three decades is that while U.S. corporations have maintained the relative magnitude of foreign versus domestic investment, their global competitors have expanded their foreign presence even more rapidly than their own economic growth.

Why is U.S. direct investment abroad of special importance to the state, present and future, of the U.S. economy? The answer is obvious to any student of international business. It is that competitiveness of U.S. industry in the global marketplace is critically determined by its ability to make and effectively manage overseas investment. Maintaining this competitiveness is an important element in the growth and prosperity of this country.

Critical Place of R&D

Why does foreign investment have this special role in economic growth? One reason is the critical place of research and development in multinational enterprise. The empirical evidence on this role is clear. Across industries, the share of foreign assets increases significantly with the importance of R&D expenditures. When a company utilizes the fruits of its research in a foreign subsidiary, it is making full use of its intangible assets, including not only R&D, but also advertising, and management expertise. An extensive presence in foreign markets makes R&D more profitable, and therefore more likely to occur. A study by Edwin Mansfield of the University of Pennsylvania indicates that foreign sales and utilization account for as much as 1/3 of the total return to R&D. Furthermore, firms indicated that if they were not permitted to utilize new technologies in foreign affiliates, R&D would fall by as much as 15 percent, with large cuts in product rather than process R&D. The evidence speaks clearly that more overseas involvement increases R&D and especially R&D aimed at basic research and long-run projects. If, as many observers have suggested, it is knowledge that is the American comparative advantage in the future, then the ability to earn maximum return on this knowledge, including through direct foreign investment, will be critical to exploiting this advantage.

A second reason for the importance of multinational corporations is that they are well situated to react quickly to changing international economic conditions. Having already invested in foreign markets, multinationals can adapt to shifts in relative cost induced by exchange rates, domestic prices, or government policies, and take advantage of shifting market opportunities. Having already established a presence in foreign countries, they are also able to acquire and evaluate information more quickly and efficiently, and therefore react more effectively than otherwise.

To establish the critical role of foreign investment in the U.S. economy does not, alas, reveal how best to tax the income it produces. In fact, the appropriate tax treatment of foreign source income has been controversial almost since the inception of the income tax in 1913. Up until 1918, all taxes paid to foreign governments were treated as deductible expenses. At the time, many voices arose arguing for complete exemption of foreign source income from U.S. tax, on the grounds that American corporations operating abroad suffered a competitive disadvantage due to the fact that U.S. taxes were higher than the taxes that competing firms were subject to. The result of this debate was the adoption of the foreign tax credit in 1918, which has been the cornerstone of our international tax policy ever since. One guiding principle of this policy has been to leave the investment location decision to market forces, while not
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Tilting the playing field in one direction or the other.

Tax Policy and Competitiveness

Seventy years later, in 1988, the debate is again centered on the effect of our tax policy on the competitiveness of U.S. businesses. The issues are the same, but the stakes are now much higher as global economic competition has intensified. On one side of the debate, foreign investment by U.S. corporations is, as I have argued today, critical to the performance of the U.S. economy. On the other side are the competing claims of other sectors of the U.S. economy: the domestic export industry, the domestic non-traded sectors, the need for a rebuilding of the public infrastructure, with these claims all made in the context of continuing high federal budget deficits. The hard fact is that the multinationals are competing with other American industries for resources at the same time they are competing with foreigners for sales. More generous tax treatment of foreign investment need not make the economy as a whole more competitive, but may only shift resources toward that sector.

The challenge for tax policy is to balance the several goals of the tax system. One goal is to promote, or at least not interfere with, the efficient performance of the U.S. economy. The other goals are to allocate equitably the burden of taxation among the country’s citizens, to minimize the administrative and compliance costs of taxation and, lest we forget, to raise sufficient revenue. To balance these goals is indeed a challenge, and in the field of international taxation it is a challenge so daunting in its complexity that I am greatly relieved to be able, by speaking first today, to raise the challenge to the distinguished panel of speakers who follow me, and to not have to resolve it.

Major Research Effort Underway

I do have one development to report which I hope you will agree is a positive one. It is that the academic economics community has woken up to the importance of these issues, and major research efforts have begun to come to terms with the difficult issues of international taxation. As of a few years ago, not only had the issues in this field not changed much in 70 years, but neither had the state of our knowledge about the economics of these issues. This, I am happy to report, is changing. Under the auspices of the National Bureau of Economic Research, I am overseeing a major research project on the international aspects of taxation. The Office of Tax Policy Research, a research center that I head at the University of Michigan Business School, is also directing much of its research effort toward these issues.

The research is addressing several questions that are critical to this debate. Let me mention a few. First, what is the effect of U.S. and foreign country taxation on the magnitude and location of U.S. direct investment abroad? Are the effects large, does the effect depend on the home country’s tax system, and is there a significant lag in the response of investment? After all, if investment behavior is completely unaffected by tax policy, then the granting of tax preferences is merely a handout to multinational business. Particular attention is being paid to the effects of ERTA and the Tax Reform Act of 1986 on the volume and location of investment. The flows of both direct and portfolio investment are being studied. I am particularly interested in a case study of how the U.S. and Japanese tax systems affect the cross-border flows of investment between the two countries. For better or worse, the past 8 years have seen several major changes in both countries’ tax systems and, especially for Japan, in the extent of government control over capital movement. This frequent change is no doubt frustrating to the practitioner, but makes for a fascinating laboratory for economists to study.
the effects of policy on economic activity.

Second, what is the effect of taxation on corporate financial policy, including transfer pricing? The tax policy debate has focused not only on the real economic advantages of multinational enterprise, but also on the alleged advantages that multinationals can obtain by playing off governments and their tax systems against each other to minimize their worldwide tax burden and thereby gain a competitive advantage not based on real economic factors. Some observers have decried the "erosion of the global fiscal commons" and have called for international tax cooperation and harmonization to arrest this erosion. Although there has been much rhetoric on this subject, there is little hard evidence as to the extent and nature of the effects of tax on financial behavior. Research has now begun on the dividend payout behavior of foreign affiliates and on the use and determinants of transfer pricing, and how these activities respond to tax, tariff, and capital control policies.

Finally, what are the cross-border spillover effects of tax policy? How does, for example, Japanese tax policy impact U.S. corporations and what is the proper response of U.S. tax policy? Surely the U.S. Tax Reform Act of 1986 has spawned a host of tax policy changes in other countries, perhaps in imitation or perhaps as a strategic response. The common thread of the wave of tax reform has been a move toward low-rate, low-allowance systems. In addition, the European community is now facing the issue of capital income tax harmonization as it moves toward a greater integration of national markets. Research is underway to identify the major avenues of transmission of policy effects across borders and to assess their quantitative magnitude.

These are difficult questions, but they are important ones whose answers promise to inform the debates of the future over international tax policy, and international economic policy in general. I hope that in a year or so I will have the opportunity to report to you what we have learned. I would also be interested in hearing from you, who are in the trenches, about your views on what are the important unresolved questions and where our research efforts should be focused. Sometimes this news does not trickle up from the trenches to the towers of academia.

Forgotten Simplicity

Let me close by trying to revive the forgotten goal of tax policy simplicity. You may remember that the original Treasury proposal for tax reform in November of 1984 was entitled Tax Reform for Fairness, Simplicity, and Economic Growth. By the time we got to the President's proposal in May of 1985, it was entitled

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Tax Proposals to the Congress for Fairness, Growth, and Simplicity. Simplicity has been pushed from the middle to the end of the line. By the time tax reform became law, the goal of simplicity, at least for business, had fallen completely off the deck. The IRS now estimates that business taxpayers spent nearly four billion hours on tax matters in 1986, and I suspect that it is significantly higher now. Add to that the cost incurred by individuals, who spend an estimated 2 billion hours each year on tax matters, and the economic cost of complying with the tax law must easily now be $75 billion annually, and perhaps more. That the taxation of foreign-source income has become excessively complex commands nearly universal agreement. Coping with the complexity demands resources that could otherwise be used more productively. In addition, compliance is undoubtedly a barrier to foreign investment for small and medium-sized enterprises, and it creates uncertainty that disrupts long-term planning. Complexity is a tax policy in itself, it is a bad tax policy, and reform of that policy, it seems to me, is long overdue.
Mossberg claims that the most critical challenge for U.S. multinational firms in the 1990s will be the spread of economic nationalism both here and abroad. According to Mossberg, economic nationalism does not necessarily mean old fashioned trade protection but can encompass a wide range of policies to encourage domestic industry vis-a-vis foreign competition.

Mossberg cites the recently passed trade bill as a mild response to developing economic nationalism but indicates that the American public may support much stronger and more restrictive measures, particularly in regard to foreign investment in the U.S. The principal danger is foreign retaliation. Already there is evidence of significant economic nationalism in the European community and this could be strengthened by the planned harmonization of EC economies by 1992. Draft regulations of the EC would not accord the same rights within the new European market to U.S. multinationals that are accorded to European companies.

Mossberg says a strong case can be made for U.S. foreign investment as an asset, and, indeed, a weapon for the U.S., in the context of growing economic nationalism, but that policy makers are not attuned to this message.
am sure I don’t have to remind you, could well spark retaliatory measures against U.S. investment overseas. But it is a mistake to simply equate economic nationalism with old style protectionism.

For other people who are opposed to simple protectionism, it may mean other dramatic changes — a range of industrial policy pumping huge amounts of money into education or job training, export promotion, even a more aggressive government control over the dollar.

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[E]conomic nationalism . . . describes the growing feeling revealed by public opinion polls . . . that the United States must place greater emphasis on its narrow economic interests in the world . . .

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Economic nationalism may be anything really, any policy which can be justified by its proponents as advancing America’s economic position in the world. The trend, of course, is a response to the uncomfortable fact that it is not 1954 anymore when the U.S. stood alone as an economic colossus able to export goods and capital at will, to dominate foreign markets and overseas investments. The world economy, as everyone in this room well understands, is integrating and integrating rapidly, and other great exporters of goods and capital have arisen to share economic leadership with us. But the fact that economics now easily crosses borders doesn’t mean that nation states have gone away or that the American public and American political leaders have lost interest or will lose it in doing what they think best to protect the national interest of the United States.

Of course, the last eight years have only sharpened the public and political sense of this lost U.S. leadership. The fantastic accumulation of foreign debt and the rising tide of imports during the Reagan years are finally hitting home politically with unpredictable political effects. With the dollar’s recent decline and the improved coordination in economic policies of the major nations, the economic facts may be improving. But as is often the case, perception lags reality, and the political reaction is still building. The trade bill which just passed was fairly mild compared to what it might have been if you look at it from the perspective of 1985. I know that is the belief of senior policymakers in the Reagan administration. You might call it a near-miss of a disaster that it might have been. There are relatively few provisions that are definitely bound to curb trade and investment, although given particular attitudes on the part of future Presidents, the jury will be out on that.

But just because the trade bill has been passed, it doesn’t mean that the trend is over. The concept of economic nationalism, I think, will be with us for a while in one form or the other. And it is part of a broader search for a new national security policy for the United States—a fundamental redefining of the U.S. role in the world for the first time in forty years.

The Soviets are weak. (They still, of course, can destroy us and the world, but except in the pure military sense, they don’t pose any real competition or threat to capitalism or the Western world.) Communism as an ideology is in retreat on every continent. Malcontents and radicals — even they — are drifting away from it. And the new concerns, of course, are economic and not military: trade, investment, the dollar, Third World debt.

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Nearly 80 percent of [the average public] favored adopting legal curbs . . . on foreign investment in American business and real estate.

Nearly 90 percent favored government registration of foreign investors here . . .

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The United States can still be the leader of the world-shared power, but it will take some careful and creative political leadership, and we all have to hope that we will get that out of this election.

Well, what has all this to do with the ques-
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tion of American investment abroad? At first glance, it seems like the issue is far from center stage. The 1980s have been a relatively quiet period for the question of multinationals and the role they play overseas, certainly compared to the 1970s. In this year's election, the only candidate to make a real issue out of multinationals’ behavior abroad, the so-called export of jobs, was Jesse Jackson, and by all evidence, his pitch did not play very well beyond his core constituency.

Foreign Investment in the U.S.

Instead, all the attention has focused on foreign investment here, and I would just like to talk about some striking public opinion poll results that came out earlier this year. Some of you may have read about it. I wrote about it in the Journal. A poll was commissioned by a consulting firm here in town, Smick Medley & Associates. They took a large group of the average public and a much smaller group of what they called elites — politicians, businessmen, journalists, academics and so forth. The small group of elites was generally quite comfortable with the increase in foreign investment in the United States, able to put it in perspective, tended to realize that it was part of a pattern from which the U.S. also benefitted overseas. But the general public group was quite alarmed by it. Nearly 80 percent of this sample they surveyed favored adopting legal curbs of some kind or another on foreign investment in American business and real estate. Nearly 90 percent favored government registration of foreign investors here, the so-called Bryant amendment, which as most of you know, failed to make it into the trade bill. And there is no evidence that these feelings have dropped away. I believe they will persist. Although it seems like all the attention is on foreign investment in our own country, the new politics of economic nationalism will affect U.S. investment abroad, or government policies toward it, at least, for several reasons.

First and most important is the potential for retaliation because of public concern of a foreign ownership of American assets. I am talking about a perception. I understand that you all understand that the percentage of the GNP that’s involved in this is quite small. You can make an excellent case using facts and statistics that show there is really no threat. But the perception is strong and real. To the extent that

The Toshiba case did not involve a subsidiary of an American company . . . But it highlighted the question of . . . technology . . . as a proprietary national asset and that letting it slip through the borders of the United States to even a foreign affiliate of a U.S. company could be dangerous.

perception drives us toward curbs on, or paper work burdens on, or registration of foreign investment, there certainly could be retaliation overseas. I think you can see the developing regulations for the European community’s integration in 1992 as a sign of that.

There has also been, I think, a subtle shift in the way people think about the U.S role and the role of what we export in the world economy. I think there has suddenly become much greater emphasis on the export of goods rather than the export of capital. There is a sense that, for instance, it might have been much better for us after the war if the automobile industry had developed a tremendous capacity to ship cars built in America around the world rather than allocating capital to buy foreign subsidiaries. Again, I am not arguing the merits of that case, but I think the general sense is taking hold in favor of jobs created within the borders of the United States to produce goods to be sold overseas rather than exporting capital. It is not well understood that foreign direct investment creates a net contribution to our current account balance.

The third issue, I think, that could cause complications for foreign investment abroad is technology transfer. The Toshiba case, of course, did not involve a subsidiary of an American company, and it brought to mind in the Congress tremendous feeling of resentment against
Public and Congressional Attitudes

the Japanese. But it also highlighted the question of the volatility of technology, in the sense that technology is increasingly thought of as a proprietary national asset and that letting it slip through the borders of the United States to even a foreign affiliate of a U.S. company could be dangerous.

Now there is no doubt that, under this rubric of economic nationalism, you can make a strong case that U.S. foreign investment abroad is a weapon, a tool, a great asset for the United States. But that argument is not being made very strongly. It is not heard very much in the political debate.

European Integration

The biggest test coming up for the United States government's attitude toward American investment overseas, is the planned merger of the internal economies of the European Community into one market in 1992. The Reagan Administration, which, of course, is leaving office, has begun to make some strong representations to Brussels and to the European governments about the need to protect the rights of U.S. affiliates and of foreign direct investments by the U.S. in the EC. So far, the European Commission in Brussels has shown very little sympathy for this. As many of you know, draft regulations are being circulated in Europe which would not accord the same rights within the new European market to American companies as are accorded to European companies, even in the case where American companies may have been in those countries for thirty or forty years.

The officials of the European community have recently made a number of speeches and statements in which what they have essentially said is, we are creating a new thing over here and we are not going to extend internal rights to you unless you give us something else. They haven't specified what something else will be, but the politics of giving certain rights to their firms in the United States could be very complicated, given the climate here. It is quite uncertain how any new administration will be able to thread its way through the thicket of regulations and politics that is developing over there, and which, believe it or not, tends to make the bureaucratic output of Washington look simple and straightforward by comparison. I don't know how many of you have been in Brussels and have tried to work through those multinational bureaucracies, but it's not easy.

So, in the case of Europe, we will see by 1992 just how willing Congress and the government, in general, are to protect the American multinationals, to see them as an asset. I would submit that the recently negotiated Canada Free Trade Agreement is not a terrific precedent, from the point of view of those who would hold that U.S. multinationals should get greater investment rights. Although the curbs the Canadian government maintains on foreign investment were reduced by that treaty, many were still permitted to continue, and there is not a level playing field on both sides of the border. Now, the administration argues that the situation is better than it would have been without the treaty, and I think that's right. But it still raises a question of just how far the U.S. government is willing to press the case for equal investment rules and freedom to invest.

"So, in the case of Europe, we will see by 1992 just how willing Congress and the government, in general, are to protect the American multinationals, to see them as an asset. . . . the recently negotiated Canada Free Trade Agreement is not a terrific precedent. . . ."

I'll just sum up by saying that it's easy just to brush off this trend toward economic nationalism and say it's just ignorant, destructive, damaging. But I would urge those who work for and favor U.S. investment abroad not to take it lightly, to show a positive face and to make a positive case for the goals they are advancing because, I think, in a world of shared economic leadership, that economic nationalism as a political trend is here to stay for some time.
Robert L. McNeill

McNeill emphasizes the positive impact of U.S. direct investment abroad on the domestic economy. He cites the record of U.S. multinational corporations contributing $75 billion annually to the U.S. balance of payments from 1980 to 1986 through their repatriated earnings and export earnings. Despite this positive contribution, there is a skeptical congressional attitude toward U.S. investment abroad, some of it left over from the attempted Burke-Hartke legislation of the 1970s and the continuing fear of domestic job displacement because of "runaway" plants. This shows up in tax policy consideration and, more recently, with respect to the Tariff Code.

McNeill is particularly concerned over policy developments regarding foreign investment in the U.S. He cites efforts in Congress to require registration and disclosure of prospective foreign investment here with attendant loss of confidentiality. He also cites the Florio-Exon amendment which would have authorized the President to prohibit foreign investment in the U.S. on the vague grounds of potential harm to "essential commerce" or "economic welfare" of U.S. industries. McNeill sees a serious threat of foreign retaliation and danger to the U.S. investment position abroad should Congress impose overly restrictive impediments to foreign investment in the U.S.

McNeill believes, however, there may be a move to establish a Federal standard over the extent to which states and localities can offer tax or other incentives to attract foreign investment. Such incentives may be getting out of hand and giving foreign competitors an advantage over established U.S. companies.

I am going to talk about foreign direct investment primarily from the perspective of public policy. I would like to talk about both outward investment, that is, U.S. investment abroad, and inward investment, that is, foreign investment in the United States. As I said, my comments will be principally focused on public policy issues.

Shades of Burke-Hartke

U.S. direct investments abroad have long been contentious in United States public policy.
There are some in this room, if not all, who will recall how, in the early 1970s, at the instigation of the AFL-CIO, Congressman James Burke of Massachusetts, a member of the Ways and Means Committee, and Senator Vance Hartke from Indiana introduced the Burke-Hartke bill. (If you talked to Congressman Burke, he said it was the Hartke-Burke bill, and if you talk to Senator Hartke, he said it was the Burke-Hartke bill.) But that bill was introduced and its purpose was to economically isolate the United States.

Some of the things in that legislation, in fact all of the things in that legislation, are still floating around Washington. What the Burke-Hartke bill would have done, as you may recall, was to have established an import quota grid based on the average imports into the United States from 1968 to 1970. It would have taken the average imports by product in that period of time and said that in the future that would be the limit. The United States can import no more than that.

With respect to U.S. foreign investments, the Burke-Hartke bill tried to make existing investments unprofitable by changing the foreign tax credit from a credit to a business deduction which would have increased effectively the taxes on foreign income by over 50 percent, leading to double taxation. If it had been enacted, it would, I think, have led to a substantial exodus by American businessmen from abroad, because they would have been unable to compete with nationals in other countries who were paying only national tax rates. The bill also would have eliminated foreign tax deferral.

One thing that you may not recall that the Burke-Hartke bill would have done, and I raise it because I think we may see something like it considered in the next year or two, was the proposed establishment of a capital issues committee. That committee’s purpose would have been to screen all prospective U.S. foreign investments above a certain amount to see whether such investments would be at the expense of domestic jobs in the United States. Organized labor had, and continues to have, the view that foreign direct investment comes from a pie of a given size and that slices taken from that pie and placed abroad are at the expense of an investment that otherwise would be made in the United States. That is why they wanted and still want to change the Tax Code.

Foreign Investment and the U.S. Economy

There have been a lot of business organizations that have done studies in the past about the relationship of foreign direct investment to the U.S. economy. My organization did a study back in the Burke-Hartke days. While the figures undoubtedly have changed very drastically, current studies such as the one that Professor Slemrod is undertaking and the study that we in ECAT are undertaking, will probably show that the beneficial effects of U.S. foreign direct investment are as substantial now as they were in the past. In large part, this is because foreign direct investments by United States firms constitute the largest single market for United States exports.

“Organized labor [thinks that] foreign direct investment comes from a pie of a given size and that slices taken from that pie and placed abroad are at the expense of an investment that otherwise would be made in the United States.”

Approximately 85 percent of all United States exports are by U.S. multinationals. Of that, approximately 40–45 percent are exports from the U.S. parent to its own overseas subsidiaries. So that, if U.S. foreign direct investment were in any substantial way to be diminished, we would at the same time, by the same stroke of the legislative pen if it should happen legislatively, be penalizing American exporters and the workers who are involved in the export of United States products. Also, the U.S. economy benefits very substantially from the repatriated earnings flowing from these overseas foreign investments.

I am just going to give you one very remarkable statistic which is taken from official United
C. Revisiting the U.S. Stake in U.S. Foreign Investment

States government statistics. Taking into account the repatriated earnings and the export earnings of United States multinational corporations (bear in mind they account for 85 percent of all of the exports and obviously, all of the foreign direct investments), their trade surpluses "... the repatriated earnings and the export earnings of U.S. multinational corporations, ... their trade surpluses and their net investment income contributed $75 billion annually to the United States balance of payments during the years 1980 to 1986." and their net investment income contributed $75 billion annually to the United States balance of payments during the years 1980 to 1986. Bear in mind that that is the period during which the United States posture in trade swung very drastically against us; so that without these very substantial operations abroad by American companies, the United States balance of payments in the absence of these overseas investments would have been penalized to the extent of approximately $75 billion a year, perhaps more. That's a lot of money. It's very important to the United States' economy.

Attacks Through the Tariff Code

Besides looking at attacks against U.S. foreign direct investment through the Tax Code, which is the principal way, I think, that restrictions against foreign direct investment are considered here in Washington, there have been attacks against our overseas investments through the Tariff Code. Bear in mind items 806 and 807 of the Tariff Code, because they are items that I think will be attacked in the next Congress.

These items provide that the value represented by U.S. components shipped abroad for incorporation in products that are then imported into the United States is not subject to United States tariffs. If, for example, General Motors exports to its Mexican subsidiary carburetors for assembly in the finished vehicle that is then imported into the United States, the United States tariff does not apply to the value of the American carburetor. Pursuant to Tariff Code items 806 and 807, there are a lot of operations along, for example, the U.S.--Mexican border—the twin plant concepts—that would otherwise likely not exist.

Many of you who work the public policy area in Washington are aware that last year, to get at this problem of what are called "runaway plants," said to be encouraged in part through 806 and 807, a bill passed the House of Representatives that would have partially eliminated the foreign tax deferral. This bill would have required that all earnings abroad by subsidiaries of American firms would be subject to U.S. tax on a current basis to the extent that the goods produced abroad were exported to the United States. Thus, if a Mexican subsidiary exported 80 percent of its output to the United States, then 80 percent of the derivative profits would be subject to current taxation. The foreign tax deferral benefit would have been denied. We were successful in the business community in stopping that in the Senate Finance Committee, but it is the kind of thing that we will have to deal with in the next Congress.

Limiting Foreign Investment in the U.S.

Foreign investments in the United States are something of concern to all of you in this room and to our elected representatives. In the post World War II period, our national experience had been one of being a very substantial net capital exporter. It was our net capital exports that helped the reconstruction and rehabilitation of Europe and Japan. Now with our balance of trade and our budget deficit in disar-
ray, foreign capital, as you all know, is flowing into the United States to make up for our own domestic budget and trade deficits. We are importing huge amounts of foreign capital and much of that capital is visible in the form of real estate.

Those of you from Los Angeles have read the statistic that something in the neighborhood of 40 percent or more of all real estate in downtown Los Angeles is owned by foreigners. For Washington, D.C., I think, the figure is 30 or 40 percent. The building I work in is owned by Canadians. The building next door is owned by Arab investors, I think. You read about the problems in Hawaii, how the mayor of Honolulu wants to prohibit foreigners from buying up Hawaiian real estate. These things are of concern to all of us as citizens. It is somewhat new to us to see foreigners establishing productive and other facilities in the United States. It's a little scary to many people.

In reaction to this, legislation was introduced in the last Congress, principally an amendment by Congressman Bryant of Texas, known obviously as the Bryant amendment. Another amendment was introduced in the House by Congressman Florio of New Jersey and co-introduced in the Senate by Senator Exon of Nebraska: the Florio-Exon amendment. Let me just talk a moment about both of these, because I think they both will be revisited in the next Congress.

The Bryant amendment requires the registration and disclosure of all prospective foreign investments in the United States above a certain level. It's a fairly low floor. In and of itself, I don't think any citizens of our country would find this objectionable because, in the United States, domestic investors have to register prospective investments to be sold to the public and these have to be disclosed to the public. The Bryant amendment would require the same for foreign investors. But in fact, foreign investors allegedly are already subject to exactly the same registration and disclosure requirements as domestic investors. What the Bryant amendment would have done that we in the business community found particularly objectionable was to remove the protection of business confidentiality from the data submitted by the foreign investor. Had the Bryant amendment become law, Mr. Riordan, representing Mobil, would be able to go to the Securities and Exchange Commission or perhaps the Energy Department and obtain the information submitted, say, by Royal Dutch Shell concerning a prospective activity in the United States. Confidential business information registered by the foreigner would be available, whereas the same information provided to the same agencies by domestic corporations would have the protection of business confidentiality regulations.

Imagine, if you would, the European Communities and others taking similar actions against our foreign investors. Were we to do this, we could then count on foreigners doing the same in respect to our own investments abroad, which are terribly important to our economy.

The Bryant amendment was defeated but with an awful lot of difficulty. It will come back in the next Congress. Whether it will return in the exact form as in this Congress is conjectural, but there will be a major battle over foreign registration and disclosure.
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was needed. I said that Mr. Bryant didn't have to be worried because foreigners already had to what his bill was intended to do. I said that as a fact, but I am no longer sure that it is a fact. It is very difficult to get one's hands on information showing the actual requirements for registration and disclosure by the various agencies of the United States government.

So, my plea is that the Administration come

ized the President to prohibit foreign investment for those three basic reasons. We in the business community found it not objectionable at all that the President have authority to prohibit a foreign investment in order to protect national security. To argue against that would not be sensible. So, we in the business community worked to narrow the Florio amendment to national security. We were successful in so

up with a survey of what our practices are and relate these to existing practices abroad because there is great concern in Congress about what we call reciprocity. That is, we want to be treated abroad as we treat people here. The fate of the Bryant amendment's registration and disclosure requirements, and similar amendments concerning foreign investment, may in part be determined by the knowledge that we have about what foreigners do as well as about what we ourselves do.

The second amendment that was considered by the past Congress was the one I have described as Florio-Exon. This amendment — and it's going to come back, which is why I'm touching on it — had three parts:

(1) it authorized the President to prohibit a foreign investment in the United States, if in his judgment the investment would be harmful to the national security of our country;

(2) the President would be authorized to prohibit a foreign investment in the United States if it would impair the "essential commerce" of the United States, and

(3) the President would be authorized to prohibit foreign investment in this country if the investment would be deleterious to the "economic welfare" of American industries.

In its initial form the amendment author-

"... [to] large U.S. multinational corporations, one of the dangers in legislation including an "essential commerce" phrase and an "economic welfare" phrase, was that it would give the President authority to prohibit a foreign investment for almost any reason whatsoever, including foreign takeovers. ... In the interim some companies have been subject to foreign takeovers. And the views of the chairmen of those companies on the anti-takeover part of that particular legislation has changed somewhat."

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part of that particular legislation has changed somewhat.

The issue represented by this restrictive amendment in the next Congress is not going to be nearly as clear as it was the last time around. If somebody takes a run at your company, it refreshes your mind and clarifies it very quickly. So within the business community there will be, I think, some discussion and, perhaps contentious discussions, about what the view of the business community should be next time around with respect to restrictive legislation such as the original Florio-Exon measures.

State/Local Incentives to Foreign Investment in U.S.

In addition, you might see — and this is absolutely conjecture on my part — you might see considered some kind of a Federal preemptive statute concerning the ability of states and local governments to provide incentives to foreigners to invest in their locales. As you know there are few states whose governors do not lead and have not led delegations abroad to encourage foreigners to invest in their states, offering elaborate and generous incentives, in some cases in the form of waiving tax obligations or providing infrastructure support.

I have, for example, a member company, a multi-billion dollar corporation, that produces in a southern state . . . has now seen established in the same neighborhood a foreign corporation producing the same product . . . but subject to a $250 or $300 million incentive package that give[s] it a substantial competitive advantage over the long-established American corporation. . . . I would not be surprised . . . to see a statute considered that might provide Federal standards that states would be required to follow.

Finally, the Uruguay round of trade negotiations underway in Geneva has foreign investment on the agenda. In the GATT (the General Agreement on Tariffs and Trade, which provides a legal framework for the conduct of trade in merchandise), there are no rules on investment. Basically, internationally there is an absence of rules respecting foreign direct investment. There are a lot of bilateral treaties that nations have with each other, treaties concerning the right of national treatment, concerning the right of establishment and such things, but there is no international framework to appeal to if one is in difficulty.

So with great travail the United States convinced our trading partners to add foreign investment considerations to the agenda of the Uruguay round, the GATT round. The purpose is to try to establish and formulate international rules that will be beneficial to U.S. direct investors. The prospects for something happening in the foreign direct investment negotiations in Geneva are good, but they will be far less so should our Congress, in its wisdom or lack of wisdom, during the course of the Uruguay round, legislate things that would provide very restrictive impediments to foreign investors.
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James Q. Riordan

Riordan centers on the importance of keeping U.S. companies competitive abroad in the global market and the tax policy obstacles to that objective. He cites the pass-through benefits of foreign operations owned by U.S. companies which are more likely to use U.S. products and skills than foreign-owned operations. He traces the evolution of the U.S. tax regime as generally favorable toward foreign operations of U.S. companies in the 1950s, but becoming more and more restrictive and less competitive since then. This erosion of tax policy toward foreign source income was greatly accelerated by the Tax Reform Act of 1986 (TRA'86), particularly through the splintering of the foreign tax credit and much more restrictive sourcing rules. Riordan cites extreme complexity and compliance burdens on multinational companies, that, in Mobil's case, require 200 separate foreign tax credit calculations for the regular corporate tax and repeating the process with different calculations for the alternative minimum tax.

Riordan defends the overall limitation to the foreign tax credit as the proper and reasonable method for determining tax liability. But the splintering of foreign tax credit under TRA'86 has put multinationals in a worse position competitively than if only the per country method of limitation were allowed. Also, the new sourcing rules require more global income be sourced to the U.S. and more global expense to foreign operations, raising the residual U.S. tax. This problem is not faced by our foreign competitors. In combination, the foreign tax credit and sourcing rule changes both raise the potential for double taxation of multinationals' income and render U.S. companies less competitive.

Finally, Riordan says the California franchise tax under its unitary approach is an additional serious burden on U.S. multinationals. Not only does the California tax impose a competitive penalty on U.S. companies, but this has been compounded by the U.S. Treasury action, in effect denying a full Federal deduction for taxes paid to California. Riordan likens this to being "shot in the left foot by California" while the Treasury has "taken aim on the right foot."

He calls for the restoration of a U.S. tax regime that is both consistent and competitive with the regimes of other countries participating in the global market.

The market place is global as never before. U.S. companies need to be able to compete in that market place.

There has been much discussion about the need to make U.S. exporters competitive in world markets. There has been little consideration of the importance of keeping U.S. companies competitive when they do business overseas. This morning, I want to talk about the impact of the U.S. tax law on U.S. companies that conduct foreign operations. When considering this topic, four points should be kept in mind.

Tax Policy and Competing Abroad

First, U.S. companies should not be discouraged from competing for profitable opportunities in foreign areas. Profits from such opportunities help the U.S. balance of payments.
Furthermore, a foreign operation owned by a U.S. company is more likely to use U.S. products and skills than an operation owned by a foreign company. French oil companies operating in Africa are more likely to use French pumps and employ French geophysicists; U.S. companies are more likely to use U.S. pumps and employ U.S. geophysicists.

Second, the U.S. tax law (and the tax laws of certain states) as they now stand place U.S. companies at a competitive disadvantage when they conduct foreign operations. The 1986 Tax Reform Act increased the competitive disadvantage.

Third, the U.S. Congress gave little consideration to the competitive position when they enacted the 1986 Act. Congress was driven instead by short-term revenue goals. The 1986 Act continued the steady deterioration in the U.S. tax law that began in 1962.

As a result, the tax regime for taxing U.S. companies with foreign operations is worse today than it has ever been.

The historical evolution of the U.S. tax regime governing foreign operations of U.S. companies has been set out in a discussion draft prepared for this seminar. This paper shows that at the end of the Eisenhower Administration, the U.S. tax regime for foreign operations was generally competitive with the tax regimes of other countries. Public opinion was generally supportive of U.S. companies playing a full role in the global market place. Administration and Congressional policy reflected this attitude.

The U.S. system for taxing foreign operations has always been complicated. The U.S. has rejected the concept of territoriality, and instead has asserted the worldwide jurisdiction to tax the foreign operations of U.S. companies. In earlier years we offset the competitive disadvantage of doing so with the foreign tax credit, deferral and reasonable rules for sourcing income and expenses.

Beginning in 1962 during the Kennedy Administration, the rules relating to foreign operations began to change. The initial changes were narrowly drafted to deal with perceived abuses. The changes since 1962 have progressively overshot the perceived abuses and have increasingly cut into the competitive position of U.S. companies with foreign operations. The early changes in the foreign tax credit and deferral were made in respect of financial and trading activities that were thought to be easily manipulated because finance and trading operations often do not involve plant, physical operations or large staff.

In the 1970s, the attacks were directed to the foreign operations of U.S. oil companies. In recent years, the tax rules governing foreign operations have been revised to accomplish political objectives. Immediate and double taxation has been imposed on operations in certain countries (i.e., South Africa) and countries deemed to favor terrorism (e.g., Cuba and Libya) as well as on companies that are deemed to have participated in a boycott imposed by a
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foreign government.

The greatest erosion of the historic structure for taxing the foreign operations of U.S. companies occurred in the 1986 Tax Reform Act.

- The foreign tax credit was balkanized.
- Deferral was further eroded.
- The rules for sourcing income and expenses (e.g., interest and overhead) were recast.
- The alternative minimum tax was biased against foreign operations.

Each of these changes was adopted in 1986 primarily to raise revenues with little regard for its impact on the competitive position of U.S. companies with foreign operations.

Others at this seminar, I am sure, will go into details of specific examples arising out of their own experiences and business situations. The problems that have been created are legion.

I would like to touch on two areas of difficulty. The first is the balkanization of the foreign tax credit, and the second is the new rules for sourcing interest and general administrative expense.

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Foreign Tax Credit

Tax scholars and economists generally agree that the right way to limit the foreign tax credit is to aggregate all foreign operations on an overall basis. When the 1986 Act was first being considered, it was proposed to shift to a per country foreign tax credit method. There was a general outcry. The per country method was abandoned, but in its place Congress substituted a system that is far worse. We now have eight generally applicable separate baskets of income that may require separate tax credit limit calculations. Some taxpayers also must separately calculate limitations on foreign mineral income, foreign oil and gas extraction income, and foreign oil related income. In addition, we are now required to calculate the credit separately for each foreign subsidiary in which the U.S. company owns between 10 and 50% of the stock. For a company like Mobil, this means 200 separate foreign tax credit calculations for the regular corporate tax (which must be done all over again using different ratios for alternative minimum tax). The baskets and separate company calculations balkanize and splinter our total foreign business in a completely artificial manner which has nothing to do with the way we must conduct our foreign business. The administrative complexity is overwhelming.

The essence of the overall credit method is that it is appropriate to aggregate all foreign income and all foreign taxes and to give a credit for the foreign taxes to the extent the average foreign rate does not exceed the U.S. rate. Many, if not most, U.S. companies pay foreign taxes on foreign income at effective rates in excess of the U.S. rates. If the overall method was fairly computed and reasonable rules applied to sourcing of income and expense, double taxation would be avoided, and most U.S. companies with significant foreign operations would pay no U.S.
tax on their foreign income because on average foreign income tax rates are at least as high as U.S. rates.

The purpose of the 1986 rules, in large part, is to segregate operations at rates below the U.S. rate from operations taxed at rates above the U.S. rate, so that residual U.S. tax will be charged on any operation with a rate below the U.S. rates. The U.S. approach is unique. Other countries effectively permit averaging of high-taxed income and low-taxed income so that if the average foreign tax rate is greater than the home country tax rate no residual home country tax is due.

The new basket/company pattern is exceedingly complicated and imposes a huge administrative and compliance burden on both taxpayers and the government. Obviously, many companies will seek new structures to avoid this double taxation and administrative burden. If they cannot do so, they will be less competitive and, in due course, they will lose market share or sell out.

The 1986 changes in the foreign tax credit were designed to make certain that U.S. taxation is imposed on foreign source income, even if that results in double taxation and makes U.S. companies non-competitive. The result is that U.S. companies with foreign operations have been made non-competitive.

Sourcing Rules

In addition to splintering the foreign tax credit, the residual U.S. tax on foreign operations has been increased by sourcing more global income to the U.S. and sourcing more global expenses foreign. The 1986 Act made a number of important changes to the rules that had long existed in order to raise additional revenue. The practical effect of the changes in the sourcing rules has been to impose double taxation and reduce the international competitiveness of U.S. companies with foreign operations.

The rules existing before 1986 called for each U.S. company in a consolidated group of companies to source its interest expense according to the ratio of its U.S. and foreign assets or gross income. Other countries, the U.K. for example, do not require any interest expense of their multinationals to be sourced foreign. Prior to 1986, U.S. companies could finance their U.S. operations without having any of the expense sourced foreign by borrowing through U.S. affiliated companies that had no foreign assets or foreign gross income. Many, if not most, companies caused their foreign affiliates to finance their own foreign operations, but it was also possible under pre-1986 law to use a borrowing structure that allowed a full U.S. tax deduction for U.S. interest on U.S. borrowings that could be said to be used in part to finance foreign operations. This possibility was perceived by Congress to be an abuse, despite that fact that it is not so regarded in the U.K. or other countries. Even so, the Congressional response went way beyond the perceived abuse.

The 1986 law changed the rules for alloc...
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The watchword is fungibility, not competitiveness. This means that a portion of any interest expense paid by a U.S. multinational will be sourced foreign even if the debt is, in fact, clearly incurred to finance a U.S. investment. This, in turn, means that a U.K. multinational has a competitive advantage over a U.S. multinational. A U.K. multinational that borrows "U.S. government has been much more vigorous in supporting foreign multinationals in the California and Federal courts than it has been in supporting U.S. multinationals. The California situation is bad enough, but in 1987 the IRS announced that it would henceforth treat the California unitary tax as being in part a foreign source expense... [increasing] the after-tax cost of paying the California tax."

either in the U.K. through its U.K. parent company, which by definition is not in the U.S. tax consolidation, or in the U.S. through its U.S. subsidiary, which typically has only U.S. assets and does not have to be consolidated with its U.K. parent will not suffer the same disadvantage as a U.S. multinational. As a result of the 1986 law, Shell and BP not only have a competitive edge over Exxon and Mobil in their foreign operations, but the 1986 Tax Act also gives them a competitive edge in financing the expansion of their U.S. operations.

State Income Taxes

There is more to this sad story. The U.S. law provides that any expense (other than interest) that cannot be specifically traced to an item of income, must also be allocated. One of the expenses that the IRS requires to be allocated is state income tax. The IRS takes the position that state income taxes may need to be allocated in part as a foreign source expense even though under U.S. constitutional law a state (unless possibly it is a corporation's commercial domicile) is not permitted to tax income from operations outside the state. The rule has recently been extended by the IRS to state franchise taxes based on income.

The California franchise tax uses a unitary tax approach under which it calculates California income as a percentage of a company's worldwide income. The percentage of worldwide income apportioned to California is the percentage of worldwide property, sales and payroll that is represented by property sales and payroll in California. The U.S. Supreme Court has held that the California system is a reasonable method to derive a fair estimate of income from California operations. Most taxpayers believe the California system is not fair and penalizes foreign operations. The Treasury Department has tried to persuade California to change its law, because it and many foreign governments believe that the California system, in practice, taxes more than the income from California operations. California has partially changed its law as the result of pressure from foreign companies and governments, but the change is not satisfactory and, in practice, is much better for foreign multinationals than for U.S. multinationals. The Treasury Department has urged California to improve its law further.

To date, however, the U.S. government has been much more vigorous in supporting foreign multinationals in the California and Federal courts than it has been in supporting U.S.

"U.S. companies with foreign operations have been shot in the left foot by California and the Treasury has now taken aim on the right foot. It is hard to compete in today's global market with two wounded feet."

multinationals. The California situation is bad enough, but in 1987 the IRS announced that it would henceforth treat the California unitary tax as being in part a foreign source expense.
This means that the after-tax cost of paying the California tax will be increased.

The Treasury has made the unfair California tax, which imposes a competitive penalty on U.S. companies with foreign operations, more unfair by effectively denying a full Federal tax deduction for the tax paid to California. A taxpayer must unhappily accept the Supreme Court view that the California tax fairly taxes California operations, but the Treasury in effect ignores the Supreme Court ruling and proposes to treat the California tax as if it is imposed on foreign operations and therefore will be treated in part as a foreign source expense. U.S. companies with foreign operations have been shot in the left foot by California and the Treasury has now taken aim on the right foot. It is hard to compete in today's global market with two wounded feet.

Conclusion — Hobbled by Our Own Laws

The global market place is highly competitive. The year is 1988 and not 1945. U.S. companies face formidable competition from Japanese, German, UK, French and Dutch companies. If U.S. companies are made non-competitive by U.S. and state tax laws, the investments in profitable business opportunities at home and abroad will be made by foreign competitors.

"If U.S. companies are made non-competitive by U.S. and state tax laws, the investments in profitable business opportunities at home and abroad will be made by foreign competitors."

The U.S. company is penalized because Congress has drafted a tax law to overkill perceived abuses, accomplish foreign policy and raise revenues in the short term, and has taken no account of what it is doing to the ability of U.S. companies to compete in the global market place. To be competitive in the long term requires that U.S. companies have the ability to make profitable investments in foreign operations on the same basis as their foreign competitors.

"Congress has created a law more complicated than it or its staff can possibly understand or fairly evaluate, which the Treasury cannot efficiently administer, and with which taxpayers cannot reasonably comply."

In my opinion, the current situation is not what the Congress really wants. Over time, Congress has created a law more complicated than it or its staff can possibly understand or fairly evaluate, which the Treasury cannot efficiently administer, and with which taxpayers cannot reasonably comply. We have lost our focus on the guiding star of equal competition in the global market place. We have over-reacted to perceived abuses in financial planning, anger at gasoline lines, a desire to run foreign policy through the tax law and the drive to raise short-term revenue at any competitive cost.

Somewhere we have to call a halt to this unfortunate trend. We need to restore a tax regime for the foreign operations of U.S. companies that is consistent and competitive with the tax regimes that govern the international operations of foreign multinationals. I congratulate the Tax Foundation for sponsoring this seminar, and I hope that it and others like it will cause the Congress and the Administration and future Congresses and Administrations to consider the need to make changes so that U.S. companies can once again be competitive in the global market place.
Kermes addresses foreign investment from the standpoint of a major technology-oriented multinational with 50 percent of sales from international operations. Tax treatment of these operations is a major factor governing the success of the business. He stresses that SmithKline is quite willing pay a fair share of taxes with a level playing field, but the field is not level; foreign competitors have a decided advantage.

According to Kermes, there are several substantial tax issues—"potholes" on the field—that compromise SmithKline's ability to compete abroad. The arbitrary carving up of the foreign tax credit, particularly under the Tax Reform Act of 1986, has led to double taxation of U.S. multinationals. Because of the extreme complexity of the new rules, companies such as SmithKline must devote substantial additional resources to tax administration and tax accounting, resources that Kermes says could be much more productively employed in R&D or sales efforts. The allocation of expenses to foreign source income, which can also result in double taxation, is a major issue, particularly for pharmaceutical companies with respect to R&D expense. Kermes claims, for example, that because of allocations and loss of foreign tax credits, SmithKline must pay almost a 60 percent effective tax rate on its U.K. source income, while a competitor based in the U.K. would be subject to only a 35 percent effective rate on its U.S. source income.

Kermes also stresses the importance of extending the 20 percent incremental R&D credit which is particularly important to small companies on the cutting edge of technological innovation. He fears that the R&D credit extension now being considered by Congress will not be adequate.

Kermes concludes that the prime priority is to change attitudes of members of Congress and regulation writers to recognize the importance of conducting international operations on an equal footing with increasingly tough foreign competition.

What I would like to talk about is in the context of the multinational pharmaceutical industry. But the same rationale that I will talk about can apply to almost any technology-driven multinational. I am approaching the subject from the posture of the chief financial officer of a multi-billion dollar corporation who is not a tax expert, but is someone who has come to appreciate the friction that taxes can apply to the fiscal wheels of an organization.

SmithKline, like all of the others in our industry, some of whom are represented here, wants to pay taxes—at least our fair share. It is appropriate to do so. We do receive tax benefits, and we have taken advantage, as others have done, of tax constructions abroad that create incentives. Some of these incentives may be greater or less than those provided to other industries: steel and autos, for example. But we're not competing with steel and autos. We're competing with other high-tech businesses which may be taking advantage of tax incentives just as we are.

**Tax Planning and R&D Investment**

First, I would like to make a couple of comments about the nature of a very research-oriented business. Second, some comments
about the U.S. tax law and some significant aspects that inhibit our competitive potential. And lastly, comments on why I feel we need a change in attitude on the part of legislators, regulators and taxpayers if we are to improve our competitive potential.

The major players in any technologically oriented multinational industry, no matter where they have their headquarters, are driven to invest abroad, particularly in the pharmaceutical industry. You must go to the market, and ours is people. SmithKline, for example, sells in over 120 countries. Half our sales are from international operations. As a result the tax treatment of our overseas business by the United States is of significant importance to us. It largely defines our profitability and our cash flow. And that helps to shape our R&D investment decisions, the most critical single decision we make. Tax treatment is, in fact, a major planning factor that governs the course and success of our business — not the dominant factor, but a major one. We therefore devote a good deal of our time to it.

Now another fact of technological multinationals is that they succeed or fail on the basis of their technological prowess. In our field, the future of applied pharmacological research is virtually infinite in all directions. Opportunities are just tremendous. Our primary mission is to create value by bringing good health products to the world. We also have an obligation to return value to our shareholders, customers and employees. Our value-creating function is clear to us. We may not always do as good a job as we would like or as we must, but it is a constant focus. We would like to see our U.S. taxation process act more supportively in recognition of that function of creating value rather than as an adversary.

Another major factor about technology-driven multinationals is that they are fiercely competitive. The world we compete in is a global arena involving big players, very big bucks and big risks. It takes us eight to twelve years and even longer to bring a product through research, development, testing, and evaluation to the market place. I have been in some industries where products came to market in 90 days and were gone in nine months. Ours is a very different kind of time frame. Our product portfolio is tremendously expensive. It costs us $150 million to develop one product.

Relative to the development cycle, our products have a potentially short earnings life — five, seven, nine years left, maybe, on a patent protection situation. There is usually only room for one or two or three products on the shelf at a particular time. They are not like products in some of my past experience — cereals or dog food where the shelves can extend 50 feet. What we do, we have to do right, very right. We almost have to be in a zero defect environment. We have to be prepared to do it big and we have to be first, or as close to first as we can be, and therefore, we have to do it as fast as possible. What we don't need on top of all that are tax postures that add more potholes to the road we are traveling.

What's the current impact of the tax laws and regulations on this competitive potential of technology-driven multinationals? American high-tech multinationals are not being put out of their business by U.S. tax rules. However, we do need to have a level playing field with our foreign competitors, and we don't have that now.

There are four issues — or potholes in the playing field — that I would like to comment on in the next few minutes:

First, further restriction by the 1986 Tax Act of the ability of companies to take credit for taxes paid to foreign governments, leading in many cases, as Jim Riordan said, to double taxation;

Second, a super royalty in the 1986 Tax Act,
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which will require our foreign affiliates to pay higher royalties back to the United States for use of U.S.-developed technology;

Third, proposed legislation on the allocation of U.S.-incurred research expenditures to foreign source income;

Fourth, the upcoming expiration of the tax credit for incremental research and experimentation.

The background environment for all of these has been spelled out in detail in the Tax Foundation's special report, "The Competitive Burden: Tax Treatment of U.S. Multinationals" by Arthur Young & Company. What that argument amounts to, it seems to me, is this: the combination of cumbersome provisions and a philosophical antipathy to profits has left U.S. multinationals with a foreign tax treatment that does not provide U.S. multinationals with a level playing field with our foreign competitors. I won't repeat the arguments in that document. But the four potholes provide some examples of how they make our particular road a bit more bumpy.

High Cost of Tax Complexity

First, the restrictive tax credit provisions which Jim Riordan very effectively outlined. The main difficulty is that we are confronted with a very, very different set of rules from the ones we had in place before 1987. We have a different system, for example, that now goes to unnecessary extremes in segregating various types of foreign source income into separate baskets globally. We have an arbitrary fragmentation of income into many subtypes: shipping, insurance, financial services, oil related income, income from general commercial activities. And all these baskets are given separate foreign tax credit treatment. The United States now makes a distinction, for example, between dividends from a U.S. controlled and non-U.S. controlled corporation, even if the basic income from these two sources arises from the same type of commercial business.

There are also complications in the distinctions between active and passive income, leading to potential inequities and seemingly unnecessary complexities. Just the record keeping here is formidable. We have to keep track of the separate pools of earnings, separate baskets for these pools forever. Our technicians tell me that it's an administrative nightmare. I can appreciate that. But what is more saddening to me is that, in an environment in which we are all trying to be perfect, more efficient, more competitive, to compact our operations to the ultimate level, I would love to be investing more people and more money in R&D and sales. Instead, I must invest them in tax administration and management within the tax function, within the accounting function throughout the organization. I am not sure that that is nearly as productive as an investment in the best scientists or the effective salesmen.

The allocations of interest expense, general and administrative expenses, and R&D add more complexity and increase the likelihood of our having unusable or excess foreign tax credits and double taxation. Other countries do not do this. The fact is that U.S. multinationals were treated more fairly before the 1986 Act. The playing ground was considerably more level with regard to foreign tax credits. The repeated efforts at fine-tuning our tax laws in order to close every conceivable loophole and to extract every possible dollar of revenue has left U.S. business mired in complexity without enhancing competitiveness. We don't think this fine-tuning of the system is warranted or cost-effective in the long run. We face new rules virtually every two years. In our efforts to comply with the law and to do forward planning, we are constantly waiting for white papers, for regul-
tions. Our competitors in Japan or the U.K. aren’t waiting.

Today’s tax legislation is so broad that legislative staff and administrators effectively are determining the law of the land. They set tax policy on the basis of revenue needs. That’s obviously got to be a primary factor, but we

“We face new rules virtually every two years. In our efforts to comply with the law and to do forward planning, we are constantly waiting for white papers, for regulations. Our competitors in Japan or the U.K. aren’t waiting.”

think there is very little, if any, consideration or understanding of the impact of their actions on U.S. business interests abroad.

Another pothole is the super royalty in 1986 Tax Act. This requires a royalty to be paid to the U.S. developer that is commensurate with the income attributable to the particular technology. We aren’t entirely sure what that means yet, because it hasn’t been explained to us. But we are subject to it now, and we understand that it will require our foreign affiliates to pay significantly higher royalties to the United States for use of U.S. developed technology so that we can market our products abroad. And there is also the look-back feature. This means that, if we select the wrong royalty rate in good faith, the IRS can come back several years hence and retroactively change our earnings in accordance with whatever they determine the super royalty should have been. And I don’t know that there is any assurance that foreign governments will allow a deduction for the enhanced or super level of royalties. In fact, we are very doubtful that they will. So the super royalty will be another added cost of doing business abroad, more double taxation, another factor in making us less competitive.

R&D Allocation

Another pothole. The forced allocation of U.S.-incurred research expenditures to foreign source income also has the effect of causing us to lose the use of foreign tax credits. Let me give you an example of how this allocation works to make it more expensive for us to compete abroad. Take a hypothetical competitor of ours. Let’s call them Lyon. Let’s make them a British company. Lyon is reported in a recent London Financial Times article as spending a billion pounds, 1.7 billion U.S. dollars, on new research and development facilities. That’s a lot of money. They know they won’t be penalized by their government. Lyon doesn’t have to allocate expenses for R&D to their U.S. source income. Their U.S. source is not insubstantial. However, U.S. tax law and regulations require us to allocate substantial amounts of domestically performed R&D expense to our foreign source income. Lyon is subject to a 35 percent effective tax rate on its U.S. source income. SmithKline is subject to almost a 60 percent effective tax rate on its U.K. source income because of allocations and loss of foreign tax credits. We are double-taxed. Lyon is not. There are a lot of factors in the competitive environment vis-a-vis ourselves and Lyon. We didn’t need to have taxation be one of them.

The last pothole. The twenty percent credit for incremental R&D expires at the end of this year. This provision, we think, is especially helpful to small companies, many of which are at the cutting edge of technology and technological innovation and need all the encouragement we can give them. Legislation to extend this credit and to largely correct the inequity in the R&D expense allocation rules is included in the House version of the Technical Corrections Act which is now working its way through the Congress. However, we note with some con-
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cern that a watered-down version of these two provisions is in the Senate Finance Committee bill. We believe it is vital that these provisions which already enjoy Congressional support be enacted this year. They should be reenacted to encourage increased performance of R&D in and by the United States.

In summary, no foreign competitor that we know of faces the reallocation of locally incurred expenses, including R&D expense, to foreign source income. That has the effect of denying the use of foreign source credits in the United States. It can, and often does, lead to double taxation of a portion of our income. As you know, without the use of foreign tax credits, the effective tax rate on foreign income can be confiscatory — indeed, as high as 70 percent or greater on repatriated earnings, depending on the particular foreign country. How can we effectively compete when our foreign competitors aren't similarly handicapped by double taxation of their income? When, for example, a competitor in the Netherlands is not even taxed when it brings back foreign source dividends? The answer is, we can't. We are hobbled by our own government and our own tax system.

Finally, we should know that while the U.S., at 34 percent, has one of the lowest statutory income tax rates for corporations, for many of the reasons I have mentioned, the effective tax rate on our foreign source income is at the top of the scale compared to the taxes paid by foreign competitors. As I said, it can be as high as 70 percent.

Add to this to the uncertainty of our tax laws at any given time, then add in the administrative complexity imposed by our rules and regulations, and you see what I mean when I say that we are at a competitive disadvantage when operating abroad. What we mainly require is a change of attitude by members of Congress, our regulators and we, the taxpayers. We need to recognize that what we are doing is sapping our national industrial strength. We need a consistent tax policy, one that does not undergo fundamental change almost every other year. What we are asking for is not a favorable but a fair playing field on which our competitors have an equal footing, not a superior one. That's not an unfair objective, I don't believe. The future of U.S. trade relations is bound up with the achievement of that objective. The future trend of the U.S. trade deficit is bound up with our success in gaining that objective. We cannot fail to pursue it and to achieve it.

David R. Milton

May I close with an observation that seemed very clear to me as I listened to the morning session. I have heard a lot of things that I would be inclined to characterize as symptoms of negative policy. All of the litany of nasty things that are happening to U.S. companies trying to operate abroad. And of course, one of the purposes of the Tax Foundation is to try to start the discussion of policy. Strangely enough if you will look at most of the major organizations in the United States in the past years, such as the American Bar Association and the International Fiscal Association, they have all gotten themselves so involved looking only at the small pieces of technical provisions — the kind of things, I guess, that they use to earn their bread and butter — that they are not looking at policy. So hopefully, with this kind of an examination through the Tax Foundation, we can get some of these organizations to look at policy. It is a serious thing that we ought to do.
Good Afternoon. I'm Skip Wanders of Wachovia Bank, and as Chairman of the Tax Foundation, it is my pleasure to welcome you to this seminar on "The U.S. Stake in U.S. Foreign Investment."

Our luncheon guest is an accomplished public speaker, with a long and distinguished career in the United States Congress. His interest in international and commercial matters is not that of a casual observer. He is someone who is deeply involved in these matters in his role as second ranking majority member on the Ways and Means Committee and Chairman of its Trade Subcommittee.

He has served in Congress since he was first elected from the 7th District of Florida in November 1962. Earlier, he had served six years in the Florida House of Representatives and four years in the Florida Senate.

Congressman Gibbons, in his brief overview statement, says that current tax law is a disincentive to innovation and domestic investment and that a more competitive environment should be encouraged by Washington. He terms the current method of taxing overseas earnings "a disaster."

Congressman Gibbons makes a strong case for consumption taxation in lieu of a good part of the income tax. He believes that the lack of border adjustment for U.S. income taxes — which comprise a major part of the cost of government and effectively are embedded in the price of our products — means a substantial trade disadvantage for the U.S. and discourages new
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investment in U.S. plant relative to foreign operations. In general, Gibbons believes that while national policy should not subsidize U.S. foreign investment abroad, neither should it handicap it as under present practice. He also stresses that Washington alone cannot make U.S. industry more competitive. It will take a major effort by all to reinvigorate the work ethic.

Most of you are much greater experts on the law than I am, and I cringed when he said that there was no tax bill that I hadn't had a part in in the last twenty years. I've been afraid somebody would say that for years. I hope that if I ever do become Chairman — and I am not planning an assassination or coup — that we can look forward to a different era in taxation.

I think the current law is a disincentive to innovation. I think the current law is a disincentive to placing your plant and your industry here in America. And although I classify myself as an internationalist, I'm not a damn fool internationalist; I'm one that believes that internationally we ought to pursue our own best interests and hope that others can come along with us and pursue their own best interest.

I am worried about the condition of America. I am interested in our having a more competitive environment, and I think a more competitive environment begins here in Washington. Not that we have the wisdom. Not that we have the power to fill in all the blanks, but without our leadership, we're not going to be competitive. I think our current tax on profits and our current tax on earnings overseas is a disaster. I would much rather replace it with a consumption tax.

Let's continue to have a little income tax so that all those people who have learned all those fancy rules from all the fancy seminars that you have to have will have something else left to do when we finally change the law. But I am not a great fan of the Internal Revenue Code the way it is now constructed. I think I will give one homey little illustration. I have given it so many times in the Ways and Means Committee, and yet I have had so little reaction to it.

It seems to me that if you manufactured a widget or a wallet or any other thing you want to manufacture in the United States, when it leaves the United States it carries with it the full cost of government. (And government is not inexpensive, as you know.) Probably 25% of the cost of this widget is government. When it goes to other countries around the world they heap their use tax, which we call the sales tax, or their value-added tax, as they now prefer to call it, on that product. That adds another 10, 15, 20, 25 percent. Then it goes to retail.

Well, if you manufacture this widget, whatever it is, in most other countries of the world, it comes to their border and, under the rules of GATT the General Agreement on Tariff and Trade), they shave off a good part of the cost of government. So you've got this thing traveling across the ocean with little or no cost of government on it. It comes to the United States, and we don't add anything to it, except maybe a little state sales tax or something like that. Then it goes to retail. Where would you establish a plant, all other things being equal, to manufacture this? Unless you've lost your mind, you wouldn't put it in the United States, the way I reason. And I haven't had anybody tell me that was wrong, except some theoreticians who will say that the problem all wipes out in currency exchange rates. Well, hell, what do you think affects the currency exchange rates, other than all the other things that go on in the world. I don't know what affects the currency exchange rates. And it looks
to me watching them from day to day that nobody else really understands them either. So, I think our tax system, just from that simple point of view, is a mistake and that we have got to get in step with the rest of the world as far as that's concerned.

Now, on the intricacies of foreign earned income and everything else, I have tried to take a view that we should promote American industry, not subsidize it. But we should at least promote it, not handicap it. That's been my general view. It seems to me, though, that the problem of America's competitiveness is really deeply embedded in our psyche.

We grew up after World War II believing that we were the best. Americans came away from World War II thinking we were indomitable, that we had a monopoly on everything that was bright and brilliant. We had forgotten that, with everybody else's help, we had bombed the rest of civilization out of existence and that the only farms and factories that were still functioning correctly were here in the United States.

And for years we proved to be omnipotent. But we got lazy. We adopted work habits that were not good, not only from an industry point of view. They were slovenly. And some of our products became slovenly, until finally in important respects we were overtaken by more ambitious, more industrious, harder working sectors of the world. Until we are willing to get over that, none of the miracles that we could perform here in Washington are going to pull us out of this. We're going to have to devote more time to promoting the work ethic from the top to the bottom of American industry. That's one of the big challenges now. Even with the work ethic, if the government is throwing you handicaps, you still are not going to prevail. So we've got to work together, with good liaison and good dialogue back and forth, each telling the other in good faith what we need to do and working cooperatively. Otherwise, we're going to be the kind of nation that can't really hold its head up when it comes to competitiveness.

As for very immediate concerns, I don't know what is going to happen to the Technical Corrections bill. Somebody told me that it had just gotten encumbered last night with the Textile bill. If that is so, good Lord, we've got a problem unraveling that mess. I don't know what Mr. Rostenkowski is going to do about all those extraneous amendments. Rosty and I settled our differences a number of years ago and anything that I want, I'd better postpone. I think that any of you who lived through the '86 Tax Act understand what happened, if you followed my career at all.

Anyway, I am very hopeful that the Senate will rapidly pass the Canadian Trade Agreement to put more pressure upon the Canadians. You know, the Canadian-U.S. agreement would probably do more to help the two countries than anything that could happen to us immediately. And yet in Canada—a Canada that I love and like and always respected as a great democratic country—we find an appointed, unelected life-time peerage deciding whether or not there will be a Canadian-U.S. free trade agreement. If that happened in any other country on earth, I can't think of all the nasty things we would call it. But the Canadian Senate does not run for election, is not controlled by the party in power that was just elected by the people, and is there for life. What a job. And they are controlling whether or not there will be a U.S.-Canadian agreement.

I'm hoping that we will get the Caribbean bill, not this year, but early next year, because in it there is a solution to the problem faced by 40 million of the poorest of the probably half a billion people who occupy what we call Central and South America. If there is any solution for those 40 million people, it is giving them an opportunity to make something and sell it in our markets. And the Caribbean bill as we have now got it drafted will help them do that. No panacea, but we might as well admit that, unless we want the United States overrun by economic refugees, somehow we have got to
find a way to help those people help themselves and not to be totally dependent on handouts from around the world as they are now. Unless we pass the Caribbean bill as we have introduced it in the House, there is no hope that those people are ever going to improve their economic viability. They are worse off today by a combination of circumstances than they were five years ago when we first launched our interest in the Caribbean.
AFTERNOON SESSION

"Tax Policy and Foreign Investment"

Chairman: Leonard E. Kust
Of Counsel
Cadwalader, Wickersham and Taft
O. Donaldson Chapoton
Assistant Secretary of the Treasury for Tax Policy
Gary Hufbauer
Wallenberg Professor of International Finance
Georgetown University

Raymond Haas
International Tax Partner
Arthur Young & Company
Robert Z. Lawrence
Senior Fellow, Department of Economics
The Brookings Institution

Leonard E. Kust

Our subject this afternoon is hardly new. It has been debated at least since the Revenue Act of 1962 was under consideration. That Act, incorporating Subpart F, initiated a persistent hostility or, at least inhospitality, to foreign activities of U.S. business that has, with rare exceptions, dominated U.S. tax policy for almost three decades. One would think that in all that time an understanding of the relevant considerations and what tax policy best serves our national interest would surely have emerged. But, sad to say, recent legislation demonstrates that we may be farther from such understanding than we were three decades ago.

In the days of the debate preceding Subpart F and during the ascendency of Stanley Surrey the philosophical argument had been in terms of tax neutrality. But no such philosophical argument attended the 1986 Act. The 1986 provisions appear instead to have been an exercise in opportunism and expediency aimed at raising revenues under the guise of tax reform.

If we are now to return to responsible consideration of what tax policy respecting foreign activities best serves our national interest, we may have to deal again with the tax neutrality argument. But tax neutrality is an elusive standard; like beauty it lies in the eyes of the beholder. Is it neutrality in the foreign country where the market is or neutrality in the home country of incorporation or origin that we are seeking? Thus, the real question is which principle of taxation of income from cross-border activities is more appropriate — the source, i.e., the territorial principle, or citizenship, i.e., the place of incorporation principle. One or the other must be given primacy by agreement between the countries involved or by the granting of tax credits by one of those countries, or there will be double taxation.

But the choice by any one country between these principles of taxation can be rationally and responsibly made only in terms of their economic consequences. Will equal taxation of investment abroad and investment at home increase investment at home or will greater benefit to the national economy result from territorial taxation because of greater participation in foreign markets? This issue will be discussed from several points of view by our illustrious speakers this afternoon, as it was this morning, but with a more specific focus on the tax structure as it impacts these principles.

Let me add a final thought. It seems to me, as a pragmatic forecast, that the territorial principle will prevail in the fullness of time. For, as we become increasingly one world and as the international economies inevitably become more dominant, the place of incorporation will be subject to ready migration and only the source principle will abide. We may not be here to witness it, but perhaps the inevitability of it
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will begin to affect current policy decisions, particularly if the territorial principle is more consonant with national as well as international economic objectives.

O. Donaldson Chapoton

Chapoton expresses concern over tax law complexities, particularly in the international area. He stresses that Treasury is quite aware of the extent of the problems. He regrets the specialization trend among international tax lawyers because of the need to devote almost 100 percent of their time to that area. Narrow specialization adds to complexity when the practitioners do not have a good feel for overall tax law and general business.

Responsible for increasing complexity have been both the growth of international business and the drive to reduce U.S. tax rates. There was need to address the problem of widespread excess foreign tax credits post the Tax Reform Act of 1986. Chapoton says that the Congressional answer to this was overkill, but claims that there is no agreement on Capitol Hill or even within the Treasury as to how to reduce complexities without losing significant revenue.

Chapoton stresses that suggestions from the private sector for tax simplification and safe harbors must be kept separate from tax relief proposals. If Treasury goes into a proposal thinking it is only about complexity and it turns out to be tax relief or shifting tax burdens, “that is not helpful.” He welcomes proposals for “rounder cuts” on particular provisions on a revenue-neutral basis, but claims the suggestions Treasury does get all cost substantial revenue.

On competitiveness, Chapoton compliments the Arthur Young study as a good exposition of comparative treatment of multinationals. He says the issues raised in the study should be examined carefully. He restates Treasury’s official position as to guarding the revenue and questions the fairness of allowing multinationals more favorable treatment abroad than strictly domestic companies receive in the U.S. He cites the insurance industry’s experience, post-1984, in this regard.

Chapoton strongly backs the concept of deferring U.S. taxation on foreign earnings until repatriated. He says the 1986 Act made inroads on the deferral concept and these inroads should be re-examined. However, Treasury is not willing to support any basic changes in the 1986 Act at this time.

First let me just say I do think it is a very opportune time to get into discussion and I hope this session is the first of many to get into a discussion of the international tax area. We’ve got a number of things that make it appropriate. The trade deficit that we are facing, that we are worrying about quite a lot, highlights the concern about multinationals and their importance to our economy. The fact that we all — both taxpayers and the Treasury alike — are completing the first phase of digesting the 1986 Act’s foreign provisions, you filing your tax returns and we at Treasury wrapping up the important regulatory provisions. At least we’re
taking our first cut at them. Many, we will have to come back to. But we need to see how they work, and we need to discuss how bad they are or how good they are in some limited respects. Furthermore, the tax treaty program is one of our top priorities. So, it's an important time for us to discuss the role that we see tax treaties playing in the process.

From my perspective there are two major concerns about international tax law. One is the complexity of the law. I’ll call that the issue of procedure. The second deals with the substance of the law: to what extent should the tax law be used to foster and further our international competitiveness?

Worrisome Complexity

Let me first turn to the question of complexity. We hear it again and again and believe me, I know how complex these new provisions are. There was a meeting a couple of weeks ago of international tax practitioners who gathered in Washington, and they expressed real fear over the difficulty of complying with and understanding these provisions. Furthermore, the IRS is worried about enforcing and auditing tax returns because of the complex provisions. And tax lawyers, seasoned tax lawyers such as yourselves, are simply saying that these provisions are so difficult that they are going to be too complicated to apply and interpret on a meaningful basis.

"Now, many large companies have fifty percent or more of their total gross income and their activities coming from abroad. That necessarily has required us, over the years, to look harder at these activities from the U.S. tax standpoint."

I think it is worrisome that there is a real trend for tax lawyers in the international area to feel that they have to focus on that area almost one hundred percent of the time. It is getting to be a very specialized area, like pension and profit sharing plans or tax exempt bonds. If you don’t do it almost all of the time, you have trouble keeping up with it. I think that is regrettable. I think it has been regrettable in those other two areas I mentioned as well, because while the tax law is complex, it works better if the practitioner has some general feeling for the tax law and some general business feeling as well. We don’t want to get so specialized that we think only in terms of the very narrow area that we deal with.

I would suggest that these complexities really have arisen for two reasons. One is that the multinational corporations' foreign business has grown dramatically over the last twenty years. Twenty or twenty-five years ago, for most of our major corporations the foreign business was maybe 10, 20 or 25 percent of their operations at most. Now, many large companies have fifty percent or more of their total gross income and their activities coming from abroad. That necessarily has required us, over the years, to look harder at these activities from the U.S. tax standpoint.

Secondly, and probably more significant from our current standpoint is the reduction in tax rates in the 1986 Act. The '86 Tax Act has lowered the corporate rate so dramatically that virtually all multinational companies have excess foreign tax credits. This simply was not the case prior to the '86 Act. Since it is the case now, we know that companies are looking for ways to use up those excess foreign tax credits. Before the '86 Act it was probably very easy to shift income around or to shift expenses around. Given this world of excess tax credits and the low U.S. tax rates, there was some need to address those problems.

If we had not addressed those problems,
there would have been no incentive for our trading partners to reduce their tax rates. Any higher tax rates that would be paid in foreign countries would not be a burden on the taxpayer because those credits would simply come back and offset U.S. taxpayers’ U.S. tax liability. Therefore, the only one taking a hit would be the U.S. government. So those problems should have been addressed, and they were. The real question is whether there was overkill in it.

Our International Tax Counsel’s staff got together over the last week, in preparing for this conference, just to talk about what sort of positions we are worried about and what sort of things we are addressing. We talked about a lot of these issues, and I wish I could tell you that we had some good answers for all of them. I don’t think we have any good answers for these complexities. There is no unanimity on my staff as to what the problem is, where the complexities are, or how we should address them. And I say certainly that is the case on the Hill too.

From my personal perspective, I am very disappointed that we cannot take, in some cases, a rougher cut on some of these problems. The system has been fine-tuned too much. We have gotten too clever in the area and I think that both government and private practitioners share the blame because, as Leonard Kust said, ever

"I think the law is overdoing it when we have all of these foreign baskets, these interest and expense allocation rules, and we worry about whether a company is going to try to change what is not interest into interest or vice versa so that we should treat it as interest. My perspective is that we have overdone things a little bit, and I would hope that we could find ways to simplify."

since the Subpart F provisions came in in the early ’60s, we’ve learned how to deal with these complex provisions, we’ve learned how to avoid them, to get around them. We have gotten very expert at it and the tax law is just now recogniz-
the two points, or at least don't camouflage one as being the other, because that's counterpro-
ductive for all of us. If we go into a proposal
thinking that all we are addressing is complex-
ity and it turns out that we are relieving some of
the tax burden or significantly shifting the tax
burden and that is not what we intended, that
is not helpful.

One of the concepts that came up in our staff
discussion was that maybe we could draw a
distinction between protecting the U.S. tax on
U.S. operations on the one hand and protecting
the U.S. residual tax on foreign operations on
the other hand. A good example of the second
one would be Subpart F, where we don't have
deferral in all cases in operations that earn
money abroad and where we should pick up
extra residual tax because the foreign govern-
ment has left some on the table, in effect. The
suggestion was made that protecting the U.S.
tax on U.S. operations is a much more difficult
area to simplify. I am not sure that I fully agree
with that. I think it is the foreign area which has
raised most of the money in the '86 Act. The
foreign tax credit baskets, the interest alloca-
tion rules and things of that sort—that's where
most of the money was raised by the statute.
From that standpoint it might be the more
difficult to change, but it is nevertheless worth
considering.

Regarding the Subpart F rules, I think some

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on the other . . . ."

of the modifications have been somewhat ex-
cessive, the limitation of the loss rules, for ex-
ample. I am not sure there is complete justifica-
tion for some of those changes and maybe they
should, at some time, be reexamined.

Competitiveness, Abroad and at Home

Now that I have solved the complexity for
you, let me shift to the next point, and that is the
extent to which the tax laws should be used to
foster competitiveness abroad. I think the Arthur
Young study does us a great service, all of us, in
raising these questions, in making the compar-
sions between three of our major trading part-
ners, and suggesting, as it does, that U.S. tax
policy may have gone too far and made us less
competitive. That debate is one we should get

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be equity between those two."

into and I think we should consider where it
takes us.

The question is really how this point of
international competitiveness or a level play-
ing field—or, as Leonard Kust just made
reference to, neutrality—should be dealt with.
Those are concepts which sound good and we
hear them all of the time. But it is not entirely
clear where this takes us. From our perspective,
there are three things that we have to take into
consideration. One is from our standpoint of
representing the government—we need to be
sure that the government gets its fair share of
taxes from transactions. It should be a reason-
able share and it should be fair: if a U.S. tax-
payer makes money on a transaction, then we
must consider whether and to what extent that
transaction should be taxed in the U.S.

Secondly, we need to worry about fairness
between U.S. multinationals and U.S. non-multi-
nationals, that is companies that don't do busi-
ness internationally. The question is whether
we should seek to relieve the multinationals'
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foreign operations from tax so as to make them more competitive abroad and at the same time make those operations more tax-favored than a similar operation that takes place in the United States by that company or by a company that is not in a foreign business. There needs to be equity between those two. I’ll come back to that in just a second.

“. . . the Netherlands has territorial limitations on taxes. That may be desirable, and maybe if everybody had them you could make an argument . . . But obviously that simply wouldn’t be fair to the companies in our country that don’t go abroad. We would have a duel tax system: one for companies that are abroad and one for companies that are domestic. You’ve got a real question about whether that is fair.”

The third point concerns international competitiveness, fairness between our multinationals and the multinationals of other countries.

We need to take all three of those concepts into consideration and it’s not really easy to anticipate where you will come out. If we were going to look at only the lowest common denominator in the world of international taxation, that doesn’t give us a very good guideline. The Arthur Young study makes a point that the Netherlands has territorial limitations on taxes. That may be desirable, and maybe if everybody had them you could make an argument — Leonard Kust, I think, so argues — that this is ultimately where we are going. Maybe so. Maybe we ought to give some consideration to that. But obviously that simply wouldn’t be fair to the companies in our country that don’t go abroad. We would have a duel tax system: one for companies that are abroad and one for companies that are domestic. You’ve got a real question about whether that is fair.

Let me give you an example that we talked about in-house, as to what is the right answer regarding the tax burden on U.S. insurance companies. Prior to 1984, they didn’t have to worry too much about taxes. But now they have a significant tax burden on their foreign operations. This came about simply because Congress felt that they weren’t paying their fair share. The question raised is that because we are making these foreign insurance companies non-competitive internationally, shouldn’t we therefore relieve considerably the tax burden on them. If we try to do that, if we try to equalize the tax burden on U.S. insurance companies operating abroad with taxes on other foreign insurance companies operating in those same countries, we would give them a distinct advantage over competitors in the United States.

“We at Treasury have long supported . . . deferral of U.S. taxation on foreign earnings of multinationals until they repatriate the income. This is certainly so with regard to an active business operated abroad. I think there were inroads on that in the ’86 Act, and perhaps at the appropriate time those inroads should be examined. . . . The Burke-Hartke bill back in the early ’70s was one example of simply eliminating all deferral in a single swipe. We ought to be on our guard . . . because that certainly would make us non-competitive.”

It would make them more competitive internationally, but it would permit them to pay a smaller tax burden than a similar company operating in the United States. Is that fair? The
argument can certainly be made that it's fair to the extent that those activities are non-U.S. source activities and don't touch the U.S. From the other end, if it encourages exporting activities, exporting jobs in some cases, and if it reduces incentives to stay in the United States and produce, that is very clearly one of the concerns we have. This is maybe less of an argument in the insurance area than for manufacturing.

Well, let me skip to the bottom line here. Very clearly, there were substantial inroads on the concept of deferral in the '86 Act, and I am concerned about that. We at Treasury have long supported, and I have long supported, deferral of U.S. taxation on foreign earnings of multinationals until they repatriate the income. This is certainly so with regard to an active business operated abroad. I think there were inroads on that in the '86 Act, and perhaps at the appropriate time those inroads should be examined. That concept should be one that we keep in mind. The Burke-Hartke bill back in the early '70s was one example of simply eliminating all deferral in a single swipe. We ought to be on our guard against efforts to do that because that certainly would make us non-competitive. But, I think, Treasury has consistently supported the deferral concept and not supported unfair inroads on it.

Tax Treaty Program

Next, it is terribly important that we support and expand our tax treaty program. As many of you know, this has been the subject of some considerable debate and challenge. The '86 Act came into being with the treaty override provisions, and the Technical Corrections bill, of course, raises those treaty overrides to a new standard with the residual override. We are actively debating those questions. We have considerable improvement in the current form of the treaty override provisions in the Senate bill. It is not quite where we would like it to be, but we still have some hope that we can continue to improve it. But certainly it is an improvement. However that issue comes out, I think we have to recognize that there is a real challenge to our treaty program.

There is concern — and, you have to concede, some justifiable concern, particularly on the House side, but also in the Senate — that treaties take away some of the decisions made by the tax law, that Congress taxes industry one way and then we come along in a treaty and change that in some respects, with respect to specific companies operating in a specific country. I know Chairman Rostenkowski is extremely concerned about that. One of the examples of that he cites is the FIRPTA provision. The provisions of that Act have been changed by treaty. We need to be very mindful of those concerns. We need to address them intellectually and be honest about them. But we need to be sure the treaty program continues.

Treaties foster exchange of capital, exchange of ideas to the mutual benefit of our multinationals, the U.S. multinationals and multinationals of the treaty partner. In most cases there is, of course, a short-term loss of U.S. revenue as a result of the treaty, but we think that, because of the reduction in rates, over the long haul and even in the near term, the increased trade, increased activity and increased influence of our multinationals abroad will more than offset the short-term revenue loss.
even in the near term, the increased trade, increased activity and increased influence of our multinationals abroad will more than offset the short-term revenue loss. But it is important for all of us not to be casual, not to ignore the arguments and concerns that are being raised by some, particularly on the Hill, with respect to our treaty program. We ought to address those concerns and we ought to be very mind-

"To the extent that we can address the issues of complexity in administrative process by regulations, by safe harbors, by guidance, we ought to do so and we shouldn't waste any time doing that."

ful of them so that the treaty program can proceed and can work.

Go Slow on Changes from the '86 Act

Going back to the more basic question, I suppose I have now both raised and solved not only the procedural question but the international competitiveness question. The question now is, What should we do about it? What will Treasury do about it? What do I personally think about it? I think that we need to go slow in making changes. I am sure that is not what many of you would like to hear, but we just completed the 1986 Act. We are digesting it, interpreting it. We've got to get guidance out. We need to see how it works a little bit. We cannot be, and certainly the Administration cannot be, in the business of now imposing wholesale changes to the 1986 Act, either domestic or foreign. We should continue to study issues of the sort raised at this meeting today to see how significant they are, from the standpoint of both complexity and substance. We should see where that study takes us.

To the extent that we can address the issues of complexity in administrative process by regulations, by safe harbors, by guidance, we ought to do so and we shouldn't waste any time doing that. We certainly would welcome your suggestions. To the extent that it takes wholesale legislative changes of the international provisions to address complexity or questions of competitiveness, I simply think we ought to be careful and not start changing the concepts of the '86 Act too quickly. But we certainly should keep talking about them and I do welcome the opportunity to speak about them and to answer any questions you might have.
Gary Hufbauer

Hufbauer focuses on the tax treaty program. He describes its purpose to encourage international investment and competition by minimizing double taxation. Without the treaty program there would be far less global competition and the administration of national tax laws would be much more difficult, according to Hufbauer.

He traces the history of Congressional "disaffection" with the treaty process, which stems basically from the much smaller role that the tax writing committees of Congress play in the treaty process compared to regular tax legislation. The manifestations of this disaffection are: 1) reluctance to approve treaty incentives, particularly in developing countries, with the result that the U.S. treaty network covers only 22 percent of the Gross Domestic Product of developing countries compared to 46 percent for the treaty network of our major competitor, Japan; 2) benign neglect of pending treaties with a steady lengthening of the approval process by the Senate Foreign Relations Committee and the full Senate; 3) most importantly, a shift in policy toward overriding treaty provisions. Since the Revenue Act of 1962, Congress has become increasingly willing to legislate in conflict with existing tax provisions. New benchmarks for overriding treaties were established by the Tax Reform Act of 1986 and the 1988 Technical Corrections Act.

Hufbauer fears that this trend will erode the treaty negotiating ability of the U.S. and invite foreign retaliation. He says that the future of the treaty program is caught up in the larger debate between the "nationalistic agenda" of restricting imports and foreign investment and the "open world economy agenda" of encouraging international commerce and investment. The direction of this debate will largely control the direction of the treaty program.

Let me start by putting the tax treaty program in a broad context. Two views are now in contention over the proper direction of U.S. international economic policy.

The first view may be characterized as a nationalistic agenda. According to this view, the United States should meet the challenges of the world economy by limiting imports; by monitoring the overseas investment of U.S. firms; and by regulating the "buying of America" by foreign firms.

The second view may be characterized as an open world economy agenda. According to this view, the United States should meet the challenges of the world economy by striving for better quality, higher productivity, greater savings, and better education. Meanwhile, the United States should encourage, not restrict, international commerce and investment.

The U.S. tax treaty program is caught up in this larger debate. If, to my regret, the nationalistic attitude prevails, U.S. tax treaties may come to be viewed as having little value for the United States. If, on the other hand, the open economy view prevails, then tax treaties will continue to be seen as a cornerstone of U.S. participation in the world economy.

As you know, the U.S. income tax treaty program started with the U.S.-French treaty of 1932. (Prior tax treaties focused on narrow topics, such as shipping income.) Over the next five decades, the treaty program went through
several phases, generally broadening the scope of income tax treaties. The United States now has 35 income tax treaties in force. We have wholly or partially terminated 23 tax treaties; and we are now negotiating 16 treaties.

**Combating Double Taxation**

The goal of tax treaties is to combat double taxation. Double taxation has the same adverse impact on international investment that tariffs have on international trade; both act as artificial barriers to international competition.

"Double taxation has the same adverse impact on international investment that tariffs have on international trade; both act as artificial barriers to international competition."

have on international trade; both act as artificial barriers to international competition. The U.S. tax treaty network seeks to minimize double taxation by three mechanisms:

1. By dividing sources of income between taxing jurisdictions and by defining which country is the primary taxing jurisdiction and which country is the secondary taxing jurisdiction;
2. By limiting withholding taxes imposed by the source jurisdiction on remittances of dividends, interest, royalties, and other forms of investment income;
3. By requiring the secondary taxing jurisdiction to establish a foreign tax credit mechanism or an exemption system.

In addition to reducing double taxation, tax treaties have numerous provisions designed to combat tax evasion and to assist tax administration.

The tax treaty program seeks worthy goals. Without the treaty network, there would be far less competition on a global basis, and the administration of national tax laws would be much more difficult. Yet Congress is not entirely happy with the treaty program, for reasons that may be briefly surveyed.

The underlying problem is the Constitutional difference between the enactment of a tax treaty and the passage of tax legislation. In the treaty process, the role of the tax writing committees in the House and the Senate is smaller; and their role is by courtesy rather than by right. This particularly rankles the House Ways and Means Committee.

**Congressional Disaffection with Treaties**

Over the past quarter century, there have been three main manifestations of Congressional disaffection with the treaty process.

First, treaty incentives have come to be regarded as improper. Congress believes that tax treaties should not provide incentives for outward investment by U.S. firms; this view dates from the debates in the late 1960s over the U.S.-Brazil tax treaty. The consequence is that the U.S. treaty network covers only ten small developing countries. By contrast, the Japanese network covers 14 important developing countries, the German network covers 22 developing countries, and the British network covers 37. In economic terms, the U.S. treaty network covers only 22 percent of Gross Domestic Product (GDP) earned by developing nations, whereas the Japanese network, for example, covers 46 percent.

The second manifestation of Congressional disaffection is benign neglect. It takes longer and longer for a tax treaty to be approved by the U.S. Senate. Until 1960, the average time between initial signature and final ratification was about 15 months. That period has now reached 24 months. Much of the delay stems from the fact that treaties must be recommended by the Senate Foreign Relations Committee prior to approval by the full Senate. The Foreign Relations Committee invariably seems to...
have more urgent business than pending tax treaties.

The third and biggest manifestation of Congressional disaffection is treaty override. Under the U.S. Constitution, a treaty, like a Federal statute, acts as supreme law of the land. Accordingly, a subsequent treaty may override a prior statute and vice versa. However, for reasons of international comity, the repeal of treaties by implication is disfavored by the U.S. courts; in ambiguous cases, the courts typically favor the treaty.

With these principles in mind, let us review the interaction between tax legislation and tax treaties. For five decades, the Internal Revenue Code (IRC) recognized the priority of treaties over domestic tax law. This recognition was, in fact, codified in Sections 894(a) and 785(d) of the Internal Revenue Code of 1954.

The policy toward treaties shifted in the Revenue Act of 1962. That act provided for a general treaty override; but the only conflict was with the real estate provisions of the Greek tax treaty (which was soon renegotiated to eliminate the conflicting provision). This episode is a tiny echo of Marbury v. Madison: the Congress established a new principle in a context that had little practical importance.

The Tax Act of 1966 reverted to old ways, and gave precedence to treaties. However, the Tax Reform Act of 1976 overrode treaties relating to calculation of the foreign tax credit, (especially the optional per country method). Likewise, the Crude Oil Windfall Tax Act of 1980 overrode treaties.

In the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), a new formula was first introduced: contrary treaties would take precedence for 5 years (until 1985), giving Treasury time to renegotiate; then FIRPTA would take precedence.

The Tax Reform Act of 1986 expanded the scope of treaty overrides in a significant way. Generally, in the name of preventing tax abuse, the Act extended the branch profits tax to foreign enterprises, notwithstanding conflicting treaties.

"Congress believes that tax treaties should not provide incentives for outward investment by U.S. firms; this view dates from the debates in the late 1960s over the U.S.-Brazil tax treaty."

Treaty partners do not see explicit override provisions of the 1986 Act in the same light as they are viewed by the U.S. Congress, namely as a means of "fighting tax abuse." Instead, they see tax concessions that were negotiated in good faith with the U.S. government unilaterally snatched away by the Congress. The consequences of the treaty override tendency are hard to foretell, but they are worrisome. The negotiating credibility of the United States is eroded. In the end, treaty override invites retaliation.
The analogy with U.S. corn gluten exports to the European Economic Community (EEC) deserves mention. The EEC regards the flood of corn gluten imports from the United States as an “abuse” of the Common Agricultural Policy, an abuse that was not contemplated when the tariff was originally bound at a zero tariff rate many years ago. The United States, however, regards the zero tariff rate as a negotiated and paid-for concession. The United States has often threatened retaliation if the corn gluten concession is unilaterally withdrawn.

With this piece of trade history in mind, the United States should not be surprised if foreign nations retaliate against any U.S. legislative override of tax treaty benefits.
Tax Policy and Foreign Investment

Raymond Haas

Haas reviews Arthur Young & Company's recent study entitled "The Competitive Burden: Tax Treatment of U.S. Multinationals," of which he was the principal author. The study's primary conclusion was that our principal competitor countries abroad impose considerably less burdensome taxation on the international operations of their companies' operation abroad compared to U.S. tax treatment of foreign earnings of U.S. multinationals. This results from the U.S. refusal to accommodate tax sparing provisions — tax incentives offered by other countries for doing business there — and the double taxation of foreign source earnings of U.S. multinationals. This double taxation occurs despite the foreign tax credit mechanism designed to avoid it. Haas blames the situation on a series of legislative changes culminating in the Tax Reform Act of 1986 and on an increasingly restrictive interpretation of tax legislation by the Treasury and Internal Revenue Service.

Three major competitors were selected for the study: Japan and Germany, because they are by any measure our foremost competitors, and The Netherlands, because of its long tradition of engagement in international commerce and because of its radically different treatment of foreign source income. The Netherlands utilizes the exemption or territorial system that allows foreign operations to be taxed in countries where they take place but not in the home country. All three offer their home multinationals considerably more favorable tax treatment than does the U.S., with The Netherlands the most accommodative. Arthur Young also informally surveyed five other major capital exporting nations — Australia, Belgium, Canada, France and the U.K. — and found that these countries also treat their home multinationals less restrictively than the U.S., even if they use the foreign tax credit type of system used by the U.S.

Haas traces just how implementation of the U.S. tax system operates to the disadvantage of U.S. multinationals with a series of examples. He concludes that the exemption system practiced in The Netherlands would be the "right answer" for the U.S. to become more competitive. But if that is not feasible, the foreign tax credit system could be restored to really avoid double taxation instead of promoting it.

As you may know, Arthur Young prepared a study earlier this year entitled "The Competitive Burden: Tax Treatment of U.S. Multinationals". You have a copy of it in front of you, and there is also a four-page handout [see pages 56-57] with a few examples that I hope will make some of the points that have been discussed earlier a little easier to focus on.

Let me start off by summarizing what our study demonstrates. The overall conclusion is that three of our primary competitors impose less burdensome taxes on the international operations of their companies operating abroad. This is true, we think, even though the U.S. rate has been dropped to 34 percent, which is the lowest of all the countries examined, the other
The conclusion we reached is that the U.S. is hurting its multinationals because of two features of the U.S. tax system that are treated differently by the other countries we studied.

First of all, our system overrides any tax incentives that local countries offer for doing business there. This is particularly true in the developing nations and in countries where our competitors have tax sparing treaty provisions. You can find in our study a list of all the tax sparing provisions that exist.

Secondly — and I think this was the point that Secretary Chapoton and Gary Hufbauer were discussing — not only does the U.S. try to pick up the slack when a foreign country offers an initiative but the U.S. company operating abroad may actually wind up being double taxed despite the foreign tax credit which is supposed to avoid double taxation. That is to say that, in many cases even though a foreign operation of a U.S.-owned group is paying tax at a rate in excess of 34 percent, by virtue of a series of technical implementation steps, it’s very, very difficult for a company paying 34 percent overseas to get full credit against the U.S. tax for those taxes paid overseas. In my mind, that is basically double taxation.

What we were trying to do in this study is to create an awareness of a system that is not helping the U.S. economy. I would also like to make a point that the ’86 Tax Reform Act is not a stand-alone culprit. It merely is the latest in a series of laws over the last 25 years or so that have had the same general effect: to increase the U.S. tax cost on U.S. companies operating abroad. In addition to the legislative changes, there is now very clear evidence that the government will change, by administrative fiat, a lot of provisions or practices that have existed for a long period of time. Recently, by administrative process, a long standing interpretation of how that law should stand has been significantly altered in a way that it is estimated will be very expensive to a lot of companies operating abroad. There was lip service given to the fact that this would have a negative effect in terms of international competitiveness, but those of us who have followed the proceedings think that this aspect was not given the highest priority.

Why did we choose Japan, Germany and the Netherlands for our study? Our perception was that Japan and Germany are viewed as our primary international competitors, and we chose the Netherlands because the Netherlands also has a long tradition of being engaged in international commerce, with major multinationals like Unilever (which has gobbled up a lot of U.S. companies recently), Shell and Phillips, all major players. Secondly, the Netherlands has, as was mentioned earlier, a tax system that is radically different from ours. It is an exemption or territorial system that lets foreign operations be taxed in the country where they take place and that is neutral in the home country, in the Netherlands. This deck of countries was not stacked. If anyone is skeptical about that fact, we have also informally surveyed the U.K., Canada, Australia, Belgium and France, five other major capital exporting nations. It is
our conclusion that, on the major points of our study, those countries are either close to the Netherlands or at least much better than the United States, even if they have a foreign tax credit system.

Let me then go to the examples I have handed out to try to make two primary points.

**U.S. Bias Against Repatriation**

Page 1 of the four-page handout illustrates one of the main points of our study: that the U.S. tax law, much more so than that of our competitors, overrides foreign country tax incentives. If you look at the first page, the facts are basically that there has been a $10 million investment in a Singapore operation, the earnings are $1 million, and Singapore, in order to induce its economy’s development, gives a tax holiday. The real question is, What happens in the home country?

If you look down at the second half of the page, the part entitled “Home Country Consequences,” the first line, statutory tax rate, shows the U.S. at 34 percent and Japan, Germany and the Netherlands at higher rates. So your natural first reaction would be that this must be the best place to operate out of.

The second part asks, What is the actual tax due upon the repatriation of these profits from, in this case, Singapore back to the home country? The easiest to dispose of are Germany and the Netherlands. There are no further taxes in Germany or the Netherlands because those two countries, the Netherlands under their domestic law, and Germany by treaty, basically have an exemption system. Germany does have a treaty with Singapore. So the Dutch do it under their domestic law and the Germans do by virtue of their treaty.

Now then we go to Japan and the United States. The U.S. mathematics are pretty simple. It’s 34 percent times $1 million of earnings when repatriated. The Japanese rate is 56 percent, so you would expect to see a tax bill of $560,000. In fact, it is only $230,000. Why is this? Japan has a tax treaty with Singapore. Japan has treaties with a lot of the developing world, and Japan, in this treaty, voluntarily forgoes taxing 33 percent of the income coming back from Singapore. Without tax sparing the Japanese would have levied a tax of 56 percent and change. But by virtue of the Japanese-Singapore treaty, Japan gives a credit for the 33 percent normal Singapore tax even though this tax was not levied because of the tax holiday. Japan gives a credit for that fictitious tax and spares Japanese tax at the Singapore rate. So the actual Japanese tax is not $560,000 it is only $230,000. That’s a permanent saving.

Now, the U.S. $340,000 is paid when the profits are remitted back to the United States.

“**It’s fair to ask, ‘Why does U.S. tax policy penalize the company that repatriates its profits?’ . . . the remittance of earnings to the U.S. parent is a positive factor in the balance-of-payments situation. . . . repatriated earnings add to the capital pool available for domestic investment. . . . I think a tax system should be neutral relating to repatriation. Ours more strongly suggests non-repatriation than repatriation.’**

It’s fair to ask, “Why does U.S. tax policy penalize the company that repatriates its profits?” First of all, the remittance of earnings to the U.S. parent is a positive factor in the balance-of-payments situation. Secondly, repatriated earnings add to the capital pool available for domestic investment. Thirdly, I think a tax system should be neutral relating to repatriation. Ours more strongly suggests non-repatriation than repatriation. Under the other tax systems involved there either is no bias against repatriation, in the case of Germany and the Netherlands, or in the case of Japan, there is a bias against repatriation, but the cost associated with that bias is significantly less than the U.S. tax cost.
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Promoting Double Taxation

The second basic situation is illustrated in the next three pages of the handout. I am going to focus on pages 2 and 3. This second basic scenario is when U.S. companies are operating abroad in high tax jurisdictions. Pages 2, 3 and 4 basically deal in analysis and example form

“Belgian, French or Australian operations of a U.S. company will be subject in those other countries to taxes at the 40, 45, 50 percent level. These are high-tax jurisdictions, and if you want to do business there, you have to pay the tax. The essence of this double tax issue . . . is that the U.S. system taxes repatriated earnings even though they are already taxed overseas at or above the 34 percent rate. On the other hand, none of the other countries surveyed have systems that result in double tax.”

with the area of avoiding, or as I would like to say, in the case of our foreign tax credit system, promoting double taxation. The objective should be the avoidance of double taxation.

For example, Belgian, French or Australian operations of a U.S. company will be subject in those other countries to taxes at the 40, 45, 50 percent level. These are high-tax jurisdictions, and if you want to do business there, you have to pay the tax. The essence of this double tax issue, which we think the analysis and example illustrate, is that the U.S. system taxes repatriated earnings even though they are already taxed overseas at or above the 34 percent rate. On the other hand, none of the other countries surveyed have systems that result in double tax.

If you turn to page 2 and 3 of the handout, you see that our U.S. company here has two types of operations overseas, and let’s assume they are engaged in exactly the same type of business. There is no passive income involved. The only difference is, in case 1, the ownership interest is 100 percent of the foreign operation while in case 2, due to the restrictions of the foreign country in terms of what is permitted, the U.S. company has a less than 50 percent interest. It may want 100 percent, but it is precluded under a local law or practice from doing so. The earnings are $2 million, the taxes paid are $680,000, or an average rate of 34 percent.

Now, looking down at the bottom of page 2, you think that there should be no residual U.S. tax. Two active business operations overseas, 34 percent effective rate, that should be the end of it. Unfortunately, that is not the case. Once again, in the case of Germany and the Netherlands, there is a zero tax regime because of the exemption system. Under the Japanese system, if there is no tax sparing, at the time of repatriation, there might be taxes up to 56 percent taking into account both the foreign taxes and the Japanese taxes. They do have the 56 percent rate, but please keep in mind they have tax sparing provisions with many countries. The big surprise is in the U.S. column. Even though these foreign operations are active, are in the basic core business of the company that the company does in the United States, and even though they are subject to 34 percent foreign taxation, they are once again taxed in the United States.

“Why do we have this double tax in the case of the United States? There are many reasons . . . But probably the worst culprit is the allocation and apportionment of interest and other expenses under the 861(a) and 864(e) rules.”

If you would turn to page 3, I want to point out that in the second half of this page there is an area called anticipated tax consequences and then, beneath that, an area called actual
taxes paid. In the anticipated tax consequences you see that the anticipated home country tax for the United States is zero because the foreign taxes are at 34 percent. On the other hand, in the case of Japan, the additional anticipated taxes are $450,000, that being the differential between the 56 percent rate and the 34 percent rate actually paid on the foreign operations. When you get down to the bottom of the page, in the case of Japan, yes, they do pay $450,000. In the hypothetical example here, the U.S. company has to pay $360,000. The $360,000, together with the taxes already paid, brings the total worldwide rate for the U.S. company up to 52 percent. Now that is less than the 56 percent that exists in Japan, but it does illustrate very clearly the double tax on U.S. operations.

Why do we have this double tax in the case of the United States? There are many reasons and the particulars would obviously relate to the facts of the particular company involved. But probably the worst culprit is the allocation and apportionment of interest and other expenses under the 861(a) and 864(e) rules. This has a very arbitrary effect of causing U.S. company deductions to be treated as expenses against the foreign income thereby eliminating, in a technical sense, the ability to get foreign tax credits for the foreign taxes, but in a more practical sense really arriving at a partial disallowance of interest expense.

Now, one can ask whether in our treaty programs we should be trying to get foreign countries to allow these expenses as deductions against the income in those countries. This would be one way of getting conformity of U.S. tax accounting, if you will, and foreign tax accounting.

Another factor is the baskets-of-income approach which is really quite artificial, as I think was indicated earlier today. This particular company has only one business and no passive income. Merely because one of its foreign operations is not controlled and the other one is, the company cannot, under the separate basket rules, average the two tax rates that exist in the example. These are things that I see in practice on a very frequent basis. These are not outlandish examples.

I would just take one more second to note some of the other things that we found in our study. All countries studied — and I will add to that list the U.K., Canada, Belgium and France — have significant tax sparing provisions with blocs of developing nations.

Secondly, we have our anti-deferral rules, called Subpart F rules, that prohibit the continued deferral from U.S. tax certain income earned by foreign subs of U.S. companies. Some other countries analyzed also have systems like that. They are generally much less onerous than ours. For example, all other countries surveyed would allow their foreign subsidiaries to lend their excess funds back to the home country without creating a dividend equivalent. This would allow cheaper financing for companies struggling to compete. We treat it as a dividend and levy residual U.S. tax at that point.

We are not in the business of recommending specific legislation, but it is my personal opinion that, in the long-term, the right answer is an exemption system. I personally wonder whether that is feasible in an environment with the deficit that we have now. But even if it is not feasible, it seems to me totally appropriate to go back and undo a lot of the things that have been done to the foreign tax credit system so that it ends up being a double tax avoidance mechanism rather than a double tax promotion mechanism.
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"The Competitive Burden: Taxation of U.S. Multinational"

Page 1 of handout

Example of Host and Home Country Tax Consequences for Singapore Tax Holiday Operation

**Host Country Taxation of Foreign Earnings**

- **Investment - Singapore operation**: $10,000,000
- **Earnings**: $1,000,000
- **Tax paid to Singapore**: $0

**Home Country Consequences**

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th>Japan</th>
<th>Germany</th>
<th>Netherlands</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Statutory tax rate</td>
<td>34%</td>
<td>56%</td>
<td>56%</td>
<td>42%</td>
</tr>
<tr>
<td>B. Actual tax due on repatriation of earnings to home country</td>
<td>$340,000</td>
<td>$230,000</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>

The above example shows the tax consequences for U.S. companies with $10 million investment in a Singapore operation, with no tax levied by Singapore itself. U.S. companies have the largest tax burden: they would pay $340,000 in tax on the revenues from this operation. This is much higher than the $230,000 for their equivalent in Japan or the absence of any tax paid by their equivalents in West Germany or the Netherlands. Such a tax burden adds greatly to the costs of U.S. multinational and hampers their ability to be competitive in world markets.

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**Analysis Showing U.S. Double Taxation on Foreign Operations After Tax Reform**

<table>
<thead>
<tr>
<th></th>
<th>Investment in foreign operations: $20,000,000</th>
<th>Earnings: $2,000,000</th>
<th>Tax paid to foreign countries: $680,000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Home Country Consequences</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Statutory tax rate</td>
<td>U.S. 34%</td>
<td>Japan 56%</td>
<td>Germany 56%</td>
</tr>
<tr>
<td>B. Actual tax due on repatriation of earnings to home country</td>
<td>U.S. tax even if foreign income subject to 34% tax</td>
<td>Japanese tax only if foreign tax imposed or considered imposed (tax sparing) if less than 56.4%</td>
<td>None</td>
</tr>
</tbody>
</table>

Double taxation is avoided in the Netherlands and Germany through their exemption systems, and in Japan through its more flexible foreign tax credit limitation rules. As the attached example shows, double taxation is a reality for U.S. multinationals. Two of the primary causes, which are part of the overwhelming array of U.S. foreign tax credit rules, are: 1) the allocation of interest and other expenses against repatriated foreign operating income; 2) the inability to average separate "baskets" of foreign income.

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**Example Illustrating Double Taxation of Foreign Earnings of U.S. Multinationals After Tax Reform**

Facts: Multinational has a 100%-owned foreign subsidiary and a 49%-owned foreign joint venture which all engage in the same type of business operation.

(All amounts in $000s)

<table>
<thead>
<tr>
<th>P &amp; L Statement</th>
<th>Multinational</th>
<th>100%-owned Foreign Subsidiary</th>
<th>49%-owned Foreign Joint Venture</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>4,000</td>
<td>2,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Interest expense (2,000)</td>
<td>(2,000)</td>
<td>(1,000)</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Profits before tax</td>
<td>2,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Tax (FS - 50%, JV - 10%) see top of p. 57</td>
<td>(500)</td>
<td>(100)</td>
<td></td>
</tr>
<tr>
<td>Profit after tax - dividend</td>
<td>500</td>
<td>900</td>
<td></td>
</tr>
<tr>
<td>Withholding tax (6% rounded)</td>
<td>(30)</td>
<td>(20)</td>
<td></td>
</tr>
<tr>
<td>Net received by MNC</td>
<td>1,320</td>
<td>470</td>
<td>850</td>
</tr>
</tbody>
</table>

Foreign Taxes - 680; 34% effective rate on 2,000 earnings

- 56 -
**Anticipated Tax Consequences**

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal tax rate applicable to 2,000,000 earnings</td>
<td>2,000</td>
<td>2,000</td>
</tr>
<tr>
<td>x .34</td>
<td></td>
<td>x .564</td>
</tr>
<tr>
<td>Less: expected foreign tax credit</td>
<td>680</td>
<td>1,130</td>
</tr>
<tr>
<td>(680)</td>
<td>(680)</td>
<td></td>
</tr>
<tr>
<td>Anticipated home country tax</td>
<td>0</td>
<td>450</td>
</tr>
</tbody>
</table>

**Actual Taxes Paid**

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net dividend received</td>
<td>1,320</td>
<td>1,320</td>
</tr>
<tr>
<td>Add back: foreign taxes incurred</td>
<td>680</td>
<td>680</td>
</tr>
<tr>
<td>Domestic gross income</td>
<td>4,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(2,000)</td>
<td>(2,000)</td>
</tr>
<tr>
<td></td>
<td>4,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Tax (U.S. - 34%, Japan - 56.4%)</td>
<td>1,360</td>
<td>2,260</td>
</tr>
<tr>
<td>Less: foreign tax credit (page 2)</td>
<td>320</td>
<td>680</td>
</tr>
<tr>
<td>Residual tax</td>
<td>1,020</td>
<td>1,580</td>
</tr>
<tr>
<td>Less: home country tax on domestic income</td>
<td>(680)</td>
<td>(1,130)</td>
</tr>
<tr>
<td>Net home country tax on foreign income</td>
<td>360</td>
<td>450</td>
</tr>
</tbody>
</table>

**Example: U.S. Double Taxation After Tax Reform**

Foreign tax credit limitation - U.S. system now contains two significant features not found in Japanese system: extensive apportionment of parent company's interest expense to repatriated foreign operating profits and separate foreign tax credit limitations for different “baskets” of income (e.g., non-controlled foreign joint ventures and controlled foreign subsidiaries.)

Assumed facts for interest apportionment: assets of multinational corporation itself; amounts in $ 000.

<table>
<thead>
<tr>
<th></th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home country assets</td>
<td>20,000</td>
</tr>
<tr>
<td>Shares of foreign subsidiary - cost</td>
<td>1,000</td>
</tr>
<tr>
<td>Retained earnings of foreign subsidiary</td>
<td>9,000</td>
</tr>
<tr>
<td>Shares of joint venture - cost</td>
<td>10,000</td>
</tr>
<tr>
<td>Total</td>
<td>40,000</td>
</tr>
</tbody>
</table>

**Japan**

1. Foreign income - Foreign deductions
2. Foreign tax credit limitation (FTCL) = 2,000 - 2,000 (11,000/31,000) x 2,260
3. FTCA - FTCL

**Company Total**

<table>
<thead>
<tr>
<th></th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>FTC (1) or (2)</td>
<td>320</td>
</tr>
</tbody>
</table>
Lawrence explores some major issues in direct foreign investment. To gauge the impact of such U.S. investment abroad on U.S. competitiveness, one must go beyond short-cut definitions and consider the role of multinational corporations beyond national boundaries. National competitiveness is a difficult concept because it is increasingly difficult to ascribe national identities to corporations. Lawrence believes this has a major beneficial effect in keeping international markets open and encouraging international commerce.

Lawrence emphasizes that the U.S. still maintains the highest productivity level in the world despite the relative gains of other countries. Our direct foreign investment has helped produce productivity gains abroad, particularly in Europe, but he sees this as a net gain for the U.S. as well. He cites the result of a recent study showing that the share of world exports held by U.S. multinationals was virtually the same 18 percent in 1983 as it was in 1966. In this sense our trade performance has been much better than measured by the conventional balance-of-payments statistics. And American management, at least management of our multinational companies, which is often criticized for lack of competitive thrust, has not performed that badly. Key questions of economic efficiency here and abroad need to be addressed in the broader context of the educational system, labor-management relations and other factors.

He says it is very important to maintain favorable conditions for U.S. firms to operate abroad. He is concerned, in particular, about the harmonization of economies in Europe scheduled for 1992. This presents both opportunity and risk for U.S. multinationals; opportunity because of the potentially bigger and more competitive market with one set of rules; but also risk if new barriers are erected against U.S. participation. He cites the current dispute with the European Commission over treatment of financial services, whether U.S. financial institutions will be allowed the same freedom of movement within the Community as the European nationals. Lawrence is also concerned about potential “industrial” policies in the U.S. which could exclude foreign competition and invite retaliation abroad.

My remarks are not really going to be addressed to the question of taxes. I am going to deal with direct foreign investment more generally and try to discuss, firstly, what the effects of U.S. direct foreign investment abroad have been on our competitors. Then I will turn briefly to some of the major policy questions in the direct foreign investment area that we face looking out over the next few years.
Tax Policy and Foreign Investment

Firstly, what do we mean by “U.S.” if we take a multinational corporation, such as IBM Europe? If IBM Europe does well, is this an improvement in U.S. competitiveness? If Honda USA does well, is that an improvement in U.S. competitiveness? Well, obviously, the answer depends what stance you want to take.

There are two definitions of what we mean by “U.S.” One refers to nationality: American corporations around the globe are U.S. nationals. And the second refers to residence. So when answering the question and appraising American competitiveness, one has to deal with both of these questions. Are we looking at U.S. capital and management, including those in the concept? Or are we only considering U.S. workers and firms resident in the United States? I think many of the tensions that we see in the policy discussion that Gary Hufbauer referred to earlier come from this tension between the nationalistic, or rather a residence view of what we mean by “U.S.” and an international view, which is a much broader concept. And both of these are clearly key in thinking about what impact U.S. direct foreign investment has on our competitiveness.

My own view is that this blurring of what we mean by U.S. competitiveness is very beneficial for the long run. Indeed, national competitiveness is having less meaning, in my judgment, precisely because it is increasingly difficult to ascribe national identities to corporations. As the Japanese come here, that is also being achieved. And indeed, I think, direct foreign investment is a major vehicle keeping markets open today because of the difficulty of ascribing nationality.

When you come to the second notion of competitiveness, it gets even more murky. Competitiveness is a word like love or democracy. It means very different things to different people. And when I listen to people talking about it, I think they really use that term in at least three distinct senses. Let me touch on each of those and discuss how direct foreign investment affects it.

Sometimes when people talk about competitiveness, they are actually asking the question, “How does the United States compare?” Take some desirable achievement of an economy, take absolute levels of productivity, output per worker, how does the United States stack up against other countries? A second use of the word is how we perform in international trade. That’s very different. Then there is a third concept, which I happen to believe is the most important, which is, “Are we efficient? Are we, in a sense, doing the best we can?” And, let me touch on each of those, because that third concept takes you into the policy dimension.

Productivity Comparison

Firstly, how does America compare? Well, the one standard, if we look at our absolute productivity levels, what’s striking is that we remain number one. The United States continues to provide its citizens with the world’s highest living standards. American output in manufacturing per worker remains the highest in the world. That is not true in every industry. The Japanese have approached our levels on average, and they are ahead of us in certain ways. Now the second key point is, of course, that the relative position has shifted dramatically. Our predominance was on the order of 50 percent higher at the end of the war compared to European productivity levels. Today, Germany is probably 85 percent of our levels. So there has been a dramatic convergence of foreign productivity levels with ours.

Now, what role did direct foreign investment play in that? I think if you look back, it’s clear that the diffusion of U.S. technology abroad was a major feature in bringing foreign economies much closer to American productivity levels. And direct foreign investment abroad has been a major part of that diffusion. So if you want to take the definition of competitiveness as our relative position in the world, I think you will conclude overwhelmingly that
The U.S. Stake in U.S. Foreign Investment

direct foreign investment abroad has changed our relative position, indeed, has "hurt" it. Now in my judgment, that doesn't mean to say this has been undesirable, because I don't look on competitiveness in this fashion as being very important. Most economists, indeed, tend to concern themselves much more about absolute living standards than they do about relative living standards, and it is clear, to me at any rate, that there have been major benefits to the U.S. from this direct foreign investment abroad. Be that as it may, if you take our relative position, direct foreign investment has contributed to a relative decline.

Trade Performance

What about trade performance? I think here we have had a long debate in the literature, which is basically inconclusive. There are plausible cases that you can make that sometimes direct foreign investment is a complement to our exports. At other times, you can argue that it is a substitute for exporting from the United States. We have numerous studies; some show one thing, some show the other. A lot depends on who's doing the study. So, I think, in fact, it's inconclusive, and there should be no surprise about that.

What is striking, actually, is that we have had a recent study by Cravison-Lipson who have uncovered the following interesting fact: if you look at the share of world exports held by U.S. multinationals, remarkably perhaps, you find no decline over the post-war period. They find that the share of world exports held by U.S. multinationals was 17.7 percent in 1966 and the same 17.7 percent in 1983. That is very striking, and it highlights again this distinction between how U.S.-run multinational companies have done, on a global basis as compared to what the U.S. as a geographic area has done. There, there is a decided decline in our share of the world markets. But, indeed, the particular performance of U.S. multinationals raises some questions, important ones, in trying to diagnose what the nature of America's competitive problems are.

Some people allege that our key competitive problems lie in management. They say our managers are short-sighted. They don't look at the long haul. They are too responsive to equity markets. Others say it is the cost of capital which gives our management a tremendous disadvantage. I find it very striking, if you accept Cravis-Lipson's evidence, because it suggests that maybe our managers aren't that bad. These companies around the world have not really done worse than their competitors, and they are being managed by people who are presumed, ultimately, to be responsive to American equity markets; and indeed, listening to the discussion today, who are being subjected to these discriminatory tax provisions that the U.S. is applying.

Nonetheless, American management has not actually performed that badly, if you look at the performance of multinational corporations. That is a striking contrast to what's happened in the United States itself. One is led to look more to geography, to look more at, say, our educational system and the way, maybe, workers and managers get on in this country, rather than simply to ascribe it to poor management.

... it's clear that the diffusion of U.S. technology abroad was a major feature in bringing foreign economies much closer to American productivity levels. And direct foreign investment abroad has been a major part of that diffusion.
Key Questions on Efficiency

Let me just turn, finally, to that key question which has to do with efficiency. Are we doing the best we can? I think that's the most important question. I believe that direct foreign investment is good for the United States when it represents an undistorted choice. I think we all agree that neutrality should be the objective, and I think that, in fact, we are facing some major challenges looking out into the future—not simply in the tax area.

Firstly, for American residents, there is much we have to do to insure our competitiveness. Part of this comes from the fact that we are in integrated global markets and we can no longer afford to presume that companies are forced to produce here. This refers not only to the role of the exchange rate in determining the cost of production in the United States but clearly to factors like our education, our technology, our regulations and our taxes.

Secondly, we have to insure favorable conditions for U.S. firms abroad. Here, there are key issues being decided currently on the rules of the game. I agree with the objectives that we have laid out. We have made headway in the U.S.-Canada trade area, in these matters. Maybe we haven't done as much as we could have done, but certainly we have made progress.

European Harmonization

Our attention now must turn to Europe and the GATT. I am specifically interested in what is happening in Europe. I think that, broadly speaking, a single European market is a very positive development for the United States. It's really not the details of that development, but quite frankly, Europe needs a shot in the arm. I think that the 1992 movement can give it that. I see European corporations and U.S. corporations, indeed, starting now to take strategic moves motivated by 1992 which they would never have contemplated otherwise. Injecting competition, particularly in parts of the European economy such as the services sector, the ones that are considered to be non-traded, can be a vital contribution to Europe. It is in the U.S. national interest to see Europe grow, and that's going to be the number one benefit.

The number two benefit is that U.S. corporations essentially do take a more multinational perspective, and being able to move freely across those market places is going to be very beneficial. Our major problems lie in the possibility of the erection of new barriers. We have seen very worrying signs about that coming out of the Commission. Just to name one, take the clash that we are having with the Europeans potentially in financial services. The United States is calling for national treatment, essentially allowing U.S. financial institutions located in London, say, or anywhere around Europe, to have the same freedom of move-
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Immediately and quote that back to you as soon as you start to deal with other areas. I am particularly concerned currently about the high-tech areas. We have a number of new industrial policies underway in the United States. Take Semitech, for instance, or our superconductivity program. We are excluding foreign companies from participating in those programs, and lo and behold, we now find moves in Europe to exclude our multinationals from full participation there. It hasn’t quite happened. The reverberation around the globe is extremely important. We have to monitor our own activities because we are in this global arena and the situation is very sensitive currently.

I believe that multinationals will help in keeping markets open. I think that is key, that by having one another’s companies in others’ nations, we’re providing “hostages” of a sort. That really is a benefit in keeping these markets open. I also feel that these companies in direct foreign investment will be the major victims if we don’t succeed in this development.

When you compare the goods area to the services area, you should be aware now, looking at Europe, about the benefits of the GATT. We maligned it continuously, but the fact is we have agreed on those external borders that encircle the European community, and so we can be more secure. At least we have a legal redress when it comes to insuring that Europeans don’t take advantage of forming an internal market to raise barriers. It’s clear that that has to be our major priority looking ahead into the future.
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