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Development Committee - Task Force on Private Foreign Investment 1979-81

(2)

R81-129/2

FROM: Vice President and Secretary

June 15, 1981

STUDY RECOMMENDED BY DEVELOPMENT COMMITTEE

TASK FORCE ON PRIVATE FOREIGN DIRECT INVESTMENT

By the President's memorandum dated May 20, 1981 entitled "Study Recommended by Development Committee Task Force on Private Foreign Direct Investment" (R81-129), it was recommended that the proposal contained therein be approved in the absence of objection by the close of business on June 5, 1981, and be further extended to the close of business on June 12, 1981 (R81-129/1).

In compliance with a request from an Executive Director received on June 12, 1981, the President's memorandum entitled "Study Recommended by Development Committee Task Force on Private Foreign Direct Investment" (R81-129) will now be included in the agenda for a meeting of the Executive Directors on a date to be determined.

Distribution:

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Document Date	Document Type	
07 January, 1981	Memorandum	

Correspondents / Participants
From: M. M. Ahmad
To: Mr. Hans-Dieter Hanfland, EDS

Subject / Title
Development Committee Office Memorandum regarding edits to a paragraph on report of task force

Exception(s)
Information Provided by Member Countries or Third Parties in Confidence

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A.May	April 28, 2025

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File Title	Barcode No.
Development Committee - Task Force on Private Foreign Investment - 1979 through 1981 - Volume 02	30021229

Document Date	Document Type	
10 January, 1979	Memorandum	

Correspondents / Participants
From: Sir Richard King
To: Mr. E. Stern and Mr. E. Sturc

Subject / Title
Development Committee Office Memorandum
Task Force on Private Foreign Investment

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Additional Comments

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A.May	April 28, 2025

JOINT MINISTERIAL COMMITTEE
OF THE
BOARDS OF GOVERNORS OF THE BANK AND THE FUND
ON THE
TRANSFER OF REAL RESOURCES TO DEVELOPING COUNTRIES

(Development Committee)

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DC/TF/PFI/80-5

January 25, 1980

TASK FORCE ON PRIVATE FOREIGN INVESTMENT

The attached paper by Mr. Robertson discusses investment incentives in home and host countries. It will be discussed by the Task Force at the meetings in Washington to be held on February 19-20.

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INVESTMENT INCENTIVES IN HOME AND HOST COUNTRIES

Paper for IMF/IBRD Development Committee
Task Force on Private Foreign Investment
in Developing Countries

David Robertson
Treasury, Canberra
January 1980

Terms of Reference

The paper would initially outline the types of investment incentives offered by home and host nations to international investors (e.g. fiscal and other tax-related incentives, border tax and other trade related incentives front-end cash grants and subsidies, operating grants and subsidies). It would be useful if the paper included a representative illustration of incentives offered by a sample of home and host nations. The paper should then assess the effects of incentives by dealing with the following questions:

1. Do host nation incentives draw investment to developing nations which otherwise would not go there?

2. Do developing nations compete with one another for international investment by means of incentives?

   (a) If so, how great is the problem?

   (b) Can magnitudes of transfers to investors as a result of investment incentives be estimated?

3. Do home nations' incentives cause investment to stay at home which might otherwise go to developing nations?

4. On balance, do investment incentives of home and host nations collectively result in a global economic "dead weight" loss? In a net loss or gain to developing nations?

It is recognized that many of the issues posed above cannot be easily or definitively addressed; the paper is to represent a best effort to address issues within time constraints.

Task Force Secretariat
July 1979

INVESTMENT INCENTIVES IN HOST AND HOME COUNTRIES

INTRODUCTION

Private foreign investment is undertaken in anticipation of profits and occurs where viable markets for outputs are expected to exist for the life of the productive asset created. Government policies to provide incentives for investment, therefore, can only marginally affect the attractiveness of investment opportunities by increasing expected profits and/or reducing the uncertainty associated with those expected profits.

The paper written by Professor J.H. Dunning that was discussed at an earlier meeting of the Task Force established that three groups of variables influence foreign direct investment decisions:

- product-related variables
- company-related variables
- country-related variables.

This paper relates mainly to the third group of variables. The most important considerations in this group are general economic conditions, which are to some extent influenced by general economic policies.* Many governments also employ measures designed to stimulate or restrict foreign investment of particular types or in specific regions or industries. Empirical studies (cited in Dunning) have suggested that these incentives (and disincentives) are not a significant determinant of foreign investment flows, but the fact that governments continue to implement such measures indicates that further study is required.

The range of government interventions influencing foreign investment decisions encompasses many policies in host and home countries, and in third countries, and some of these policies may not be primarily designed to influence private foreign investment. It is necessary, therefore, to limit the scope of this paper to policy instruments designed to affect directly private foreign investment flows into developing countries, both on the part of capital-exporting and host countries, and certain other measures which have a strong influence on international private investment flows, even though this impact may be secondary to another policy aim.

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* See references in paper by Professor J.H. Dunning.

It is also necessary to recognise that private foreign investment is no longer restricted to equity participation and the traditional MNE package. New forms of participation have evolved to meet the changing climate of opinion towards foreign firms in host countries. These new forms of participation include:

- technology transfers, with or without equity participation;
- technology transfers in combination with management contracts, and management and technical training;
- tripartite agreements and new forms of joint venture;
- export marketing agreements and subcontracting.

These new forms have arisen as a response to the rise of nationalistic trends and policies in many developing countries which have caused difficulties for MNE subsidiaries, and because they offer greater stability and reduced risks to MNEs. The traditional MNE package evolved in the second quarter of the 20th century as the most profitable means of operating in a world separated into distinct national markets by trade barriers and where markets for important business inputs (technology, management, finance, raw materials) were imperfect or non-existent. This led firms to 'internalize' operations and retain control of their activities by foreign direct investment. The new trends distinguished above represent a movement towards the creation of new international markets for intermediate goods and services, which involve contractual arrangements between suppliers of these inputs and purchasers who are unrelated to the suppliers.

The new forms of participation have evolved slowly over the last decade or so and they represent the outcome of several forces acting within the world economy:

- host governments have improved their knowledge of MNE operations and devised more effective policies to obtain required components of the MNE package at lower cost;
- cost consciousness in advanced industrial countries has made access to low-cost labour and raw material supplies an important consideration for MNEs;

- the increase in the number of firms engaging in overseas operations has increased competition between them and resulted in new forms of business activity;

- growth in the number of enterprises, government and semi-government bodies seeking to purchase intermediate inputs, such as technology, finance, management etc, has created genuine markets in intermediate inputs;

- alternative sources have become available for some intermediate inputs from state-owned enterprises (eg East European enterprises,* Arab banks, international agencies (UNDP)).

Incentive and disincentive policies in host countries, which fall in the first category, have caused MNEs to refine their operations and make them more compatible with host governments' aims. MNEs are global maximisers with operational mobility (at least in the medium and long term) and they seek to adapt continually to changing economic conditions. Host governments, on the other hand, seek to maximise net benefits from private foreign investment.

On the whole capital exporting countries have had little reason to be concerned about foreign investment outflows except for periodic restraints for balance of payments reasons. Generally, any effects on private foreign investment outflows have been secondary consequences of policies designed for other purposes, such as regional policies or general investment incentives at home. However, in recent years there have been increasing concerns among some groups in some capital exporting countries over 'exporting jobs' and losing technological advantages, especially in the US and the UK.

Many capital-importing countries and especially developing countries, choose to implement certain policies to influence international flows of investment or to induce foreign investment for particular policy objectives. Three main aims are apparent:

i) to attract private foreign investment and increase total investment;

ii) to channel private foreign investment inflows into preferred activities;

iii) to regulate the operations of MNEs.

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* C.H. McMillan, Growth of external investments by the COMECOM countries, The World Economy, September 1979

The policies used to pursue these aims may involve subtle uses of economic signals using the price system or the application, or waiver, of specific administrative controls.

The purpose of this paper should be to consider the effectiveness of these policies in achieving the intended aims of governments and to assess the respective efficiencies of the different types of measures employed. There is a marked lack of empirical research into these questions so the examination that follows is largely qualitative and the conclusions are impressionistic.

CLASSIFICATION OF INCENTIVES AND DISINCENTIVES

As a first step it is necessary to classify the great variety of incentives and disincentives employed in host developing countries, and by capital-exporting countries to promote private foreign investment. Three alternative forms of classification are possible:

(a) By objectives - i) increase total investment
ii) achieve specific development
iii) increase local participation/ownership

(b) By impacts - i) alter factor costs
ii) alter product prices
iii) increase range of production
iv) increase after-tax cash flows
v) reduce uncertainties

(c) By types of instruments

i) administrative controls (or exemptions)
ii) foreign exchange controls
iii) financial measures, including credit arrangements
iv) direct tax-related incentives (depreciation, tax-holidays etc.)
v) indirect taxes (tariffs, subsidies etc.)
vi) grants in cash or kind.

Alternative (c) allows the most clear classification. Many instruments used as incentives or disincentives could fall under more than one of the classes in the other two classifications. For example, a tariff intended to expand production in an import-substituting industry could fall into i) or ii) in classification (a), and ii), iii) or iv) in classification (b).

Investment incentives and disincentives in host and home countries* in tables 1(a) and 1(b) and 2 have been classified according to alternative (c).

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* Investing, Licensing and Trading Conditions Abroad, Published by Business International Corp.

INCENTIVES AND DISINCENTIVES IN HOST COUNTRIES

Direct foreign investment in developing countries (excluding oil-producing countries), which accounts for about one-quarter of foreign direct investment in all countries, is concentrated in ten countries, which in 1975 accounted for over 40 per cent of the total in developing countries. Nine of these countries are middle-income developing countries (NICs), which have been receiving an increasing proportion of direct foreign investment flows to developing countries during the last decade. The tenth country, India, is a low-income country.

The incentive schemes of 8 developing countries have been examined; six drawn from the ten countries mentioned above, the other two are Indonesia and Korea. These give a reasonable cross-section of developing countries, except that there is no country drawn from the least developed countries of Africa, which tend to be small and low-income and because of this do not have sophisticated development policies and tend not to receive much private foreign investment. All the countries in this sample receive a substantial share of foreign direct investment. The importance of foreign firms in total investment, however, varies among the countries. The very large countries, like India and Brazil, would be expected to attract a large proportion of foreign investment even though it may be only a small proportion of total investment.

Two of the eight countries covered in this survey, Brazil and Mexico are middle-income Latin American countries which have large stocks of foreign investment; two are low-income countries, India and Indonesia; two are island economies, Hong Kong and Singapore; and the last two, Korea and the Philippines are middle-income Asian countries which, like Mexico and Brazil, have relatively large domestic markets.

The incentive schemes employed by many developing countries are geared specifically to encouraging foreign investment, rather than investment in general. There has been some change in the character of these incentives over time, with progress from expensive, non-discriminatory incentives in earlier years to more specific performance-oriented policies and more attention to measures that encourage development of locally-owned enterprises or of local participation in new foreign ventures. As a consequence, most of the developing countries that have successfully attracted foreign investment now make extensive use of administrative controls to regulate the activities and behaviour of private foreign investors (see tables 1(a) and (b)). At the same time, many governments have become more selective among foreign investment proposals, introducing screening systems and using incentive measures selectively.

Among the eight countries surveyed, Hong Kong is the only one which has almost no special incentives scheme to encourage foreign investment. Instead, Hong Kong relies on its free port status, low tax rates, good infrastructure, freedom from government interference, political stability and capital availability to attract potential investors.

All the countries have set very specific development objectives in association with their incentive schemes. Countries like Singapore, Korea and Hong Kong, which are highly industrialised, lack natural resources and have small domestic markets (except Korea), but have highly-skilled labour forces, place emphasis on highly technological, skill-intensive and export-oriented manufacturing industries. Brazil, Mexico, Indonesia and the Philippines are concerned to encourage foreign investment that assists regional development and development of priority industries (eg import-substituting industries, heavy industries and producer-goods industries). India, however, displays a rather different and more restrictive attitude towards private foreign investment. Although regional development remains an important objective, foreign investment is permitted only in those industries which are export-oriented and for which technology is not available locally.

Types of Instrument Employed

Hong Kong and Singapore adopt a liberal and welcoming attitude towards private foreign investment. The other six countries, however, impose restrictions on the activities of foreign investors. The most common are limitations on foreign equity or minimum local-equity participation and control, local content requirements, restricted access to local financeng and price controls.

The extent of foreign exchange controls vary considerably among the countries. Singapore, Hong Kong and Mexico do not have any foreign exchange controls; the Philippines have restrictions on the repayment of foreign loans; Indonesia restricts capital remittance while the foreign investor is receiving tax incentives; and Korea, Brazil and India have fairly rigorous systems of exchange controls, whereby all capital flows require approval. India also provides special foreign exchange allocations for export-oriented firms and priority industries.

As capital resources are generally scarce in developing countries, incentives that involve the provision of capital funds to foreign investors are relatively insignificant, and usually available only to foreign firms that are in partnership with local firms (eg Korea). Government loans and equity participation are generally available for high priority projects only. Indonesia does not offer any financial incentives.

The most common incentives offered by developing countries are the tax-related incentives. Apart from Hong Kong, all the other countries offer tax holidays and tax concessions on corporate incomes, accelerated depreciation of industrial plant and buildings and exemptions from import duties. Exemptions from other taxes, eg withholding tax, capital gains tax, property tax, etc. are also provided in some countries.

As with the financial incentives discussed earlier, grants in cash and kind are relatively unimportant. India is the only country offering cash grants based on the value of capital investment, but as its foreign investment policy is so restrictive, it is unlikely that many foreign investors would be able to take advantage of it. Korea provides grants for export financing, but these are provided only to foreign firms operating in joint-ventures with local firms. Brazil and Mexico provide free land for plant sites. Hong Kong provides land at concessional rates, for approved projects. The other countries, Singapore, Indonesia and the Philippines do not offer any such incentives to foreign investors.

INCENTIVES AND DISINCENTIVES IN HOME COUNTRIES

Among the developed net capital exporting countries, the United States, Japan, Germany and the United Kingdom account for the largest direct investment flows to developing countries.

Measures to discourage private foreign investment outflows

The policies undertaken by these countries are primarily directed towards encouraging domestic investment and encouraging foreign investment inflows rather than discouraging foreign investment outflows to developing countries. To the extent that these policies result in domestic investment being more attractive than foreign investment outflows, however, (eg lower costs of production or higher after-tax profits for a manufacturer producing for the domestic market) they would serve to discourage private foreign investment flows to developing countries.

Incentives offered by these countries are designed to achieve specific economic objectives in addition to increasing the overall level of investment (Table 2). In all the four countries, priority is given to regional development, and with the exception of Japan (which still has a relatively tight labour market), to job creation. Japan is, however, concerned with social development and environmental protection (incentives are offered to encourage firms to move out of crowded industrial centres and to adopt anti-pollution measures) and the development of "key industries".

Principal measures employed are the provision of low cost financing and direct tax incentives, namely accelerated depreciation and corporate tax exemptions or concessions. Among the countries, only Japan has continued to use quotas and import licensing extensively to insulate local industry from foreign competition - tariffs are still common to all the four countries. Grants in cash and kind are more important in UK and Germany. They include grants based on the cost of capital goods, wage subsidies, assistance in training workers, low utility rates, cheap land, free construction of road and rail links, research and development grants, etc.

The incentives are available to both foreign and domestic investors generally, except in Japan where only domestic investors are eligible. With the exception of the UK, the incentives are not easily available to investors. In the US only "new investors" and "small businesses" would be considered; in Japan "key industries" and social development projects; and, in Germany, industries setting up in West Berlin and border areas.

Measures to Stimulate private foreign investment outflows

The development of policies and measures in DAC member countries to stimulate private foreign investment in developing countries has grown in parallel with their official aid programs.* While official aid has been used predominantly to provide social and economic infrastructures, private investment has provided the bulk of the external contribution to the directly productive sources. Donor governments, therefore, have sought to encourage private foreign investment in developing countries, especially with incentives which can be selectively applied to sectors and projects which are of notable developmental value.

The incentive programs offered vary considerably among countries, particularly with regard to the range of measures offered and the period of operation of the schemes. The various measures employed can be categorised as follows:

1) investment insurance and guarantee schemes covering "political" or "non-commercial" risks ie risks which are outside the investor's control and for which no commercial insurance is available;

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* OECD-DAC, Investing in Developing Countries (OECD, Paris 1975)

2) direct tax-related incentives for investment income from developing countries;

3) information and promotion activities, particularly in the financing of pre-investment and feasibility studies;

4) provision of "risk capital" (loans and equity) and related financial services to local projects through government-sponsored investment corporations, and/or directly to investor from home country;

5) provision of technical assistance.

The United States, Germany and Japan have offered a relatively broad range of incentives for investment in developing countries for many years (Table 3).* Together with the United Kingdom, they account for by far the highest levels of investment in developing countries among the net capital exporting developed countries. An analysis of their incentive schemes shows that very similar approaches have been adopted by all four countries.

In all four countries investment insurance/guarantee schemes are operated by the government to give protection to enterprises investing in developing countries. The terms of these schemes are very similar, ie 90%-95% coverage of new capital investment (equity and loan), retained earnings and remitted profits, up to 15-20 years, against political risks - expropriation, war and transfer risks. Germany and the US also operate a separate guarantee scheme for funds provided by institutional lenders. The political risks of investing in developing countries may also be reduced by inter-government investment agreements - both Germany and Japan have concluded bilateral agreements with a number of developing countries.

Fiscal incentives have generally been limited to double-taxation agreements and (excluding UK) tax credit for losses incurred in operations in developing countries. Germany, however, offers additional incentives in the form of deferred taxes on retained earnings used for further investment in developing countries, as well as profits generated by these investments.

Apart from the UK, there is active government support in providing information on promotion of investment in developing countries, both through private and government-sponsored organisations. Financial assistance with pre-investment surveys is given by Germany, Japan and the UK (the latter on host country government request only).

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* Investing in Developing Countries (OECD, Paris 1978)

In all four countries, direct equity and debt investment are undertaken by the respective government in major development projects, through host country financial institutions, or regional development banks. Loans may also be provided to home country enterprises to facilitate investment. The provision of these funds may (Japan), or may not (Germany), be tied in with the procurement of goods or services from the home country.

Apart from Germany, measures undertaken by the government to provide technical assistance to developing countries appear quite significant. In the US and Japan the effects are channelled through various private organisations which provide technical and managerial assistance to private businesses. In the UK, industrial training is provided to nationals from developing countries.

ANALYTICAL BACKGROUND

In view of the frequent recourse by governments to investment incentives and disincentives, it would be expected that strong support for these policies would be found in economic theory. This is not the case.

It is well established in economic literature that capital inflows resulting from government interventions that cause distortions in market prices may lead to income-reducing effects in the capital-receiving country.* In the case of a tariff on imports, for example, the reduction in national income may be decomposed into three effects:

i) the loss due to tariff created distortions in consumption and production;

ii) the loss or gain that arises from the distribution of investment in the presence of a tariff, even for nationally-accumulated capital;

iii) the loss arising when foreign profits are repatriated.

Effect i) is the income (or welfare) loss normally associated with the imposition of a tariff. The net effects of ii) and iii) are specifically associated with additional capital attracted into the protected industry. If foreign profits are taxed before they are

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* J.M. Bhagwati, "The theory of immiserizing growth : further applications" in M.B. Connolly and A.K. Swoboda (eds) International Trade and Money (1973); H.G. Johnson, "The possibility of income losses from increased efficiency or factor accumulation in the presence of tariffs" Economic Journal (1967)

allowed to be repatriated the extent of income losses arising from tariff-induced foreign investment would be reduced. As long as the tariff remains in effect, however, the price distortions it causes will prevent national income from being maximised.

This analysis can be extended to cover other types of intervention policies, such as tax concessions, production or export subsidies, investment grants, financial assistance, or any other measures that affect relative prices or costs. Some of these policies may be used to attract inflows of other resource inputs, such as technology, management, organisation, etc. These inflows augment existing resources in a similar fashion to capital inflows and would be expected to increase productive potential, but depending on the circumstances surrounding the incentive policies the actual effects may be to reduce national income (welfare) in the community.

These arguments are easily generalised. If policies are introduced that lead to an inflow of foreign resources into a country, that country's terms of trade* will tend to improve if these additional resources are used intensively in the country's imports, but deteriorate if they are employed intensively in the country's exports. According to the theorem on tariffs and capital inflows explained above, these inflows may then lead to a reduction in income. The introduction of an optimum tax or subsidy on these inflows will ensure that national income is maximised,** but inppractice determining the optimum tax/subsidy is not feasible. All other arguments for restrictions on international flows of capital or other resources, however, are either non-economic (in which case the costs of these aims needs to be known) or 'second best' arguments that may or may not improve income (welfare), depending on circumstances.

The case for incentives to attract foreign investment, then, must be founded on something other than the comparative statics arguments that establish that a policy-induced capital inflow may lead to a reduction in income in the capital-receiving country. It would appear to rest on the presence of some distortions in markets before the incentive measures were introduced. That is, the industry receiving the new investment is potentially competitive on world

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* The extent of changes in the terms of trade depends, of course, on the structure of international markets and the size of the country concerned (ie its importance in international trade).

** R.W. Jones, "International capital movements and the theory of tariffs and trade", Quarterly Journal of Economics, February 1967

markets but some kind of entry-fee or threshold has to be overcome before efficient production is achieved - the traditional infant industry arguments. Assistance to infant industries, however, must be based on the presence of "externalities" and it should be time-limited if it is to achieve its aim of creating an internationally competitive industry. If import substitution eventually gives way to exports from the assisted industry, the national income may be raised above the free trade optimum attainable before the incentives were introduced, even allowing for foreign earnings that may be repatriated.

Policies to restrict or stimulate foreign investment fall under the heading of 'second best' alternatives. Apart from the ability to tax earnings of foreign capital, the gains for the host country arise from lower prices to consumers and the effects on incomes of indigenous factors - that is, by appropriating some of the economic rents earned by foreign firms for their superior resources or organisation (or their monopolistic position). Yet the immediate effect of investment incentives is to increase the economic rents accruing to foreign investors, in the same way that import tariffs augment domestic producers incomes. And if an investment would have been undertaken without the incentive then the incentive measure, whatever its form, will serve merely to increase the rents that would accrue to the foreign investor. This does not, of course, mean that no benefit accrues to the host country, only that any net benefits could have been greater if the policy costs could have been avoided, or reduced.

The whole subject of investment incentives and disincentives, therefore, comes under the theory of 'second best' which states that in the presence of economic distortions any instruments employed to offset the distortion may or may not increase national income depending on the circumstances. This makes it very difficult to evaluate the effects of investment incentives and disincentives in any general fashion. To assess the effects of any particular incentive (or disincentive) measure it is necessary to define the alternative position - that is, what would have happened in the absence of the measure. This kind of exercise is extremely difficult to carry out in practice, since there are many alternative positions and, frequently, interrelationships between the parameter changed and other parameters.

THE EFFECTIVENESS OF INCENTIVES

Investment decisions are based on many considerations and incentive instruments are only one consideration. Studies cited in Dunning's paper have shown that incentive measures appear to have little influence on foreign investment decisions. Nevertheless, many host governments persist with these policies, and continue to devise new instruments, which suggests that governments still believe they have a significant impact on investment decisions.

Attempts to measure the impact on total investment flows of all incentives as a group are unlikely to produce significant results because of the conflicting aims of some of these instruments and the complex interactions and overlaps of the ranges of instruments employed to influence investment flows in host and home countries.

For example, incentives may develop from a series of government interventions relating to the same investment decision. A tariff may be introduced to encourage the development of import substitution in an industry or sector, which gives rise to excess profits being earned by a foreign firm that enters the market. If these profits are largely remitted back to the parent company, pressures will develop in the host country to apply exchange controls to restrict repatriation of profits. If introduced these exchange controls may encourage the MNE to modify its inter-affiliate pricing policies in order to repatriate income, by overcharging on imports, royalties, management fees etc or undercharging for exports by the subsidiary. This may lead to further regulatory measures. As the returns for existing investments in the country decline, foreign investors will be discouraged from new investment. To overcome a decline in new investment, the government may decide to seek new investments in export industries by providing tax holidays, tax-free industrial areas, low-rent factories etc, and if successful these new industries may attract workers and other resources away from the protected import-substituting industries - which will offset the initial effects of the tariff! This kind of escalation and overlapping would make it very difficult to measure the effects on income in the host country.

Different countries' policies can also come into conflict and make evaluation of one country's policies difficult. If one host country offers tax concessions to attract foreign investment and another host country that is an alternative location for a particular investment introduces similar tax arrangements, there

will be direct competition between these countries. Incentive instruments may also have reinforcing effects. If a developing country offers a tax holiday for foreign investment in a particular industry, it encourages the investor to take out profits, and if a home country or tax haven also offers concessions on remitted incomes the outflows from the developing country will increase. The developing country is presumably concerned to maximise benefits from the investment attracted and the result of a tax holiday could be quite the reverse under these circumstances.

These examples indicate some of the difficulties associated with empirical studies on the effects of incentives in developing countries. Nevertheless, some studies have been made.

Root and Ahmed* tested 44 economic, social, political and policy variables for their significance in discriminating among 41 developing countries divided into 3 groups; "unattractive", "moderately attractive" and "highly attractive" with respect to foreign investment in manufacturing. Six variables were found to be statistically significant determinants in this discriminant analysis:

- per capita GDP
- extent of urbanisation

} (market size)

- commerce, transport and communications (infrastructure)
- frequent changes in government (political stability)
- ratio of exports to imports (import capacity)
- corporate tax level (host country policy)

The first five variables could be anticipated after reading Dunning's synthesis. Only the last variable relates to government policy directly.

The study found that tax rates in the "unattractive" group were markedly higher than in the other two groups. Two other related variables - complexity of tax incentives and liberality of tax

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* F.R. Root and A.A. Ahmed, "The influence of policy instruments on manufacturing direct foreign investment in developing countries", in Journal of International Business Studies 1978

incentives - were not statistically significant in the Root and Ahmed study, and this was in accordance with earlier studies.* However, there was some evidence that complex incentive policies deter investors because of the uncertainty created. Moreover, the widespread availability of tax incentives in developing countries (38 out of 41 countries in the sample offered tax incentives) suggested that competition tended to neutralize the effects of tax incentives. Root and Ahmed concluded that tax incentives may, therefore, be necessary but are not sufficient to attract foreign investment. Another theoretical study by Takao Hagaki also points to the importance of corporate taxes on international trade and investment in the presence of multinational firms.** This suggests that there is reason to look more closely at tax incentives.

Other policy variables considered by Root and Ahmed were attitudes towards joint ventures, local content requirements and limitations on foreign personnel. None of these was statistically significant. However, the fact that these three variables plus the two tax incentives variables did not systematically influence direct foreign investment in developing countries does not mean that individually they do not affect investment decisions. Other variables in the investment climate may act to neutralize or overwhelm their impacts on investment decisions.

The kind of study undertaken by Root and Ahmed suggests that further analysis of the effects of host country incentives should be undertaken at a more disaggregated level. Evidently, GNP growth and market size are important determinants of investment in import-substitution industries and incentive policies would carry little weight in investment decisions. On the other hand, these variables would be less important in export-oriented industries or extraction industries, which depend on availabilities of necessary technology, finance and management, and availability of overseas markets. It would seem that incentives of various kinds might be more relevant in such investment decisions. Further examples could be listed, but it is apparent that any general assessment of the impact of investment incentives on investment decisions is not possible and that more specific studies are necessary. Each investment decision depends on many considerations.

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* G. Reuber, Private Foreign Investment in Development (Clarendon Press, Oxford, 1973)

** Takao Hagaki, "Theory of the multinational firm: an analysis of effects of government policies", International Economic Review June 1979

Ultimately, it may be necessary to examine the effects of particular decisions at the firm level. The characteristics of an MNE are important and will probably determine a short list of possible foreign investments - eg if MNE is a manufacturing company aiming to produce in an overseas market it will be concerned with import-substitution policies but also market size and potential growth. Once a short list has been determined, alternative government policies may well influence the final decision and here incentives are significant (although probably more relevant for export industries than for import substitution). Ultimately, of course, the decision is likely to be reached after extensive negotiation between the MNE and potential host governments.

Since so many foreign investments are now preceded by extensive negotiations between MNEs and host governments, it is necessary also to recognise the flexibility of governments and MNEs. Many investment incentive policies now seem to be tailor-made for projects rather than introduced to act as general encouragement to investors. This carries over also into periodic re-negotiations. In addition, MNEs have some degree of flexibility about initial investment decisions. Once committed to a plant or factory, of course, in most industries a commitment has been made for many years and the bargaining strength shifts towards the host government. Some MNEs have short-run flexibility - so-called footloose industries, such as apparel and some types of assembly - and can react quickly to changes in policies, but most plants involve large commitments. The variability and adjustment means that the value of particular incentives change frequently.

Developing countries can, of course, be far more certain about the impact of their disincentive policies than their incentive policies, since ultimately they can, if they wish, prohibit foreign investment of particular kinds or in specific sectors. Many developing countries employ administrative procedures to regulate entry in this manner (see Table 1(a)). There is, therefore, some asymmetry in the effects of incentives and disincentives. There are, however certain links too that should not be ignored. If foreign investment becomes too regulated, or if these regulations are arbitrarily widened from time to time, this will create uncertainties about the investment climate and may discourage foreign investors from undertaking investments in sectors where the same governments may wish to attract investments, and may even be providing incentives. To overcome such uncertainties it may be necessary to increase incentives for investment in desired areas.

There appear to be close relationships between investment incentive and disincentive policies and the development of new forms of foreign participation. Incentive and disincentive policies have been used to persuade MNEs to invest in countries in ways that are more acceptable to host governments, and MNEs have adapted to this new environment by deriving new types of activities that reduce risk and uncertainty but raise returns from their world-wide options. There has undoubtedly been feedback between these changing policy stances.*

The scope of incentives and disincentives provided by home countries has been examined in the papers by Mr Barratt and Mr Sepulveda. The discrepancy between their two papers is whether home countries could do more to encourage foreign direct investment in developing countries. There was no dispute over the conclusion that very little effort had been made so far by major capital exporting countries to encourage or discourage outflows of foreign investment to developing countries; the only active promotion of outflows has been by tax policies, bilateral investment treaties and investment insurance schemes. This does not deny the influence on outflows of general economic policies and economic circumstances in the home countries at any particular time but such influences would be incidental, arising from broader policy aims. Nevertheless, it has to be recognised that some policy options available to capital-exporting countries can have substantial indirect effects on foreign investment in developing countries. The general slowing-down in economic growth in OECD countries in the 1970s has tended to reduce investment levels world-wide and to increase uncertainties associated with investment opportunities. It has also been accompanied by rising protection of domestic markets in many OECD countries, particularly against imports from newly industrialising countries. These countries have been major recipients of foreign private investment in the 1970s, and have maintained very satisfactory levels of economic growth, but if their access to OECD markets for their exports is seriously curtailed (and even if it is thought to be threatened) then it is likely to cause uncertainties about foreign direct investment in export industries in these NICs. This illustrates the kind of disincentives that can arise indirectly from home countries' economic policies. In a time of growing international economic uncertainties it is necessary to be sensitive to these effects. Similar considerations would arise if changes were made in taxation policies (eg US proposal to remove tax deferral), extension of preferential trading regimes (eg expansion of EEC and its association agreements), export credit financing, or major changes in relative prices of commodities (such as oil) which will affect investment opportunities. The effects of these policy changes on investment flows to developing countries cannot be estimated.

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* Lilla Bautista, New forms of foreign investment - host country viewpoint, DT/MD/BRT/MD.15

EFFICIENCY OF ALTERNATIVE INCENTIVE MEASURES

The paper circulated by the Secretariat, "Incentives in LDCs" (DC/TF/PFI/79-19) reaches a number of interesting conclusions on the efficiency of incentives policies from the point of view of host countries. These may be summarized:

i) Direct incentives are preferable to indirect measures, because their costs to host governments are more readily estimated and their effects more apparent to investors than measures that take effect through product or factor prices.

ii) Grants or subsidies that can be included in firms accounting procedures for decision purposes are preferable to tax measures, which depend on achieving profits, and non-quantifiable measures such as exemptions under restrictions or regulations.

iii) Tax concessions are inefficient incentives to attract foreign investment, because of 'leakage' into home countries' tax systems and because of uncertainties about their value to investors until earnings are known.

iv) Some types of incentives may attract foreign investors at the expense of domestic investors by providing preferential access to finance, markets, foreign exchange etc.

It was pointed out at the beginning of this paper that in addition to being concerned about the effectiveness of incentives (and disincentives) in attracting foreign investment, host (and home) governments also have to be concerned about the cost-effectiveness of alternative measures. The consultant's paper on "Incentives in LDCs" offers some guidance on this matter but there are some provisos attached to the conclusions that should be made explicit.

The conclusion that tax concessions are an inefficient way to attract foreign investment seems to be based on a consideration of theoretical 'ex post' costs to the host government. If a host government decides to provide, say, $1 million in incentives to attract foreign investment, to offer it by means of tax concessions would have a value to foreign investors of less than $1 million, because some of the additional income earned through tax concessions is likely to be taxed in home countries if profits are repatriated to the parent company. On the other hand, a direct subsidy on production or factor inputs would tend to reduce the costs of production by that amount and raise the expected return on the investment. In addition, this effect would be more certain for the investor than a tax concession which would apply only if profits are earned.

The consultant's paper also assumes that different forms of incentives which have the same budgetary cost to a host government are considered to be the same by potential investors. That is, $1 million in expected tax savings over 5 years will be viewed by firms as equivalent to $1 million in production subsidies over the same period or capital grant of equal present value. Yet, in practice firms may have a preference for a tax concession where they may be prepared to gamble on a project that could be highly profitable but involve a higher risk. Tax concessions on profits would then be worth more than the subsidy to those firms. Much, therefore, depends on the nature of the project and corporate behaviour of potential investors.

The efficiency of alternative incentive measures must also be considered in terms of the kinds of foreign investment a developing country government wishes to promote. For example, time-limited tax concessions may attract foot-loose industries which are able to move on to other countries once the concessions run out, if they are unable to re-negotiate them. This can be very disruptive to a developing economy.

Incentive policies are aimed at maximizing net benefits to the host country, yet this consideration of tax concessions is conducted largely in terms of 'costs' to the host country in terms of revenue foregone. If a tax concession is successful, however, it will result in an increase in tax revenues, both from the profits of the investor and the additional incomes created for domestic resources (wages, interest, dividends, rents, etc). Thus, even though the concession involves a lower revenue than would have occurred without it, total revenues will be higher as a result of the investment attracted by the concession than it would have been without it. In other words, substantial net benefits may accrue as a result of the incentive. And, of course, in so far as an investment attracted by the incentive does not achieve taxable level of profits, no revenue 'cost' will arise, although additional incomes (and tax revenues) will still be created for domestic resources employed in the project.

One of the reasons why many host developing countries may have been attracted to tax concessions as an investment incentive is because direct incentives (subsidies, grants, etc) make an immediate drawing on the budget, whereas tax concessions only represent a 'cost' to revenue if a project becomes profitable. Tax concessions on other incomes (eg fees, royalties) that might be paid to the parent company would, of course, have a more certain effect on tax revenues.

From the point of view of host governments, it is difficult to see how the somewhat uncertain effects of alternative incentives can be compared in this way, especially since tax concessions are based on an expectation of profits from investment opportunities which may not be achieved. Governments are concerned that incentive schemes should attract investment bringing net benefits to the community, and since most incentives are now applied selectively to attract investments to specific industries or regions, and are often packaged to suit particular investors, the concept of 'costs' to tax revenue do not seem appropriate.

The developing countries covered in tables 1(a) and (b) show a widespread use of tax incentives, suggesting that budgetary considerations may have been an important influence on their choices of incentives. In contrast, the capital-exporting countries appear to have preferred greater use of grants and subsidies (table 2).

Host countries' policies aimed at discouraging or restricting private foreign investment have a much surer impact than incentives. Administrative controls and licensing can be used to regulate or prohibit foreign investment, usually justified by a belief that the market mechanism is unable to allocate scarce resources in a socially acceptable way. These regulations allow governments to control investment and allocate resources in accordance with predetermined priorities. Additional reasons are the prevention of monopolies and the promotion of regionally balanced development. Price controls have been motivated by equity or 'distributive justice' considerations, desires to achieve an adequate supply of raw materials and intermediate inputs and in an attempt to reduce inflationary pressures. Developing countries have had frequent recourse to administrative controls and studies have shown that they can give rise to a variety of economic costs. Not least among these are the uncertainty caused by their arbitrary implementation and the costs created by administrative complexities and delays, which discourage foreign investors. Such disincentives are not readily compensated by dispensations or other concessions.

To maximise the net benefits derived from private foreign investment it is essential for the incentives provided by host and home countries to be the most efficient, and all unnecessary or inefficient measures should be avoided. Before anything can be said about the efficiency of alternative measures, however, it is necessary to consider not only the 'cost' to the government budget, but also the attitudes of investors to the alternative measures.

CONSIDERATION OF ISSUES

The terms of reference for this paper include several specific questions about the effectiveness of incentives and disincentives, and additional questions are posed in the Secretariat paper DC/TF/PFI/79-17. It seems necessary to offer some kind of answer to those questions although it has not been possible to reach any clear answers in this paper. There is little clear evidence on the effectiveness of incentives or disincentives provided by host or home countries and it is doubtful whether the nature of the subject will permit much useful empirical research to be done.

Many host developing countries obviously consider incentive measures are important because they maintain an array of incentives (and disincentives) to affect private foreign investment flows, and they are continually refining and adapting them, and inventing new ones. This suggests that these instruments are seen as effective, at least at the margin, in influencing the level of foreign investment flows. Logically one would expect that if one country offers some incentive that raises the level of return (profit) on a particular investment, then it will tend to attract investment more readily than other countries that do not offer this advantage, other things being equal. It is this latter qualification that raises the problems, because many countries offer a wide range of incentives to foreign investors, so that even if businessmen make a comprehensive survey of countries suitable for an investment (ie based on enterprise and product characteristics), the complexity, overlap and competition of the many incentive (and disincentive) measures will make it impossible to make a "perfect knowledge" decision.

Nevertheless, it is possible to make a number of observations about the effectiveness of incentives provided by host countries:

- The effectiveness of particular incentive measures depends on enterprise and product variables for each investment decision. General incentives, like tax allowances, depreciation allowances and tax holidays will have different values depending on profitability, import content in final output, value added locally, capital intensity of production, etc of a venture.

- Different firms/industries will be attracted by different types of incentives. An import-substituting manufacturing activity could be expected to be more responsive to market portection (tariffs and quotas) than to tax allowances, promoted more by depreciation allowances than reduced profits tax (capital intensive) in the host country, and encouraged more by export credits for capital equipment in home countries. On the other hand, an export-oriented manufacturing venture could be expected to be more responsive to low-cost labour, tax-free ports and cheap power supplies. Nevertheless, investors are likely to be less affected by incentives than by domestic sales potential in the first case and export prospects in the latter.

- The different responses to alternative incentives makes any general evaluation impossible. Impressionistic evidence to suggest that many host countries now recognise the uncertainty of effects from specific incentive policies is provided by the increasing number of negotiated agreements between host governments and foreign investors.

There appears to be competition among developing countries in the provision of incentives. The negotiated agreements mentioned, appear clearly to provide opportunities for foreign investors to play-off one host country's offer against others. Moreover, Ahmed and Root showed that nearly all developing countries in their sample provided tax concessions to foreign investors, in one form or another. This probably accounts for the apparent ineffectiveness of tax incentives in stimulating investment in developing countries (DC/TF/PFI/79-17). If all host countries offer the same incentives they cease to be promotional and merely represent a general transfer from the host countries to foreign investors.

In as far as there is competition among developing countries in providing incentives it must raise the costs (or reduce the net benefits) of private foreign investment. For some developing countries, of course, this is no problem; namely, countries that do not use incentive policies (eg Hong Kong) and countries that actively discourage foreign involvement in their economies.

The Paris meeting of the Task Force was generally agreed that investment incentives employed in capital exporting countries for domestic reasons would not be expected to affect foreign investment flows to developing countries because they would tend to be applied to different types of investment and different industries. However, assistance or protection for ailing industries or regions would seem likely to reduce export opportunities for some industries in NICs. (Attention has been drawn to this above.)

Whether or not a particular incentive program provided by a host developing country actually increases the total volume of foreign investment it receives depends on assumptions about the "alternative position" - a factor which is crucial to any assessment of the effects of any policy changes. Supposing an incentive program attracts foreign investment to a country, there is still the question whether it:-

i) adds to capital formation in the host country but causes an equal decline in investment in the capital-exporting country;

ii) leads to an increase in capital formation in the host country without reducing investment in the capital-exporting country; or

iii) substitutes for investment in the host country without decreasing investment in the capital-exporting country.

If the foreign investment caused by an incentive program is believed to contribute to economic development, then alternative ii) would appear most realistic. There seems to be little general support for alternative i) because in many areas there is little substitutability between investment in developed and developing countries. Although opponents of foreign investment on grounds of job loss or surrender of technology by home countries would presumably support this hypothesis, it would seem to have only limited applicability to specific industries. Alternative iii) would be supported by those who believe that the foreign investment initiated merely pre-empts investment opportunities in developing countries and reduces domestic savings. If this is the expected outcome, then measures discouraging or prohibiting foreign investment would be in order. If either of the other two cases is thought to apply, then there is reason for developing countries to introduce measures to promote foreign investment, while it would be in the interests of capital-exporting countries to give incentives to foreign investment outflows only under alternative ii) or iii).

In practice the impact of foreign investment on the volume of world investment will vary between industries and according to economic circumstances over time. Most foreign direct investment is industry specific. If a firm wishes to invest overseas it will seek investment opportunities in areas where it has experience and possesses firm-specific advantages. Hence, investment

in extractive industries is unlikely to result in an outcome such as alternative i) and iii), but investment in an overseas manufacturing plant for exporting to developed country markets could easily lead to the situation described in alternative i). In circumstances of full-employment and rapid economic growth alternative i) would be interpreted in a favourable light from a macro-economic management point of view, and if the same conditions applied in a host developing country then alternative iii) would be acceptable. On the other hand with unemployment and sluggish growth attitudes would be quite different. The effectiveness and desirability of employing investment incentives in home and host countries would be quite different in those different industry and economic circumstances. Once again this shows how difficult it is to generalise about the impact of foreign investment incentive policies and foreign investment flows.

Another subject raised in DC/TF/PFI/79-17 is the rationalisation of investment incentives offered by developing countries. The proliferation and variability of investment incentives (and disincentives) gives reason for concern about international mis-allocation of resources, and competition between countries' incentive policies, and overlap of different incentive measures within countries gives cause for concern about the extent of income transfers from host countries to foreign investors. It would obviously be beneficial to both home and host countries if unnecessary or inefficient measures (incentives and disincentives) could be removed. However, beyond that, it is doubtful whether countries would unilaterally reduce efficient incentives for fear that the countries that retained them would gain an advantage in attracting investors. (The almost universal use of tax incentives may be necessary to maintain a competitively attractive climate for foreign investment.) Moreover, the flexibility adopted by host governments in negotiating "incentive packages" with foreign investors, which appear to be becoming increasingly common, would act against general programs to reduce incentives. Moreover, it should be borne in mind that some incentive measures (and dis-incentives such as performance indicators) are already subject to provisions in international agreements such as GATT (eg export subsidies).

CONCLUSION

The conclusion of this paper must be that certain types of incentive policies can influence investment decisions in certain activities. Although there is a lack of empirical measurement of the effects of different types of incentives, it is evident that incentives have more impact on some types of investment than others. The influence of these instruments appears to be greatest where larger variables such as growth in GDP and market size are less important; that is, investments that are not dependent on the local market or some particular resource requirement (eg minerals or cheap labour). In order to establish the effectiveness of particular incentives, therefore, it is necessary to consider the effects of different incentives on types of foreign investment decisions.

One of the consequences of more active promotional policies in host countries has been the "unbundling" of the MNE package and the development of new forms of participation. This has been greeted generally as a favourable development for developing countries. It gives them freedom of choice about sources for capital, technology, management etc. No evidence has been found to show that there is any benefit beyond the independence it provides from MNEs. On the other hand, there may be losses arising from the unbundling of the MNE package and these have not been investigated either. Until a study is made of the effects of unbundling it will be difficult to assess the effects of the incentive/disincentive measures that cause the unbundling.

The proliferation of incentive schemes in host developing countries has probably led to neutralisation and waste in some instances. Many incentives are now probably provided for defensive purposes, to offset advantages that other countries may have achieved by introducing such measures. Even in cases where incentives are negotiated with the host government of a package and tailor-made for a particular investment decision, there may be a defensive element.

There would be advantage to all concerned if incentives provided by host developing countries could be rationalized, by avoiding measures that compete between countries and by removing conflicting measures in the same country. The latter is within the power of national governments, but it would require information on the effectiveness of different kinds of incentives. The former, however, is more difficult. Many incentives are not industry-specific (like tariffs), and firm- or project-specific incentive packages are difficult to

disentangle and often time-limited, so it would be difficult to negotiate for their removal multilaterally. On the other hand, the fact that many incentives have a restricted life means that any agreement to reduce the use of some kinds of incentive could be achieved fairly quickly as existing provisions expired. The defensive manner in which many incentives are used, however, would still have to be overcome.

Despite the attention given to investment incentive (and disincentive) policies in many developing countries, it appears that most of the instruments have only a marginal effect on investment decisions in most instances. The most important considerations for potential investors are expected profits, which depend on business opportunities, resource endowments and infrastructure in host countries. The ultimate concerns of foreign investors, therefore, will be the economic situation and prospects, and a stable political climate in potential host countries.

TABLE 1 (a)

INCENTIVES AND DISINCENTIVES IN HOST COUNTRIES

TYPE OF INSTRUMENT	BRAZIL	MEXICO	INDIA	INDONESIA
(1) Administrative controls	Restrictions on access to local financing, acquisition of rural lands, investment in "national security zones" and banking; local content requirements; local participation and control.	Import licensing; local capital participation and control; local content requirements; price controls; controls on principal & interest repayment of foreign loans.	Import controls; limitations on foreign equity; local content requirements.	Limitations on foreign equity.
(2) Foreign exchange controls	Fairly rigorous system of exchange controls for balance of payments reasons; restrictions on foreign borrowing.	No exchange controls..	Special foreign exchange allocations for export-oriented firms and priority industries.	Few exchange controls; capital remittance not permitted while an investor is receiving tax incentives.
(3) Financial measures	Loans and equity from state development agencies, negotiated on a case by case basis.	Low-interest loans from specialised promotion funds.	Medium and long-term loans provided by development banks; some government equity investment.	-
(4) Direct tax-related incentives	Accelerated depreciation; tax holidays in development regions; tax credits.	Tax holidays from 3-10 years; tax reductions of 10-40%; fiscal stamp exemptions.	Tax holidays of up to 5 years on profits up to 7.5% of capital employed; investment allowances.	Accelerated depreciation; tax holidays of 2-6 years; reduced tax rates for mining projects; exemptions from withholding tax for mining enterprises.
(5) Indirect taxes	Duty and tax concessions on imports; exemption from local taxes.	50-100% exemption from import duties; tariffs.	Exemption from tariffs and excise taxes for export firms; special tax deductions for export promotion expenses.	Exemption from property tax; exemption or reduction of import duties.
(6) Grants	Free land for plant sites. (Incentives administered under separate schemes to encourage investment in (1) priority industries, (2) depressed and thinly settled regions, and (3) export-oriented manufacturing industries. In recent years the Government has become increasingly selective in the provision of incentives and has also introduced measures that discriminate against foreign investors.)	Free land. (Incentives are designed to promote high volume low-cost production of basic goods and thereby increase employment, production and markets.)	Grants of up to 15% of fixed capital investment in backward areas; subsidies for worker housing, establishing industrial estates, transportation of raw materials and finished goods. (Foreign investment permitted in selected industries only. The Government prefers majority local ownership and control through joint ventures on licensing agreements in exported oriented industries for which technology is not locally obtained.)	- (Incentives were originally directed towards promoting capital-intensive mining industries but are being re-directed to labour-intensive manufacturing industries.)

TABLE 1 (b)

INCENTIVES AND DISINCENTVIES IN HOST COUNTRIES

TYPE OF INSTRUMENT	PHILIPPINES	KOREA	HONG KONG	SINGAPORE
(1) Administrative controls	Restrictions on foreign equity participation in extractive industries, local borrowing and employment of foreign nationals in administrative and managerial positions, local content requirements; price controls.	Limitation on foreign participation; minimum foreign investment amounts; changes in terms of investment agreements; loan contracts and foreign licensing arrangements subject to official approval; local content requirements; price controls.	-	-
(2) Foreign exchange controls	Controls on foreign loans and repayments.	Stringent foreign exchange controls; remittance of profits, dividends, interest, fees and royalties subject to approval; capital repatriation restricted to 20% each year and permitted only after two years of operation.	-	-
(3) Financial measures	Access to funds from Government financial institutions for "preferred industries".	Loans for export financing available to Korean firms only; foreign firms operating in partnership with local firms are eligible too.	-	Concessionary financing in the form of loans, guarantees and equity participation; export credit.
(4) Direct tax-related incentives	Accelerated depreciation; tax credits.	Exemptions from corporate tax, defence tax, property tax, property acquisition taxes for first 5 years and a 50% reduction for next 3 years; similar exemptions on dividends, interest on approved loans and fees paid under technical assistance contracts.	-	Accelerated depreciation; tax holidays and concessions.
(5) Indirect taxes	Exemption from or reduction on import taxes and duties, capital gains tax, withholding tax, sales tax, excise tax, excess profits tax, etc.	Exemption of imports from import duties and commodity taxes, and of exports from value-added tax; tax deduction allowance on research and development expenses.	-	Special tax deductions for export promotion; exemption from import duties.
(6) Grants	- (Priority given to projects which increase production of food and commodities that have become scarce in world markets, which are export-oriented or are based on indigenous resources such as farm products and minerals.)	Grants for export financing available only to foreign firms operating in partnership with local firms. (The government has adopted a more selective policy in the last few years. However a wide range of incentives is still available to foreign investors.)	"Special industrial land policy" which provides land at concessional prices for capital and technology-intensive industries; development of industrial estates. (Apart from "land policy", there are no special incentives scheme.)	Subsidies for worker training programs; research and development grants (for local companies only). (Has a well-established open-door policy towards foreign investment. Incentives schemes directed towards projects that involve high technology, are skill-intensive and export-oriented).

TABLE 2

INCENTIVES AND DISINCENTIVES IN HOME COUNTRIES

TYPE OF INSTRUMENT	US	JAPAN	UK	GERMANY
(1) Administrative controls	-	Quotas, withholding of import licences	-	-
(2) Foreign exchange controls	-	-	-	-
(3) Financial measures	Guarantees for small bank loans ($500,000); loans to cover up to 65% of cost of new fixed assets.	Long-term loans at low interest rates for social development projects.	Provides guarantees for open market borrowing; medium-term loans at preferential rates or interest free; deferred repayments.	Provision of medium-term loans at subsidised/preferential interest rates for investment in production goods as well as research and development.
(4) Direct tax-related incentives	Property tax & sales tax exemptions or reductions.	Accelerated depreciation and tax exemptions for "key industries" and "new and important" products.	First year depreciation of 100% for new machinery and 50% for new buildings; 100% write-off on research and development expenditure.	Accelerated depreciation in border areas (up to 50%) and in West Berlin (up to 75%); reduced corporate and sales tax in West Berlin; deferred taxes for small and medium sized companies in certain development areas. Exemption of exports from value added tax.
(5) Indirect taxes	-	Tariffs	EEC tariffs	EEC tariffs
(6) Grants	Research and development grants; assistance in training workers.	Research and development grants.	Regional development grants of 22% to 50% of industrial buildings, plant and machinery; wage subsidies; training grants; subsidised housing for workers; ready-made factories; and interest relief grant.	Regional development grants of up to 13.75% on cost of capital goods; interest subsidies; low utility rates; cheap land and free construction of road and rail links etc.
	(Incentives designed to encourage investment in areas of high unemployment and low family income; generally available to "new investors" only.)	(Very limited incentives; available to Japanese companies only to foster growth in specific industries. Increasing use to encourage environmental protection.)	(Main objective used to be balance of payments effects but now almost always job creation. Incentives available to both foreign and domestic investors.)	(Incentives available to both foreign and domestic investors, directed towards regional development and more recently job creation.)

TABLE 3

MEASURES TO STIMULATE PRIVATE FOREIGN

INVESTMENT OUTFLOWS TO DEVELOPING COUNTRIES

TYPE OF INSTRUMENT	US	JAPAN	UK	GERMANY
(1) Investment insurance and guarantee advances	Investment insurance - 90% for 20 years for equity investment and term of the loan for debt investment; loan guarantees (generally up to 50% of total project financing) for funds provided by US institutional and commercial lenders.	Investment insurance for direct equity investment and long-term loans - 90% up to 15 years; inter-government investment protection agreements.	Investment insurance for equity investment and associated loans - 90% up to 15 years.	Guarantees for capital and loans provided in connection with equity participation - 95%, up to 20 years; separate scheme for private "untied financial credits"; inter-government investment protection agreements.
(2) Direct tax-related incentives	Limited incentive through "tax credit" system which result in lower taxes being paid on income repatriated from developing countries than on equivalent income from developed countries.	Double taxation agreements and tax credits system.	Double taxation agreements.	Double-taxation agreement; deferred tax on home-country profits used for investing in developing countries as well as profits earned from investment; tax credit for foreign losses.
(3) Information and promotion activities	Financial participation in the identification, assessment, survey and promotion of private investment projects.	Subsidies for pre-investment surveys, provided through various organisations eg Export-Import Bank of Japan, Overseas Economic Co-operation Fund.	Subsidies for pre-investment studies, available only on host country government's request.	Dissemination of information on investme opportunities and conditions through government and private organisations.
(4) Provision of risk capital	Direct investment and direct loans to projects; loans to private investment funds, and regional development banks eg Caribbean Development Banks; loans to small indigenous entrepreneurs; access to home country capital market.	Several schemes whereby long-term soft loans are provided to foreign governments for projects carried out by Japanese enterprises or to Japanese investors undertaking investment alone or in joint-venture with local enterprises.	Capital aid to finance infra-structure or facilitate host country equity participation in projects involving UK investment; provision of equity, debenture and loan capital in wholly-owned or joint-venture projects; development loans to governments and/or development agencies.	Loans on favourable terms to small and medium-sized German firms with limited investment capacity; direct equity participation and debt investment in development projects or through host country's development banks/institutions (funds not tied to procurement of goods or services in Germany); access to home country capital market.
(5) Provision of technical assistance	Various measures to encourage, organise and subsidise private non-profit organisations which provide technical and managerial assistance to private businesses.	Subsidises various technical assistance activities provided by private organisations.	Provides project management and industrial training in UK for nationals from developing countries, and technical assistance in formulating development plans.	-

JOINT MINISTERIAL COMMITTEE
OF THE
BOARDS OF GOVERNORS OF THE BANK AND THE FUND
ON THE
TRANSFER OF REAL RESOURCES TO DEVELOPING COUNTRIES

(Development Committee)

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January 24, 1980

TASK FORCE ON PRIVATE FOREIGN INVESTMENT

Attached is Chapter 6 from American Multinationals and American Interests by C. Fred Bergsten, Thomas Horst and Theodore H. Moran. This chapter is being circulated for use by the Task Force in its consideration of the effects of home country tax policies on direct investment in developing countries.

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CHAPTER SIX

Tax Issues

TAX POLICY is the most tangible expression of the official U.S. attitude toward the foreign direct investment of American corporations. Although the Internal Revenue Code as it applies to the foreign-source income of corporations is all but incomprehensible to the laity, the economic and political questions it raises are clear. Does it encourage firms to invest abroad rather than in the United States? Can American multinationals avoid taxes by shifting income from the United States into tax-haven countries? If the foreign tax credit were repealed, would American firms seriously lessen their foreign investment? Would they increase investment in the United States? Would certain tax changes lessen the competitiveness of American firms in world markets? Would such changes hurt the economies of other countries, thereby disturbing the world economy and U.S. foreign policy?

This chapter begins with a summary of American taxation of foreign-source income, to explain what U.S. policy is and from whence it came.[1] After a review of the economic literature on the taxing of foreign investment income, we indicate the inadequacies of the conventional approach,

1. For a complete survey see Lawrence B. Krause and Kenneth W. Dam, *Federal Tax Treatment of Foreign Income* (Brookings Institution, 1964); Peggy B. Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments* (Harvard Law School, 1969). For a detailed study on the foreign tax credit see Elisabeth A. Owens, *The Foreign Tax Credit: A Study of the Credit for Foreign Taxes Under United States Income Tax Law* (Harvard Law School, 1961); Elisabeth A. Owens and George Ball, *The Indirect Credit* (Harvard Law School, 1975). Most studies of the historical background of current policy draw directly or indirectly on Jacob Stewart Seidman, *Legislative History of Federal Income Tax Laws, 1938–1861* [sic] (Prentice-Hall, 1938).

and in the sections that follow we analyze U.S. taxation of American manufacturing multinationals and recommend changes.

Current U.S. Tax Policy

When the corporate income tax was imposed in 1913, the rate was set at 1 percent of income, which may explain why no one worried too much about details. Rather than taxing only income from domestic operations, the United States taxed foreign-source income as well. The earnings of an unincorporated foreign branch of an American company were taxed as they were earned, but the comparable earnings of a subsidiary incorporated in a foreign country could be reinvested abroad without incurring any immediate U.S. tax liability. Taxes were payable only when an American investor paid itself a dividend. This deferral of U.S. taxes on retained earnings was consistent with the practice of taxing individuals' dividend income and not their pro rata share of a corporation's retained earnings. Whether corporate investors should be treated as private individuals was quickly resolved at the outset, and the deferral accorded to U.S. investors has remained a cornerstone of tax policy ever since.

For the first five years of income taxation, the United States taxed all income of its residents net of foreign taxes; foreign tax payments were simply deducted from the taxable income of the investor. The investors were paying higher total taxes than their foreign competitors, and the additional burden became heavier as the American tax rate went up.[2] After five years of this double taxation, one witness before the House Ways and Means Committee asked for a tax exemption for foreign-source income or, that failing, a lower tax rate. Although he was the only witness to address himself to the issue, the Ways and Means Committee, the House, the Senate and the President accepted a foreign tax credit as a good compromise. Foreign taxes, rather than constituting a mere deduction from taxable income, could now be credited directly against the U.S. income-tax liability. Thus, in 1918 the second cornerstone of U.S. tax policy, the foreign tax credit, became firmly entrenched.[3]

2. See Krause and Dam, *Federal Tax Treatment of Foreign Income*, pp. 27–43.

3. Suppose that a foreign affiliate of a U.S. firm earns $100 from its local operations and that the foreign and U.S. corporate income tax rates are 10 percent and 25

Because the foreign-tax credit is basic to U.S. policy, we should note its more important features. First and foremost, only taxes on the income of American investors can be credited against the American tax liability; excise, sales, value added, and other such taxes cannot. This distinction derives from the notion that the burden of an income tax is borne by the investor, but that of a sales or similar tax is passed on to customers.[4]

While distinguishing an income from a sales tax may appear easy, in actual practice one can be made to pass for the other. The most notorious

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percent, respectively. Suppose that $50 is reinvested locally, and the balance repatriated to the parent firm. Under all conditions and assumptions, the foreign government gets $10, the $50 is reinvested, and the remaining $40 is split between the U.S. investor and the U.S. government. Before 1918, if the affiliate were an unincorporated branch, the U.S. Internal Revenue Service would have allowed the $10 deduction for foreign taxes and collected 25 percent of the remaining $90, which amounts to $22.50. The parent's after-tax income would, thus, have been $17.50. If the affiliate were separately incorporated, the United States would have applied its 25 percent to only the $40 dividend, kept $10 in taxes, and left the U.S. investor with $30.

In 1918, a foreign tax credit was extended to taxes paid to foreign governments by U.S. corporations and to taxes deemed paid through their majority-owned affiliates. For an unincorporated branch, this meant that its potential U.S. tax liability was 25 percent of the pretax $100, but this $25 liability was reduced $10 for taxes paid to the foreign government, so the branch paid only $15 instead of $22.50 and the parent's after-tax income was $25 instead of $17.50. The potential tax liability of the separately incorporated subsidiary was 25 percent of its $40 dividend, or $10, against which 4/10 (the ratio of dividends to pretax foreign earnings) of the foreign tax payments, or $4, could be credited. U.S. taxes were thus reduced to $6 and the parent's receipts increased to $34.

Under this formula, the subsidiary has an advantage over the branch even if all foreign earnings are paid out as dividends and $50 is reinvested from after-tax U.S. earnings. Such is the case because the subsidiary's potential tax liability is 25 percent of $90 (instead of $100). Although the parent can claim only 9/10 of the $10 as foreign taxes deemed paid, it still comes out ahead ($22.50 less $9 is $13.50 in U.S. taxes), compared to the $15 paid by the branch. This situation was changed in 1962 for subsidiaries in the developed countries by requiring investors to gross foreign income by foreign taxes deemed paid before computing their U.S. tax liability (and at the same time allowing them to make an analogous adjustment in their foreign tax credit). After 1962, the $40 dividend would be grossed up by 4/9 (ratio of dividends to after-tax earnings) of the $10 in foreign taxes deemed paid, so that the U.S. potential tax liability would be $11.11 (25 percent of $44.44), against which the $4.44 could be credited. The resulting $6.67 paid in U.S. taxes is, thus, somewhat higher than the $6 paid before 1962 and in less-developed countries from 1962 to 1976.

4. The distinction is not supported by empirical research on tax incidence. See Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice*, 2nd ed. (McGraw-Hill, 1976), chap. 18.

case in point has been the income taxes based on posted prices set by the oil-exporting countries. Had these taxes been based explicitly on the value or the quantity of crude oil extracted, they would not have qualified for a tax credit in the United States. Had the oil-exporting countries employed a simple income tax, they would have had to police the transfer prices used by the integrated oil companies (the lower the price of crude oil exports to downstream affiliates, the less the taxable income of the oil-exporting countries). In 1950 the United States, anxious to encourage petroleum companies to invest in friendly countries, allowed oil-exporting countries to base an income tax on a posted price, whose only real function was to inflate taxable income (and hence provide a mechanism for transferring U.S. financial assistance without congressional approval). As the posted price bore less and less relation to the market price, this income tax became a per-barrel royalty in disguise.[5] Although this particular subterfuge was consciously initiated by the United States, the general problem of distinguishing one type of tax from another can occur whenever any foreign country tries to protect or increase its tax revenues by setting transfer prices on intrafirm exports of American multinationals. This distinction between taxes and other payments eligible and ineligible for the foreign tax credit is becoming increasingly blurred as foreign tax authorities become more sophisticated in taxing investment income.[6]

A second critical feature of the foreign tax credit is that it cannot exceed the taxes tentatively due the U.S. Treasury on foreign-source income alone. Thus the foreign tax credit cannot be used to reduce an American corporation's taxes on its domestic income. This limitation has a very pragmatic rationale. If a dollar paid in taxes to a foreign government can be offset by a dollar not paid to the U.S. Treasury, American investors have no incentive to resist higher foreign taxes. The U.S. Treasury, not the investors, would bear the burden of increased foreign taxes. A limitation on the foreign tax credit caps the revenue loss of the U.S. Treasury, a loss which otherwise could be massive.

5. In July 1976, the IRS announced that it would henceforth investigate whether these payments did represent direct taxes eligible for the foreign tax credit. In January 1978, Saudi Arabian and Libyan taxes based on "posted prices" were ruled not creditable.

6. For evidence on the similarity of treatment toward export platform investments see Grant L. Reuber and others, *Private Foreign Investment in Development* (Oxford: Clarendon Press, 1973), pp. 299–300.

Although as of 1976, U.S. investors must use an overall method in determining the limitation on their foreign tax credit, the per-country method has been used in the past and remains an option for the future.[7] If the per-country method were used, an American investor would first calculate its tentative U.S. tax rate and then multiply that tentative tax rate by its income from each foreign country to determine the allowable credit for each. The tentative tax rate is the ratio of total taxes tentatively due the U.S. Treasury (before deducting the various tax credits) to the global income of the U.S. corporation. For a corporation with no capital gains or other income taxed at an advantageous rate, the tentative U.S. tax rate would be the 48 percent statutory tax rate. With capital gains and other such income, the tentative tax rate may drop below 48 percent. Whatever the investor's tentative tax rate turns out to be, it determines the maximum tax credit that can be claimed for income from each foreign country.

Alternatively, the American investor could use the tentative tax rate to calculate a single, overall limitation on its total foreign tax credits from all countries. An American investor could thereby combine income and tax payments from different countries. The accounting requirements imposed on the multinational firms and the Internal Revenue Service auditors are greatly reduced by this averaging, for transfer prices for transactions between affiliates have little effect on the tax credit.

This accounting simplicity has its economic cost, however. An American investor with sizable investments in high-tax countries may be greatly tempted by tax holidays or low tax rates in other countries. After paying the minimal foreign taxes, all after-tax income may be repatriated without incurring any additional U.S. tax liability, for the U.S. taxes tentatively due may be offset by excess tax credits from the high-tax countries. Furthermore, the high-tax countries may feel that they have little to gain by reducing their taxes on U.S. investments since, through the overall credit mechanism, such tax cuts may be automatically offset by higher taxes owed to the U.S. Treasury. Although it streamlines the accounting and auditing requirements, the overall method modifies and complicates the effect of national taxes on international investment behavior.

7. Since passage of the Tax Reduction Act of 1975 (89 Stat. 54–65), the overall approach must be used on all "foreign oil-related income." Laws pertaining to manufacturing firms have required one or the other calculation method but at one time required the calculation yielding the larger tax liability.

Why, then, did any corporation ever choose the per-country limitation over the overall limitation, since the latter allowed the firm to use excess tax credits from high-tax countries while the former did not? The answer to this question is intimately associated with that to another: why would a firm ever have an unincorporated branch, rather than a locally incorporated affiliate, since the latter allows the firm to defer U.S. taxes while the former does not?

If all foreign investments earned profits, subsidiaries would be preferable to branches for tax avoidance, and the overall limitation would be superior to the per-country limitation. But not all foreign investments earn profits, not in the short run and certainly not as far as the tax accounts are concerned. Particularly notable exceptions are natural-resource investments, which often show huge losses (often accounting phenomena due to treating exploration, drilling, and other development costs as current expenses rather than capital costs subject to depletion or depreciation) during their first years of operation. Analogous losses, though less spectacular and prolonged, are incurred by manufacturing investments with high start-up expenditures. The tax implication is that losses of an unincorporated branch could be subtracted from the domestic earnings of the American parent and thereby used to reduce U.S. taxes. But, to do this, the American investor had to use the per-country method. If it elected the overall method, it had to combine its foreign gains and losses and deduct only its net foreign losses from its domestic income. If its foreign gains exceeded its foreign losses, the investor would pay foreign taxes on all its profitable investments and be unable to deduct its losses from any of its taxable income, foreign or domestic.[8]

In the early 1960s, U.S. taxation of foreign investment income became a major domestic political issue. With the surge of American investment in Europe widely regarded as a major cause of the U.S. balance-of-payments deficit in the late 1950s, the Kennedy administration proposed eliminating the deferral of taxes on unrepatriated income. The Treasury argued that eliminating deferral would discourage capital outflows and encourage firms to repatriate a higher proportion of their foreign investment earnings. The elimination of deferral was a much larger step than Congress was willing to take, however, and the Revenue Act of 1962 simply limited its scope in several respects.

The most straightforward change the Tax Reform Act of 1962 brought

8. This was one aim of the Tax Reduction Act of 1975 (see note 7).

about is the grossing-up requirement, which raised the effective rate of taxation on foreign-source income. Before 1962, foreign-source income and applicable tax credit were based on a subsidiary's income after the foreign income tax; since 1962, foreign-source income has been grossed up to include taxes paid by the subsidiary. Grossing up guarantees that a subsidiary repatriating all its earnings as dividends will bear the same tax burden as an unincorporated branch. The increase in taxes from grossing up depends on the foreign income tax and the dividend payout rates. The maximum impact comes when a foreign subsidiary pays 24 percent of its income in taxes to the foreign country and repatriates the remaining 76 percent. If grossing up is not required, the U.S. tax liability amounts to an additional 18.2 percent of pretax income; if grossing up is required, the U.S. tax liability is 24 percent of pretax income. Grossing up thus increases total taxes from 42.2 percent to 48 percent of the pretax income from such an affiliate. To encourage direct investment in developing countries, they were exempted from the 1962 grossing-up requirement.

The Revenue Act of 1962 also sought to limit the accumulation of taxable income in tax-haven subsidiaries. Rather than defining tax-haven countries, the act defined base-company income: it arises from an affiliate organized with tax avoidance as a significant purpose; it is generated by buying or selling within the multinational or is passive income such as dividends and royalties from affiliated companies. An example is the income earned by a Swiss affiliate used as a financial intermediary between an American parent and a German or French subsidiary. After 1962, the commissions and fees received by the Swiss affiliate could be classified as base-company income and deemed a dividend to the U.S. parent and subject to U.S. taxation. Base-company income was then no longer fully entitled to deferral.[9]

9. The Revenue Act did, however, create significant exceptions to the base-company income rules. If the hypothetical Swiss and German affiliates together made sufficient dividend distributions to bring the average tax rate up to a specified minimum, the deemed distribution of base-company income could be reduced or eliminated. This was called the minimum-distribution exception. Likewise, if base-company income were reinvested in qualifying investments in less-developed countries, no dividends were deemed distributed to the American parent. Third, if base-company income were less than 30 percent of the affiliate's total income (it might have additional income from manufacturing), no dividends were deemed distributed. Finally, income from shipping and air transport were specifically excluded from base-company income. These rules were tightened considerably in the Tax Reduction Act of 1975.

If the base-company income rules can limit the abuse of deferral, tax avoidance will remain an issue as long as national income tax rates differ and investors have some flexibility in their intrafirm accounts. If the transfer price assigned to intrafirm exports can be lowered, the use of interest-bearing debt minimized, or charges for head-office or technological services pared, taxable income can be shifted from the parent to its overseas affiliates. The multinationals do not have a free hand in avoiding taxes, however. Under section 482 of the Internal Revenue Code, the Service can challenge any intrafirm transfer price or charge it believes does not conform to the arm's-length standard (that which would prevail between an independent buyer and seller). But the arm's-length standard is ambiguous and difficult to administer. In buying and selling complex products or their components, an objective measure of an arm's-length price may be impossible to find. Likewise, many activities jointly benefit foreign and domestic operations. Research efforts, for example, may be directed at developing new products for both domestic and foreign markets. While such joint costs must be apportioned between the beneficiaries, the proper formula for allocating such costs may be ambiguous. To avoid unnecessary U.S. taxes or to satisfy foreign demands, the multinationals may resolve the arm's-length ambiguity in favor of their foreign affiliates.[10]

An alternative to monitoring transfer prices was considered by the House of Representatives in 1962. Rather than trying to determine an appropriate price for every intrafirm transaction, global income could be allocated in proportion to assets, sales, or some other stable base. (The income tax payments of U.S. corporations to the different states in which they operate within the United States are often allocated on the basis of the shares of their payroll, capital, and sales in each.) For example, if two-thirds of a multinational's sales were in the United States and one-third abroad, then two-thirds of its global income would be attributed to

10. By 1968, there had been 800 challenges. See Treasury Department, "Summary Study of International Cases Involving Section 482 of the Internal Revenue Code" (January 1973; processed). Manipulative transfer pricing in the oil industry cost consuming countries a minimum $205 million tax loss in 1966 and $240 million in 1970, according to the implications in Glenn P. Jenkins and Brian D. Wright, "Taxation of Income of Multinational Corporations: The Case of the United States Petroleum Industry," *Review of Economics and Statistics*, vol. 57 (February 1975), pp. 3–10.

the U.S. parent for tax purposes. Such an allocation formula would greatly reduce a multinational's ability to avoid taxes, but the resulting allocation of taxable income might be rather arbitrary. Different formulas give rise to different geographical allocations of taxable income and become a bone of contention among local tax authorities, as occurred among the states of the United States in administering their "three-factor formula."[11] In the end, the House scrapped any use of formulas and encouraged the Internal Revenue Service to use its existing authority to monitor transfer prices more closely than it had in the past.

The Revenue Act of 1962 also included an investment tax credit, which was not extended to overseas investment.[12] In the hope of stimulating domestic economic growth and improving the international competitiveness of production in the United States, Congress authorized American investors to credit an amount equal to 7 percent of their new capital equipment against their income taxes.[13] The investment tax credit has had an on-again, off-again history: it was passed in 1962, liberalized in 1964, suspended in 1966, reinstituted in 1967, repealed in 1969, brought back in 1971, and increased to 10 percent in 1975. Because Congress was not particularly concerned by slow growth abroad, and even hoped that the measure would strengthen the U.S. trade balance, the investment tax credit has never applied to the foreign investments of American firms.[14]

Faced with a large and growing balance-of-trade deficit in 1971, and arguing that deferral encouraged foreign production at the expense of U.S. exports, President Nixon proposed in his new economic policy of August 15, 1971, not to eliminate deferral but to create a similar advantage for American exporters: domestic international sales corporations, or DISCs. (As with the investment tax credit in 1962, it was also argued that other countries used similar devices so that such a step by the

11. A view sympathetic to income allocation (and yet recognizing that technical problems must be resolved in constructing the formula) is taken in Gerard M. Brannon, "National Shares of Multicompany Income" (paper prepared for the Organisation for Economic Co-operation and Development, 1973: processed).

12. 76 Stat. 962–73.

13. The success of the investment tax credit is a matter of some debate. See Gary Fromm, ed., *Tax Incentives and Capital Spending* (Brookings Institution, 1971).

14. Tax treaties negotiated in the mid-1960s with several developing countries to extend the investment tax credit to earnings from investments in those countries were not approved by the Senate.

United States would simply offset what others were already doing.)[15] A DISC is essentially a dummy corporation to which export profits can be ascribed. While 50 percent of such profits must be paid out to the owners and thereby subject to normal U.S. taxation, the remaining 50 percent are tax-deferred as long as those earnings are reinvested in export-related projects. Furthermore, American exporters are not bound by the usual arm's-length standard in determining how to allocate total profits between manufacturing and exporting; instead, they can use special rules, which guarantee a high return for the DISC and, thus, low taxes on U.S. exports.

In the early 1970s, the AFL-CIO lobbied hard, but unsuccessfully, to get Congress to eliminate both deferral and the foreign tax credit. Without a foreign tax credit, all foreign-source income would be taxed by foreign governments and then again by the United States. The unions hoped that this double taxation would limit American firms' willingness to invest abroad and enhance the unions' bargaining strength in wage negotiations. Whether the impact would have been as labor hoped, Congress refused to vote such legislation.

But the Tax Reduction Act of 1975 indicates that the unions, and others who wish to tighten the tax treatment of foreign income, have made some headway. The U.S. Senate actually voted to end deferral, the first time that either legislative branch has done so, though it was reinstated in the Senate-House conference committee. The most significant changes in the act affected the multinational petroleum firms.[16] To force these companies to pay higher U.S. taxes, Congress modified their foreign tax credit in two ways. First, a separate limitation was placed on the foreign tax credits deriving from the extraction of oil. In 1975 only 52.8 percent of income from oil extraction could be claimed as a tax credit; the limit dropped to 50.5 percent in 1976 and 50 percent thereafter. In short, the high payments to oil-exporting countries offer far fewer U.S. tax

15. See Gary C. Hufbauer, "The Taxation of Export Profits," *National Tax Journal*, vol. 28 (March 1975), pp. 43–59.

16. *Tax Reduction Act of 1975: Law and Explanation* (Commerce Clearing House, 1975), pp. 47–48. The act tightens the rules pertaining to base-company income, making it harder for the multinationals to exploit tax-haven situations. Both the minimum distribution exception, by which deemed distributions could be reduced through actual dividend payments, and the option of reinvesting earnings in less-developed countries, are eliminated entirely. Furthermore, dividends are deemed paid when base-company income exceed 10 percent (instead of 30 percent) of the affiliate's total income.

credits than heretofore. Second, the per-country method can no longer be used for any oil-related income. Having no choice but to use the overall method, the petroleum companies have to offset foreign drilling and exploration expenses with other foreign-source income rather than against domestic U.S. income.

The Tax Reform Act of 1976 has a variety of provisions affecting U.S. taxation of foreign-source income. The exemption from grossing up of income from less-developed countries was terminated; income from these countries is now taxed in the same manner as income from developed countries. The deferral of U.S. taxes on export income allocated to a DISC is restricted to income from exports over and above a base value (which, in turn, equals 67 percent of the average value of exports during an earlier, four-year base period). By limiting DISC benefits in this way, Congress hoped to stem loss of tax revenues without destroying incentives to make new exports. An exemption for a portion of the income of a western hemisphere trade corporation, which some U.S. investors use to export or invest in Canada or Latin America, will be phased out by 1980. All U.S. investors, not just the oil companies, must henceforth use the overall method of calculating the limitation on the foreign tax credit. And finally, the act denies both deferral and the foreign tax credit to certain income of U.S. companies participating in or complying with an international boycott, such as that Arab countries imposed against Israel.

After an extended debate, the Treasury recently issued new guidelines for administering sections 861 and 863 of the Internal Revenue Code.[17] These guidelines describe the proper allocation of research and development, interest, and stewardship expenses among foreign and domestic affiliates in determining the overall limitation on the foreign tax credit. Under the new guidelines, U.S. manufacturers deduct a higher portion of these domestic expenses from their foreign-source income, reducing the ceiling on the foreign tax credit. Unless the investor has a deficit of foreign tax credits, its foreign tax credit will fall and its U.S. tax payments rise. The only way the investor can avoid a comparable increase in its global tax burden is by passing on the higher charges to the foreign affiliates, thereby reducing foreign tax payments. The multinationals argue that foreign tax authorities will not allow higher deductions for

17. U.S. Office of the Federal Register, *Federal Register*, vol. 42 (January 6, 1977), pp. 1195–1214.

U.S. expenditures, and that the new guidelines, therefore, subject the disputed income to double taxation.

To summarize: the basic foundations of U.S. tax policy, deferral and the foreign tax credit, were laid down fifty years ago and, although modified several times, have remained more or less intact ever since. It was only in the 1960s, when the U.S. Treasury proposed eliminating deferral to help the balance of payments, that tax policy became controversial. It has, in the 1970s, become very controversial indeed. Congress chose not to eliminate deferral or the foreign tax credit but rather to offset their unwanted effects through a variety of compensating measures. An investment tax credit was given to domestic, but not foreign, investment (1962); the Internal Revenue Service stepped up its policing of transfer-pricing practices; deferral was extended to export earnings through domestic international sales corporations (1971) and then modified (1976); the per-country method of calculating the limitation on the foreign tax credit was eliminated for the oil companies (1975) and then for all investors (1976); income from developed countries was no longer exempt from grossing up (1962), nor that from less-developed countries (1976); the eligibility of base-company income for deferral was limited (1962 and, especially, 1975), and new guidelines were issued for allocating R&D, interest, and stewardship expenses among domestic and foreign affiliates (1977). Most recently, President Carter in early 1978 proposed the elimination of both deferral and the DISCs. Maintaining the foundations of a policy, but making one qualification after another, has made it difficult to determine the real thrust of U.S. policy, much less whether it promotes the national interest of the United States.

Tax Policy and Traditional Economic Theory[18]

Traditional economic analysis of taxation is everything that actual U.S. policy is not: clean, coherent, and reasonably easy to understand. It ignores the balance-of-payments, unemployment, and other "short-run" concerns and focuses on "long-run" issues, such as the distribution of income between capital and labor or efficiency in the international location of capital. Such theory is too ethereal to be of much use in drafting

18. Peggy B. Musgrave, *Direct Investment Abroad and the Multinationals: Effects on the United States Economy*, a study prepared for Senate Foreign Relations Committee (GPO, 1975), chap. 7, surveys this literature.

tax legislation, but the way it relates policy to goal is in refreshing contrast to actual practice.

The conclusions of the analysis can be easily stated. A basic theorem is that both the home and the host country benefit from international investment and that the welfare of both is maximized by unrestricted investment. This proposition in investment theory is analogous to Ricardo's theorem that two countries can benefit from international trade predicated on comparative advantage and that free trade maximizes world welfare. But any one country may benefit by restricting international exchange: home countries can benefit by limiting capital exports to force a higher return, host countries by limiting capital imports to lower borrowing costs. Restrictions by either are, however, beggar-thy-neighbor policies, since the country imposing restrictions gains less than its investing partner loses.

Traditional theory also explores the impact of international investment on the distribution of national income between labor and capital in both the home and the host countries. In the home country, the export of capital hurts domestic labor by making it less productive and helps domestic capital by lessening competition. Wages fall, and the return on capital rises. In the host country, the opposite happens, wages rise and the return on capital falls. Local labor becomes more productive when it works with more capital, while locally owned capital suffers from increased competition. Thus, in each country, one faction will tend to support foreign investment and the other to oppose it, as long as the issue revolves around these purely economic considerations.

If either the home or the host country taxes the income of capital, the pattern of international investment may be distorted, and some of the potential global benefits may be lost. In fact, investment decisions will be distorted unless capital export neutrality prevails (that is, unless an investor pays the same total tax on foreign investment as it does on domestic investment). Capital export neutrality can be achieved in a variety of ways. If the host country refrains from taxing foreign investment, then the home country can tax its domestic and its foreign investors at the same rate. Alternatively, if the host country taxes foreign-owned investments, the home country can give a full tax credit to its foreign investors for taxes paid in host countries. The critical difference between these two methods is who collects the taxes, the home country or the host country.

From a national standpoint, taxes paid abroad are hardly as good as taxes paid at home. In traditional analysis, the national gain from foreign investment for the home country is measured by the sum of the returns of the foreign investors and the revenues of the home treasury; national benefits include both public and private gains. Because taxes paid to the foreign government have no benefit for the home country, it has no reason to give its investors a tax credit for foreign taxes paid. The national gain is maximized by disallowing any credit for foreign taxes and allowing only a simple deduction for foreign taxes paid, as was done in the United States from 1913 until 1918.[19]

National neutrality, as opposed to capital export neutrality, prevails when investors have no incentive to invest abroad when the national interest would be better served by domestic investment. The proposal to eliminate the foreign tax credit and allow only a simple deduction for foreign taxes paid has been justified as maximizing U.S. gains from international investment.[20] We hasten to add, however, that this argument presumes that tax policy of other countries is fixed. If foreigners retaliate by changing their tax laws, both home and host countries may wish the tax war had never started.[21]

We should also define capital import neutrality (or competitive neutrality), a standard often advocated by the multinationals. Under this approach, American investors would pay the same taxes on their overseas income as their foreign competitors do. An easy and obvious way of providing capital import neutrality would be for the host country to tax foreign capital at the same rate as locally owned capital and then for the home country to exempt foreign investment income from taxation.[22]

19. The social cost of foreign direct investment to the United States, based on this concept, is estimated at about $2.5 billion annually in Wilson E. Schmidt, "U.S. Capital Export Policy: Backdoor Mercantilism," in *U.S. Taxation of American Business Abroad* (American Enterprise Institute, 1975), pp. 28–31.

20. See Peggy B. Musgrave, "Tax Preferences to Foreign Investment," *Economics of Federal Subsidy Programs, Part 2: International Subsidies*, papers submitted to Joint Economic Committee (GPO, 1972), pp. 176–219; and her comments in *Tax Subsidies and Tax Reform*, Hearings before the Joint Economic Committee, 92:2 (GPO, 1973), pp. 192–96, 200–02.

21. See Koichi Hamada, "Strategic Aspects of Taxation on Foreign Investment Income," *Quarterly Journal of Economics*, vol. 80 (August 1966), pp. 361–75.

22. France and the Netherlands follow this practice. It is advocated for the United States by Norman B. Ture, "Taxing Foreign-Source Income," in *U.S. Taxation of American Business Abroad*, pp. 37–66.

These simple conclusions about national tax policy depend on simple assumptions about the international investment process. The most dramatic qualifications of the simple traditional theory come not from introducing new wrinkles but from altering the fundamental assumptions about the foreign investment process. Suppose, first, that foreign investment entails the transfer of technology rather than capital. Unlike a capital outflow, the international transfer of technology does not inhibit domestic production. While traditional economists have studied this sort of international exchange,[23] the implications for taxing foreign investment income have not been widely appreciated. If technology can indeed be transferred to foreign production without materially harming domestic production, the national interest in taxing this foreign-source income evaporates, because nothing is gained from trying to keep it at home. On the other hand, nothing is lost in taxing that income, because the foreign investor will make the transfer despite the tax. In the short run, the home country's tax policy affects only the distribution of the benefits between the public and the private sector; in the long run, high taxes may discourage R&D spending.

Another modification of the simple conclusions adduced above comes from opening a second channel for international capital flows. Traditional analysis assumes that foreign investment entails only equity capital, not debt. The distinction between the two is critical, because the two types of income are taxed in very different ways. Equity income is taxed primarily in the host country, with the home country giving a foreign tax credit, while interest income is typically subject to a small withholding tax in the host country and bears the full income tax in the home country.

If foreign investment can be either debt or equity, the investors' choice between the two may be determined largely by tax or other policy considerations. For example, American multinationals sharply increased the use of debt to finance their foreign operations during the period of the U.S. balance-of-payments controls on outflow of U.S. capital to finance foreign direct investment. If the home country eliminates its foreign tax credit, the primary impact may be to encourage the substitution of debt for equity in international capital flows. A seemingly substantial reform in national tax policy may change the form, but not the volume, of international lending.

23. Michael Connolly, "Trade in Public Goods: A Diagrammatic Analysis," *Quarterly Journal of Economics*, vol. 86 (February 1972), pp. 61–78.

Assessing Current U.S. Tax Policy

Traditional tax theory suggests three standards by which U.S. policy might be judged: national neutrality, capital export neutrality, and competitive neutrality. National neutrality, aimed at maximizing the national advantage, allows U.S. investors to deduct foreign taxes from their taxable income but denies a tax credit. Capital export neutrality, which should maximize the global benefits of international investment, could be obtained by eliminating deferral but giving an unlimited foreign tax credit. Competitive neutrality, which achieves tax equity between investors of different nationalities, requires an exemption of foreign investment income from U.S. taxes.[24] Accordingly, the current U.S. policy of exempting subsidiaries' income from U.S. taxation until dividends are paid and then giving a foreign tax credit has been characterized as a hybrid of competitive and capital export neutrality.[25] With a foreign tax credit at its base, U.S. policy falls short of national neutrality.

This characterization of U.S. policy is, at best, a rough one. The difference between competitive and capital export neutrality can be substantial, so knowing that U.S. policy falls somewhere in between is useful but hardly definitive. How much difference in actual practice is there between competitive and capital export neutrality? How much difference does deferral really make? How much of that difference is offset by the U.S. investment tax credit or DISC, neither of which applies to foreign investment? The complexity of the U.S. and foreign tax systems and the diversity of investors' tax circumstances make it difficult to offer more than rough answers. Nevertheless, we attempt in this section to evaluate the overall thrust of existing tax policy.

The best sources of information on the income and taxes of individual corporations are the 10-K forms filed annually with the U.S. Securities

24. Tax analysts sometimes relate tax liabilities to services provided the taxpayer by the government collecting the revenue. We assume no relation between them.

25. See Krause and Dam, *Federal Tax Treatment of Foreign Income*, pp. 53–54; Musgrave, *United States Taxation of Foreign Investment Income*, pp. 120–21; and Gary C. Hufbauer; "A Guide to Law and Policy," in *U.S. Taxation of American Business Abroad* (American Enterprise Institute, 1975), pp. 1–6. Full capital import neutrality would require host countries to avoid any levies on foreign companies, such as withholding taxes on remitted dividends, which they did not levy on local firms.

and Exchange Commission. Until recently, these forms provided minimal information about foreign versus domestic sales, assets, income, and taxes. Most corporations published only consolidated statistics for global operations. Under pressure from the Securities and Exchange Commission to present disaggregated financial statistics and to reconcile book income reported to shareholders and taxable income reported on tax forms, however, American corporations give more detailed data on their global operations. We have thus been able to compile basic tax and financial statistics from the 1974 10-K forms for six large petroleum companies and thirty-six large manufacturers, all of which have substantial foreign operations. Although many corporations did not report certain data, and definitions vary from one corporation to another, some basic patterns of multinational behavior are revealed (table 6-1).

In columns 1 and 2 we show U.S. and foreign income taxes payable in 1974 as a percentage of book income before taxes in the respective areas. Columns 3 and 4 show taxes payable plus taxes deferred as a percentage of book income before taxes.[26] Tax burdens vary substantially from one corporation to another. For example, International Business Machines paid U.S. income taxes equal to 51.3 percent of its U.S. book income before taxes, while International Telephone and Telegraph paid only 19.7 percent. The twenty-four manufacturing corporations reporting the relevant tax and income data paid U.S. taxes averaging 30.7 percent of U.S. book income, slightly higher than the 28.5 percent average for the six petroleum companies but well under the statutory 48 percent rate, reflecting the combined impact of accelerated depreciation, the investment tax credit, DISC, the favorable tax treatment of capital gains, and so forth.

Whether one looks at taxes payable or taxes payable plus taxes deferred, foreign taxes as a percentage of foreign book income usually exceed U.S. taxes as a percentage of U.S. book income. For the six petroleum companies, foreign taxes payable are almost 70 percent of foreign book income, or more than twice the proportion for U.S. taxes. These foreign income taxes consist largely of taxes paid to oil-exporting

26. Because depreciation allowances for tax purposes are accelerated compared to those used in reporting book income to shareholders, corporations deduct from their book income taxes paid and taxes deferred. The figure (taxes payable or taxes payable plus taxes deferred) that gives the better picture of a firm's tax burden is a conceptual problem, not only a technical one.

Table 6-1. *Income Tax and Financial Ratios for Selected American Petroleum and Manufacturing Multinationals, 1974*

Multinational and rank according to sales	*Tax payable as percentage of before-tax income*		*Tax payable plus tax deferred as percentage of before-tax income*		*U.S. tax as percentage of global tax*		*U.S. before-tax income as percentage of global before-tax income*	*U.S. assets as percentage of global assets*	*U.S. sales as percentage of global sales*
	U.S. tax: U.S. income (1)	*Foreign tax: foreign income* (2)	*U.S. tax: U.S. income* (3)	*Foreign tax: foreign income* (4)	*Payable* (5)	*Payable plus deferred* (6)	(7)	(8)	(9)
Petroleum companies									
Exxon (1)	33.4	78.2	34.9	78.8	8.1	8.3	17.0	54.2	n.a.
Texaco (4)	8.6	49.9	14.4	52.3	3.7	5.8	18.2	48.0	n.a.
Mobile Oil (5)	18.3	75.0	23.9	79.3	3.5	4.2	12.8	45.4	n.a.
Standard Oil of California (6)	20.8	49.6	14.6	50.2	11.1	7.9	22.9	n.a.	34.2
Gulf Oil (7)	47.0	78.8	21.8	80.2	8.4	4.8	13.3	n.a.	60.7
Marathon Oil (60)	43.0	79.8	36.2	79.8	14.2	12.3	21.7	n.a.	59.5
Average[a]	28.5	68.6	24.3	70.1	8.1	7.1	17.7	49.2	51.5
Manufacturing companies									
General Motors (2)	23.2	55.8	41.4	48.0	72.2	84.3	86.2	69.8	72.9
Ford Motors (3)	−18.6	55.6	15.5	64.1	−55.9	20.7	51.9	76.9	64.6
General Electric (8)	n.a.	n.a.	n.a.	n.a.	77.9	79.4	n.a.	n.a.	n.a.
International Business Machines (9)	51.3	46.9	47.5	45.5	53.1	52.0	50.9	58.0	53.1

International Telephone and Telegraph (10)	19.7	49.2	13.7	60.4	19.0	11.7	36.9	n.a.	49.2
Union Carbide (22)	25.2	49.7	30.7	54.2	41.8	44.4	58.6	n.a.	65.7
Dow Chemical (27)	n.a.	n.a.	n.a.	n.a.	61.1	63.3	n.a.	n.a.	53.0
Procter and Gamble (28)	43.1	39.4	47.1	44.7	73.3	72.6	71.5	n.a.	n.a.
Eastman Kodak (32)	39.8	45.1	41.1	48.3	73.0	72.3	75.4	66.6	63.2
Caterpillar Tractor (36)	n.a.	n.a.	n.a.	n.a.	77.8	77.4	n.a.	n.a.	81.4
Xerox (41)	50.6	38.3	53.1	47.6	58.0	53.9	51.1	51.4	58.0
Monsanto (43)	n.a.	n.a.	n.a.	n.a.	75.9	75.8	n.a.	60.7	71.4
W. R. Grace (44)	n.a.	n.a.	n.a.	n.a.	36.0	41.7	n.a.	63.5	62.4
Continental Can (52)	n.a.	n.a.	n.a.	n.a.	84.9	70.1	n.a.	n.a.	91.7
Minnesota Mining and Manufacturing (59)	41.7	41.3	45.7	41.3	61.1	63.2	60.8	8.27	n.a.
Honeywell (68)	−3.5	22.5	41.5	17.6	−25.9	75.3	56.8	50.2	59.2
Sperry-Rand (70)	39.5	32.7	44.7	47.0	51.9	45.9	47.2	76.0	n.a.
Consolidated Production Corp., Int. (71)	38.4	41.9	40.9	47.7	41.4	39.9	43.6	n.a.	50.3
Coca Cola (74)	n.a.	n.a.	n.a.	n.a.	26.2	28.3	n.a.	58.8	59.0
Uniroyal (82)	24.5	42.2	38.4	42.9	33.7	43.9	46.7	n.a.	67.6
National Cash Register (97)	n.a.	n.a.	n.a.	n.a.	23.2	37.3	n.a.	52.5	48.7
Johnson and Johnson (99)	40.0	39.7	41.1	43.7	48.7	46.9	48.5	n.a.	58.7
Warner Lambert (102)	n.a.	n.a.	n.a.	n.a.	38.2	40.6	n.a.	n.a.	57.0
Borg-Warner (108)	28.8	45.2	24.6	41.6	59.4	57.7	69.7	n.a.	72.5
American Standard (117)	40.2	60.7	59.8	55.1	56.6	68.1	66.3	n.a.	54.7
National Lead (124)	50.3	38.7	30.1	42.7	43.8	29.7	37.5	n.a.	80.6

Table 6-1 (*continued*)

Multinational and rank according to sales	*Tax payable as percentage of before-tax income*		*Tax payable plus tax deferred as percentage of before-tax income*		*U.S. tax as percentage of global tax*		*U.S. before-tax income as percentage of global before-tax income*	*U.S. assets as percentage of global assets*	*U.S. sales as percentage of global sales*
	U.S. tax: U.S. income (1)	*Foreign tax: foreign income* (2)	*U.S. tax: U.S. income* (3)	*Foreign tax: foreign income* (4)	*Payable* (5)	*Payable plus deferred* (6)	(7)	(8)	(9)
Pfizer (130)	−18.8	37.8	17.2	41.2	−20.9	12.6	25.7	53.7	47.0
Burroughs (134)	31.2	40.1	46.2	32.4	61.4	74.5	67.2	62.0	63.4
H. J. Heinz (139)	23.8	43.3	26.2	48.3	39.3	39.0	54.1	57.0	58.7
Merck (152)	n.a.	n.a.	n.a.	n.a.	77.4	77.8	n.a.	n.a.	55.0
Gillette (160)	53.2	42.1	52.4	40.9	43.8	44.2	34.8	n.a.	49.5
Crown Cork and Seal (248)	42.5	46.7	43.7	46.7	58.2	61.9	59.6	n.a.	n.a.
Schering-Plough (266)	n.a.	n.a.	n.a.	n.a.	73.8	73.4	n.a.	n.a.	55.7
Chesebrough-Ponds (309)	44.4	37.6	46.4	37.6	73.9	74.7	70.5	n.a.	68.7
Norton (311)	26.3	29.0	39.7	36.7	36.3	40.5	38.6	n.a.	55.1
Miles Laboratories (420)	n.a.	n.a.	n.a.	n.a.	20.4	20.4	n.a.	n.a.	74.8
Average[a]	30.7	42.2	38.7	44.6	46.4	53.2	54.4	62.8	62.2
Average, all companies[a]	30.3	47.5	35.8	49.7	40.9	46.6	47.1	60.5	61.3

Sources: 1974 Securities and Exchange Commission 10-K forms filed by individual corporations; global income, sales, and assets from consolidated income statements and balance sheets; most tax data from notes to income statements or supplementary notes to 10-K reports; most foreign income, sales, and assets from text of reports. Data do not include state and local taxes; Canadian data were subtracted where necessary by assuming values at 10 percent of total. Negative entries indicate excess tax credits, which can be applied to taxes for an earlier or a later year. Sales rank from "The Fortune Directory of the 500 Largest Industrial Corporations," *Fortune*, vol. 91 (May 1975).

n.a. Not available.

a. Averages based on companies for which data are available.

countries and perhaps should not be counted as income taxes. But even when we turn to manufacturing companies, foreign taxes are still comparatively larger. Income taxes paid average 42.2 percent of book income overseas versus 30.7 percent in the United States, which is a substantial differential. This differential is narrowed, but hardly eliminated, when taxes deferred are included in the measured tax burden. Foreign taxes payable or deferred average 44.6 percent of foreign book income, compared to 38.7 percent in the United States. Although one can find counterexamples (for example, IBM and Xerox), American corporations do seem to pay heavier taxes on their foreign investment income than they do on their domestic investment income.

The total taxes paid at home or abroad depend not only on domestic and foreign tax laws but also on how much income accrues in each jurisdiction. Reported income reflects the inherent profitability of domestic and foreign investment as well as the allocation of income and expenses within the multinational corporation. If a multinational has some leeway in determining the transfer price for components manufactured in the United States and sold to a foreign affiliate, a high transfer price will increase reported U.S. book income and diminish foreign book income. To determine how income and taxes are allocated between U.S. parents and their foreign affiliates, we have computed the ratios of U.S. taxes, book income, assets, and sales to the global amounts.

In table 6-1, columns 5 and 6 show U.S. taxes payable in 1974 as a percentage of global taxes payable and U.S. taxes payable or deferred as a percentage of the comparable global total, respectively. For the six petroleum companies, U.S. taxes average only 7–8 percent of the global total, using either tax measure. Among the manufacturers, the U.S. share is considerably higher: the thirty-six companies surveyed paid 46.4 percent of their global taxes to the United States, while taxes paid plus taxes deferred in the United States were 53.2 percent of the global total. In short, these large multinational manufacturers pay approximately half of their total taxes to the U.S. Treasury and half to overseas tax authorities. This is less than the U.S. share of the book income of the firms, as shown in column 7, because foreign income taxes are comparatively higher than American.

Although corporations do not consistently report the national distribution of their sales or assets, enough do to draw tentative conclusions about foreign versus domestic rates of return. The three petroleum

companies publishing the necessary statistics had 49.2 percent of their assets and 51.5 percent of their sales in the United States. Fifteen manufacturers reported U.S. assets averaging 62.8 percent of global assets, while U.S. sales averaged 62.2 percent of global sales for thirty-one of them. Thus, in manufacturing as well as petroleum, the U.S. share of taxes and book income is smaller than its apparent share of either assets or sales. The pretax return on assets or sales appears to be higher for foreign affiliates than for their U.S. parents, even though average tax burdens would seem to favor allocating income to the U.S. parents rather than their foreign affiliates.

This may simply suggest that foreign investment has heretofore been more profitable than domestic investment. Or the allocation of income may favor foreign affiliates at the expense of U.S. parents; as we see below, average tax burdens may be a poor indicator of the additional taxes payable when taxable income is increased via transfer pricing. But, whatever the cause, the statistics in table 6-1 show foreign affiliates reporting higher book rates of return than their U.S. parents.

We must investigate foreign tax practices in greater detail to understand how and why American firms may end up paying higher taxes on foreign affiliate income than they do on domestic income. This is a tall order, because statutory income tax rates vary substantially from one country to another. Worse, so do depreciation allowances, treatments of capital gains, provisions for carrying losses forward or backward, and so on. One approach is to use Department of Commerce data on foreign income taxes as a percentage of American affiliates' book income, which indicate that manufacturing affiliates paid 42.0 percent of book income in income taxes in 1966 and 40.1 percent in 1970.[27] The problem in using these statistics is that one cannot be sure what the comparable U.S. tax rate was. Book income usually exceeds taxable income because of the generous tax treatment of depreciation, but the size of that differential is hard to determine.

The next best solution is a measure of foreign tax payments as a percentage of foreign affiliate income, using the Internal Revenue Service definitions of income. Fortunately, such estimates are available. When American corporations compute their allowable foreign tax credit, they must state the ratio of current dividends to current earnings using U.S. Internal Revenue Code definitions of income. M. E. Kyrouz, working for

27. *Survey of Current Business*, vol. 54 (May 1974), table 7, p. 36.

the international tax staff of the U.S. Treasury, analyzed corporate tax returns for 1968 and computed realized tax rates for manufacturing affiliates in most foreign countries.[28]

We show in column 1 of table 6-2 Kyrouz's realized tax rates (expressed per thousand dollars of taxable income) for manufacturing affiliates in twenty-four countries for which we could obtain the necessary dividend payout ratios. Thus, for example, the Canadian affiliates of American firms paid an average of $428 in Canadian income taxes per thousand dollars taxable income.

If the affiliates reinvest all their earnings, they would pay no taxes beyond those shown in column 1 because of the U.S. policy of deferral. But when dividends are paid out, they are subject first to a dividend withholding tax collected by the foreign country and, at least potentially, to income taxes in the United States. The dividend withholding taxes are payments over and above the regular income taxes on foreign affiliate income. In the second column, we show the withholding tax rates which various countries applied to dividends paid to U.S. investors in 1968, and in the third column the portion of after-tax earnings paid out as dividends by American manufacturing affiliates. Using these three columns, we compute in column 4 the withholding taxes on dividends paid to foreign governments per thousand dollars pretax income. By adding the income taxes in column 1 to the withholding taxes in column 4, we obtain the total taxes paid to the foreign government, as shown in column 5.

We should pause here a moment and look at the figures in column 5. Foreign income and withholding taxes frequently amount to 40 percent to 50 percent of the foreign affiliates' earnings. If we use the total earnings from each country (see column 10) to get a weighted average of countries' tax rates, we see (column 5) that U.S.-owned manufacturing affiliates paid foreign taxes averaging 43.8 percent of their pretax income in 1968. While many low-tax countries (such as Taiwan, Singapore, and Ireland) are excluded from table 6-2 for lack of dividend data, the aggregate earnings of all excluded countries amounted to only 4.3 percent of the worldwide total in 1968. Thus, even if these countries collected no income or dividend withholding taxes, the global average could drop only to 41.9 percent of pretax income. Although American investors may not have religiously used the Internal Revenue Code definitions of income in computing foreign tax credits, we are probably safe in conclud-

28. See source note, table 6-2.

Table 6-2. *Foreign Tax Rates on American Manufacturing Multinationals, Selected Countries, 1968*

Ratio per thousand dollars of taxable income

Country	*Realized foreign income tax*[a] (*1*)	*Foreign withholding tax rate* (*2*)	*Dividend payout rate* (*3*)	*Foreign withholding tax paid*[b] (*4*)	*Foreign tax paid*[c] (*5*)	*U.S. tax liability*[d] (*6*)	*Foreign tax credit*[e] (*7*)	*Tax credit deficit*[f] (*8*)	*Global tax*[g] (*9*)	*Global earnings* (*10*)
Developed										
Canada	428	0.15	0.394	34	462	189	203	−13	449	0.267
United Kingdom	386	0.15	0.520	48	434	250	249	1	435	0.176
Belgium	344	0.15	0.340	33	377	163	151	13	390	0.018
France	480	0.05	0.674	18	498	324	341	−18	480	0.035
Germany	430	0.15	0.711	61	491	341	367	−25	466	0.105
Italy	411	0.05	0.755	22	433	362	333	30	463	0.019
Netherlands	345	0.05	0.725	24	369	348	274	74	443	0.020
Denmark	325	0.05	0.750	25	350	360	269	91	441	0.002
Norway	458	0.10	0.250	14	472	120	128	−8	464	0.002
Sweden	431	0.05	0.777	22	453	373	357	16	469	0.004
Switzerland	222	0.05	0.441	17	239	212	115	97	336	0.017
Japan	415	0.10	0.322	19	434	155	153	2	436	0.051
Australia	406	0.15	0.411	37	443	197	204	−6	436	0.056
New Zealand	487	0.05	0.076	2	489	37	39	−3	486	0.005
South Africa	358	0.15	0.567	55	413	272	258	15	427	0.015

Less developed										
Mexico	422	0.20	0.473	55	477	131	170	−39	438	0.038
Panama	139	0.10	0.882	76	215	365	182	183	398	0.007
Argentina	217	0.12	0.605	57	274	227	160	68	342	0.030
Brazil	300	0.25	0.643	113	413	216	248	−32	381	0.049
Chile	330	0.40	0.428	115	445	138	210	−72	373	0.003
Peru	321	0.30	0.800	163	484	261	337	−77	407	0.002
Venezuela	300	0.15	0.314	33	333	106	99	7	340	0.021
India	570	0.257	0.833	92	662	172	303	−131	531	0.005
Philippines	296	0.35	0.880	217	513	297	400	−103	410	0.010
Average, weighted by dividends	387	0.150	0.533	52	439	247	253	−5	434	...
Average, weighted by earnings	391	0.148	0.511	47	438	230	235	−5	433	...

Sources: Estimates of realized foreign income and withholding tax rates (columns 1 and 2) from M. E. Kyrouz, "Foreign Tax Rates and Tax Bases," *National Tax Journal*, vol. 28, no. 1 (March 1975), pp. 62-66; 1968 dividend payout ratios (column 3) and global earnings (column 10) calculated from *Survey of Current Business*, vol. 54 (August 1974), pp. 20-21.

a. Based on pretax income.

b. Before-tax income, minus foreign income tax paid (column 1), times dividend payout rate (column 3), times withholding tax rate (column 2).

c. Calculated by adding income tax (column 1) and withholding tax (column 4).

d. For developed countries, subject to grossing, the liability is 48 percent of dividend payout rate (column 3) times $1,000 before-tax income. For less-developed countries, exempt until 1976 from grossing, the liability is 48 percent of foreign affiliate income after income taxes, times dividend payout rate.

e. For developed countries, credit is dividend payout rate, times realized foreign income tax, plus foreign withholding taxes paid. For less-developed countries, credit is ratio of income after the income tax to income before that tax, times income tax, times the dividend payout rate, plus withholding taxes paid.

f. Tax credit is U.S. tax liability (column 6), minus tax credit (column 7); figures are rounded.

g. Tax is foreign tax (column 5), plus tax credit (column 8).

ing that foreign income and withholding taxes exceed 40 percent of the affiliates' taxable income.

Despite the severe differences in national tax laws, accounting rules, sample coverage, and dates, the various sources of tax information indicate that foreign taxes equal 40–45 percent of affiliates' income. Our limited sample of twenty-four large manufacturers in table 6-1 had foreign taxes amounting to 42.2 percent of the foreign affiliates' book income. The Commerce Department survey found that foreign income taxes averaged 42 percent of manufacturing affiliates' book income before taxes in 1966 and 40.1 percent in 1970. Using Kyrouz's statistics on realized income tax rates in 1968, plus other statistics on dividend payout ratios, we find that foreign taxes amounted to 43.8 percent of affiliates' pretax income, using U.S. Internal Revenue Code definitions.[29]

Having described foreign taxation of American investments abroad, we can now focus on U.S. taxes on their income. In column 6 of table 6-2 we show the taxes that would be due in the United States were it not for the foreign tax credit. This tentative tax liability is based solely on the dividends paid out; U.S. taxes on earnings retained by the foreign affiliates are deferred. Before 1976, for the developing countries the tentative tax liability in the United States equaled 48 percent of the dividend paid by the affiliate. A Philippine affiliate paying a $620 dividend (88 percent of $704 after-tax earnings) would generate a tentative U.S. tax liability of $297 (48 percent of $620). For developed countries, dividends must be grossed up by the portion of the foreign income tax corresponding to the paid-out dividend, which is equivalent to basing the U.S. tax on pretax income multiplied by the dividend payout rate. For example, the $189 tentative U.S. tax liability on Canadian-source income equals 48 percent (the U.S. tax rate) of 39.4 percent (the dividend payout rate shown in column 3) of each thousand dollars in pretax income.

29. We reject the notably lower rate in Robert B. Stobaugh, "The U.S. Economy and the Deferral of U.S. Income Tax on Foreign Earnings" (Cambridge, Massachusetts: Management Analysis Center, 1975; processed), p. 3-1. Stobaugh's analysis of the impact of deferral is predicated on a foreign income tax rate of only 33 percent of the foreign affiliates' income before taxes, a Commerce Department estimate for affiliates whose foreign taxes were less than 48 percent of their taxable income. The apparent rationale for excluding affiliates paying higher taxes was that they would be unaffected by the repeal of deferral. But the majority of manufacturing investors used the overall method of calculating foreign tax credit, so high taxes from one affiliate are averaged with low taxes from another. Commerce Department statistics based on all manufacturing affiliates are sounder than those used by Stobaugh.

Next we come to the foreign tax credit. For dividend income, the tax credit equals the foreign income taxes allocable to the dividend plus the withholding tax applied directly to the dividend. To take the Canadian case as our example again, the foreign tax credit would amount to 39.4 percent (the dividend payout rate) of $428 (Canadian income taxes paid), or $169, plus the $34 in Canadian withholding taxes. The foreign tax credits from the less-developed countries were less because of the exemption from grossing up (repealed in 1976). In the Philippine example, the $400 tax credit equals $217 for the withholding tax plus $183 of the income tax (88 percent of $296 times $1 - 0.296$). As we can see by comparing column 6 to column 7, as often as not, the tentative U.S. tax liability is fully offset by a foreign tax credit. The weighted average of foreign tax credits for the twenty-four countries shown in table 6-2 exceeds that of tentative U.S. taxes by $5.

What happens next depends on how the American investor calculates the limitation of its foreign tax credit. If it elects the per-country method (which it could do until 1976), it would pay the difference between the tentative tax liability and the applicable foreign tax credit whenever that difference were positive. Thus no additional taxes would be paid on Canadian-source income, but an additional $1 per thousand dollars of U.K.-source income would be payable to the U.S. Treasury. If the investor elects the overall method, it can match its total foreign tax credits from all countries against its total tentative tax liability. The negative figures in column 8 can be used to offset the positive ones. If the investor has an overall surplus of foreign tax credits, it pays no additional taxes in the United States. We can then refer back to column 5 to determine the global tax burden on foreign affiliate income, for the United States has imposed no additional taxes. If the investor has an overall deficit of foreign tax credits, it must pay to the U.S. Treasury the difference between the total tentative tax liability and total foreign tax credits.

Perhaps the most meaningful way of showing the consequences of an overall deficit of foreign tax credits is to ask what would happen if foreign affiliates in various countries generated an additional thousand dollars in taxable income and paid additional foreign taxes and dividends at the rates shown in columns 1 through 5. In the Canadian case, a foreign tax credit $13 larger than the tentative tax liability would be generated, and the American investor could reduce its U.S. taxes on other foreign income by that amount. In the U.K. case, however, the foreign tax credit is less than the increased tentative tax liability, and the

U.S. investor would increase its U.S. taxes by one dollar. Column 8 thus displays the U.S. tax on foreign affiliate income for a corporation having an overall deficit of tax credits. If we add the tax credit deficit in column 8 to the total foreign taxes in column 5, we can calculate the global tax burden on the additional foreign-source income. In some instances that global burden exceeds the foreign burden, in others it falls short.

The conclusion is that the total taxes imposed on each foreign affiliate's income depend not just on the income and withholding taxes imposed directly on that income but on the American investor's global tax situation. If the investor has sufficient overall tax credits, no U.S. taxes are paid on any foreign-source income, not even that from low-tax countries. Income from various countries is taxed at the rates shown in column 5. If the investor has insufficient tax credits, however, the global tax burden includes a U.S. adjustment, shown in column 8. The total tax burden on income from low-tax countries is increased, while that on income from high-tax countries is decreased. U.S. tax policy, if it has any impact at all, serves to increase the global tax burden slightly and to smooth the variation in tax burdens on income from different countries.

What use can we make of the calculations in table 6-2? What can we learn from knowing that the global tax burden on income from various countries is as we show it in column 5 or column 9? In answering these questions, we must distinguish between transfer pricing and location-of-investment issues. By transfer-pricing issues, we mean the flexibility that American multinationals may have in setting prices for intrafirm exports and imports; in levying charges for research and development, head-office expenses, trademarks, and goodwill; in using debt or equity in advancing funds to overseas affiliates; in charging interest on intrafirm loans; and in otherwise allocating income within the multinational firm. These are very complex decisions. Foreign exchange controls, exchange rate uncertainties, limits on profit repatriation, and the firm's internal accounting rules, and tax considerations influence firms' internal accounts strategy.[30]

30. That tax avoidance does affect various intrafirm accounts has been shown by Sidney Robbins and Robert B. Stobaugh, *Money in the Multinational Enterprise* (Basic Books, 1973), pp. 28 and 77; George F. Kopits, "Dividend Remittance Behavior Within the International Firm: A Cross-Country Analysis," *Review of Economics and Statistics*, vol. 54 (August 1972), pp. 339–42; and George F. Kopits, "Intrafirm Royalties Crossing Frontiers and Transfer Pricing Behavior" (November 1974; processed).

Tax authorities both in the United States and abroad try to constrain firms' flexibility in exporting locally taxable income. Ordinary income subject to no special deductions or credits is taxed in the United States at a rate of $480 per thousand dollars of income. If the tax rates shown in columns 5 and 9 are tolerable approximations of the taxes due on additional foreign affiliate income, then the net tax benefit of allocating income to overseas affiliates would be $480, less those rates. In some cases (for example, France), the benefit may be negative, and the American multinational transferring income to such an affiliate would pay more foreign income and withholding taxes than it would have paid in U.S. income taxes. In other cases, the tax benefits of allocating income to overseas affiliates are positive, but small. Nontax considerations may dominate intracompany accounting practices. But when foreign tax rates are substantially below American, as they are in Switzerland and Panama, the tax savings from shifting income may be substantial. Since the tax rates shown in columns 5 and 9 average slightly less than $480, we conclude that on average an American investor has a weak tax incentive to allocate taxable income to most overseas affiliates but substantial incentive to transfer income to low-tax affiliates.[31]

If we consider where the investment is made, the differential in tax rates may be even smaller. Real investment in the United States benefits from an investment tax credit, from the asset depreciation range acceleration of depreciation allowances, and, perhaps, from the use of a domestic international sales corporation. Unlike other elements in the definition of taxable income, these allowances are not extended to foreign source income and are not, as a consequence, reflected in Kyrouz's realized tax rates.

Adjusting the U.S. tax rate to account for investment tax credit or accelerated depreciation can be complex, because the tax savings are concentrated in the early years of the investment rather than spread evenly over its lifetime. Consider the investment tax credit. From 1962 to 1966, 1967 to 1969, and 1971 to 1975, 7 percent of expenditures on qualifying machinery and equipment could be deducted from current U.S. taxes. The investment tax credit serves to reduce the initial capital outlay and, thus, to raise the rate of return on domestic investment. The

31. This conclusion assumes that, for one reason or another, such income would not be treated as base-company income, which under subpart F is subject to current U.S. taxation rather than deferral.

same effect could be achieved by reducing the tax on the investment income. The size of the comparable reduction in the income tax rate depends on several factors, such as the coverage of the investment tax credit or the rules for depreciating new investment. The 7 percent investment tax credit provides roughly the same stimulus to domestic manufacturing investment as a reduction in the corporate income tax from 48 percent to 46 percent.[32] If investors can use the asset depreciation range, also, to shorten the depreciation life of investment by 20 percent, manufacturing investment would be further stimulated; the boost would be the same as lowering the income tax rate from 46 percent to 45 percent. If the rough assumptions behind these calculations are sound, we should conclude that the investment tax credit and the use of the asset depreciation range virtually equalizes the average tax burden on domestic and foreign investment. Although individual corporations may have strong tax incentives to locate certain types of investments in certain foreign countries, the average tax incentive to invest abroad rather than in the United States is minimal.

If the choice is between investing abroad to serve the local market and investing in the United States for export, tax considerations may favor the

32. Hufbauer, "The Taxation of Export Profits," pp. 43–60, derives a formula for the tax-cost-of-capital index: $I = 1 - uz - f/1 - u$, in which I is the index, u is the nominal tax rate, z is the present value of depreciation deductions from taxable income, and f is the present value of the investment tax credit or similar subsidy.

This index measures the proportion by which a tax system increases the pretax return on capital necessary to generate any given aftertax return. We assume, somewhat arbitrarily, that 50 percent of all new investment (including that in inventories and other current assets) is depreciable and that Hufbauer's estimate of z (.547) applies to those investments. Thus, our estimate of .274 is half of Hufbauer's. These estimates do not include the use of ADR allowances. If u is 48 percent and there is no investment tax credit, f equals zero and I equals 1.67. If a 7 percent tax credit applicable to 40 percent of total investment is introduced, then f equals 2.8 percent (40 percent of 7 percent), and I drops to 1.62. By taking the total differential of the formula for I, we show that reducing u from 48 percent to 46 percent would have a comparable impact on I.

Determining the impact of ADR requires additional assumptions: Hufbauer's estimate of the present value of z follows from a 10 percent rate of discount, an investment with a 13-year depreciable life, and the use of the straight-line method of depreciation. If ADR shortens the depreciable life by 20 percent, to 10.4 years, it increases the present value of future depreciation to .605 times the current capital outlay. Because we assume that only 50 percent of total investment is depreciable, our estimate of z increases from .274 to .303. By accelerating the depreciation deductions, ADR further reduces the tax cost of capital from 1.62 to 1.59; a comparable reduction in I could also be achieved by further reducing the income tax from 46 percent to 45 percent.

latter. If the American investor establishes a domestic international sales corporation to receive export commissions, it can defer indefinitely at least one-quarter of its income from U.S. taxation. The combination of a 7 percent investment tax credit, ADR depreciation allowances, and the use of a DISC can reduce realized U.S. taxes from 48 percent to 33.8 percent (75 percent of 45 percent) of pretax income.

In summary, the most striking feature of the existing tax system is its complexity and, consequently, the variation of effective rates of taxation from one corporation to another and from one country to another. Of the twenty-four companies reporting foreign tax and income statistics, American Standard pays 60.7 percent of its foreign affiliates' book income in foreign taxes, while Honeywell pays only 22.5 percent in foreign taxes (see table 6-1). For the twenty-four countries examined, foreign income and withholding taxes average 66.2 percent of taxable income in India and 21.5 percent in Panama. In averaging these tax burdens across countries, we compute a typical tax burden of 43.8 percent for 1968 (see table 6-2). Because this rate is less than the 48 percent statutory rate in the United States, we conclude that American corporations might have a weak incentive to allocate taxable income to foreign, rather than American, affiliates. The high income and withholding taxes in Canada and most countries in Western Europe discourage allocating income to those affiliates, whereas the low tax rates in certain (particularly developing) countries may attract taxable income to them.

When the issue shifts from transfer pricing to the location of investment, tax differentials narrow further. The investment tax credit and the ADR, which apply only to domestic investment, offer inducements to invest in the United States rather than abroad. Furthermore, if the manufactures are destined for export, a DISC can reduce the U.S. tax rate by one-fourth, more than enough to tilt the tax bias toward investing in the United States. Despite the widespread view that current U.S. tax policy encourages American corporations to allocate income and investment to overseas affiliates, that bias is true only in exceptional cases.

Possible Changes in U.S. Tax Policy

We turn now to an analysis of the effects of possible changes in U.S. tax policy, singly or in combination, on the location of new investment, the level of taxes paid at home and abroad, corporate profitability, and

other items of potential concern. Although one inevitably prejudges certain issues in drawing up the list of changes to be considered, we scanned a long menu: eliminating deferral, going back to the per-country method of calculating the foreign tax credit, extending the domestic investment tax credit to foreign expenditures on qualifying machinery and equipment, repealing DISC, increasing R&D charges against foreign-source income, and replacing the foreign tax credit with a simple deduction.

Repealing Deferral

Under current tax policy, an American investor's tentative tax liability and offsetting tax credit are based on the dividends it receives, which are typically a third to a half of its affiliates' total earnings. As long as foreign income and withholding taxes average less than 48 percent of the affiliates' earnings (which occurred in eighteen out of twenty-four countries represented in column 5 of table 6-2), American investors benefit from deferral. Were deferral eliminated and all foreign earnings subject to U.S. taxes, the effective rate of taxation on those earnings would be elevated to 48 percent.

Assuming that American investors could continue to use the overall method of calculating allowable foreign tax credits, the tax burden on income from various countries would increase by $480 minus the amount shown in column 5 or 9 of table 6-2. Taxes on income from a Canadian affiliate would be increased by $18 per thousand dollars of pretax income for an investor with a current overall surplus of tax credits, and by $31 per thousand dollars for an investor with an overall deficit. Since the earnings-weighted average of foreign taxes across all twenty-four countries in 1968 was 43.8 percent, repealing deferral would have raised an American investor's taxes by over 4 percent of foreign affiliate earnings before taxes in that year.

Between 1968 and 1974, foreign earnings of manufacturing affiliates increased substantially and dividend payout ratios declined from 51 percent to 40 percent.[33] Even if foreign income and withholding tax rates remained constant, the decline in the dividend payout ratio alone would have reduced the average tax burden on foreign affiliate earnings from 43.8 percent to 42.7 percent. By this reckoning, repealing deferral might

33. *Survey of Current Business*, vol. 54 (August 1974), pp. 20–21; and ibid., vol. 55 (October 1975), table 4.

cost American investors 5–6 percent of their foreign affiliates' earnings in 1974, hardly a trivial increase.

While the preceding estimates give a rough impression of the gross impact of eliminating deferral, they take no account of the multinationals' response to the increased taxes on foreign affiliate earnings. Any resulting cutback in foreign investment not only reduces taxable income and revenues but also the flow of investable funds from parent to affiliate and, thus, the global investment strategy. Telling a coherent story, much less a realistic one, about the consequences of any tax change requires a fully specified model of multinational investment behavior. Most analyses stop here, for it is difficult to estimate the probable impact on investment patterns, profitability, and the like.

In an effort to present the entire picture, we developed a microeconomic model of investment behavior to simulate the impact of changing various aspects of American tax policy. While the model necessarily simplifies and distorts real-life behavior, it does allow us to trace some of the important implications of U.S. policy. Although the impact of any tax reform, such as repealing deferral, may vary substantially from one investor to another, we believe that our analysis yields objective, if crude, estimates of the typical consequences for a large multinational manufacturer.[34]

Although we tried to keep our microeconomic analysis as simple as possible, incorporating the essential features of U.S. tax policy makes even the most simplistic model complex. Rather than incorporating the formal analysis into the text, we summarize its critical features here and refer interested readers to appendix B. The model simulates the behavior of a large manufacturer with ongoing operations at home and abroad. We ignore exporting and assume that foreign and domestic investment opportunities are independent of each other. The primary link between foreign and domestic investment derives from their competition for the multinational's investable funds. While the multinational can supplement its own cash flow with borrowed funds in financing its global investment, we assume that the investor must pay higher interest costs the more it seeks to borrow.

These assumptions constrain the predicted impact of any tax change, such as the elimination of deferral. Since eliminating deferral raises taxes

34. We do not attempt to simulate the impact of tax changes on mining, shipping, or any other nonmanufacturing industries.

on foreign affiliates' income, the investor becomes less willing to invest its own funds overseas. Domestic U.S. investment will be substituted for foreign investment whenever the tax burden on the latter is increased. Furthermore, higher taxes leave the investor with lower investable funds worldwide. While firms can increase their borrowing, they will find it growing more costly, so global investments fall when taxes increase. The net impact of a tax change is a combination of a substitution effect (for example, domestic investment rising and foreign investment falling) and a liquidity effect (for example, global investment falling). While the size of the substitution and liquidity effects depends on the elasticities of investment demand and other parameters, their existence is assumed by the very nature of our analysis. As in all simulation models, the conclusions are the product of the underlying assumptions.

Our analysis incorporates many of the essential features of intrafirm financial behavior: the use of debt and equity in transferring funds to overseas affiliates; interest payments on outstanding debt; head-office, royalty, and other intrafirm charges; and intrafirm dividend payments. As we show in appendix B, tax considerations affect optimal intrafirm financial behavior. That financial behavior, in turn, modifies the impact of tax policy. For instance, the substitution of debt for equity in financing foreign investment mitigates the impact of any tax change on foreign investment. This is the inevitable consequence of allowing firms to deduct interest costs and taxing only the return on equity. It is difficult to know how much flexibility American investors have in changing their intrafirm accounting practices and how much they would use that flexibility to avoid the burden of a tax change. Accordingly, most of the estimates developed below assume that American investors maintain constant rates for charging head-office, research and development, and other joint expenses back to their affiliates and that they maintain constant dividend payout ratios. In cases considered below, where a U.S. tax policy would encourage multinationals to manipulate these financial ratios, we indicate what those changes are and what their consequences would be.

While certain of our model's parameters could be estimated easily (for example, dividend payout ratios, debt-equity ratios), others could not. In particular, the responsiveness of foreign or domestic levels of investment to changes in the cost of capital, or of interest rates to the volume of borrowing, cannot be ascertained. These parameters are critical: the more elastic the investment opportunities and the supply of investable

funds, the greater the impact of tax changes on foreign and domestic investing. In the end we specify what seems to be reasonable values for these critical parameters and proceed with our calculations. But the mathematical nature of our analysis hardly compensates for the lack of accurate information about investment and borrowing opportunities.

Our estimates of the impact of repealing deferral on American manufacturing investors (the model does not suit other industries well) are shown in table 6-3.[35] These figures represent our best judgment of what would have happened if all foreign affiliate earnings, not just dividends, had been subject to U.S. taxation in 1974. Because of the increased tax on foreign investment income, the multinational manufacturer would substitute domestic for foreign investment. We estimate that the current rate of U.S. investment (in property, plant, equipment, inventories, and so on) would have risen by $1,429 million, or 3.9 percent more than the actual value. Likewise, new foreign investment would have fallen by $1,549 million, or 8.5 percent of its actual value. Note that foreign investment would have fallen by more than domestic investment would have risen. This is the liquidity effect: higher global taxes lead to lower global investment. Note, too, that the impact of eliminating deferral on the capital outflow from the U.S. parent to its foreign affiliates is significantly larger than its impact on foreign or domestic capital formation. This reflects our implicit assumption that American investors would have financed more of their foreign investment and less of their domestic investment with locally borrowed funds than they actually did. Changing U.S. tax policy may have more of an impact on the location of borrowing than on the location of real investment.

Table 6-3 shows how eliminating deferral might have altered the distribution of 1974 pretax earnings among foreign governments, the U.S. Treasury, and American investors. The principal gainer would have been the U.S. Treasury: the foreign affiliates' retained earnings would have been taxable, and domestic investment and income would have been stimulated. The big losers would have been the American multinationals, whose consolidated after-tax earnings would have been reduced by

35. Our simulation model was refined and its parameters reevaluated over the course of its development. Accordingly, these estimates may not be the same as those in earlier reports on our research. We regret possible confusion but believe that the comments and criticisms we received on earlier versions were too important to ignore.

Table 6-3. *Estimated Effect of Eliminating Deferral on American Manufacturing Multinationals, 1974*

Millions of dollars unless otherwise stated

Item	Initial value[a]	Change	
		Amount	Percentage
Domestic investment	36,400	1,429	3.9
Foreign investment	18,300	−1,549	−8.5
Net capital outflow	2,710	−2,466	−91.0
Consolidated after-tax profits	15,194	−534	−3.5
U.S. taxes	6,005	545	9.1
Foreign taxes	5,001	−80	−1.6

Source: See appendix B. Data previously appeared in Thomas Horst, "American Taxation of Multinational Firms," *American Economic Review*, vol. 67, p. 383.

a. Figures for domestic investment are estimates of the 1974 increase in total assets (short- and long-term) of parent corporations of American manufacturing multinationals. Figures for foreign investment are estimates of the 1974 increase in total assets of the foreign affiliates of the multinationals. Figures for net capital outflow represent the 1974 new capital outflow from parent corporations to their foreign affiliates. Figures for consolidated after-tax profits are the 1974 profits after taxes of American multinationals. Figures for U.S. taxes include 1974 income taxes on both domestic and foreign-source income. Figures for foreign taxes include taxes on affiliates' income plus withholding taxes on interest, dividends, and all other intrafirm charges.

roughly the increase in U.S. taxes. Foreign income and withholding taxes fell slightly, because foreign investment was cut back and foreign borrowing costs increased. Notice, finally, that increasing taxes is a negative-sum game: the gains to the U.S. Treasury are outweighed by the combined losses to the American investors and to the foreign treasuries. This conclusion follows from our assumption that American investors are partially dependent on their own retained earnings to finance new investment and generate new earnings.

The preceding analysis presumes that the United States could repeal deferral without any change in foreign tax laws or tax rates. But foreign governments might react to the potential loss of investment and revenues, at a minimum, by eliminating their present tax incentives for U.S. investors and thus raising their effective tax rate to the normal rate of corporate tax. The host countries might even retaliate by treating the total earnings of American affiliates as presumed dividend distributions, and thereby subjecting them to the dividend withholding tax.[36] Because this

36. Dan Throop Smith, "Taxation of Foreign Business Income: The Changing Objectives," *Taxation of Foreign Income by the United States and Other Countries* (Tax Institute of America, 1966), pp. 241–55 and Department of the Treasury, *U.S. Taxation of the Undistributed Income of Controlled Foreign Corporations* (April 1976), p. 76. A separate but similar problem arises regarding nonrepatriable

scenario may be as plausibly pessimistic as our prior presumption (no foreign retaliation) was optimistic, let us trace its implications.

The bottom line of table 6-2 indicates that foreign income taxes averaged 39.1 percent and dividend withholding taxes 14.8 percent of foreign affiliate earnings. If these withholding taxes were applied to all earnings, total foreign taxes would have averaged 48.1 percent of the foreign affiliates' income. (The effective tax rate would equal .391 + .148 (1 − .391) = .481.) If so, the multinationals' foreign and domestic investment, the intrafirm flow of funds, and after-tax earnings would remain almost as shown in table 6-3. These two scenarios differ in who collects the higher taxes, for now the foreign government would, through its withholding tax, capture a significant portion of the $566 million tax gain we attribute to the United States. So, while the United States would still gain new investment, it would capture only a small portion of the higher taxes paid by the multinationals.

We use our model to estimate the impact of eliminating deferral on American investor's current rates of domestic and foreign investment, after-tax earnings, and foreign and domestic taxes but have not projected our findings over a long period of time. Stobaugh has made a long-run analysis, which concludes that the long-run consequences of eliminating deferral reverse the short-run effects.[37] Let us contrast his analysis with ours.

Stobaugh's analysis rests on certain critical assumptions: multinationals will not invest more at home when the tax on foreign investment income increases; the rate of new foreign investment is strictly limited by the after-tax earnings on existing assets; new foreign investment has a cumulative impact on the cost-competitiveness of U.S. overseas investment, a learning-by-doing effect. The net product of these assumptions is a rigid link between the after-tax earnings on existing investment and the growth and profitability of future investment. While our own findings,

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earnings, such as those completely blocked by host-country exchange controls or those discouraged by steeply graduated remittance taxes (as in Brazil). In such instances, the parent firm could not finance its tax payments from the subsidiary whose earnings were being taxed. It would not be possible to grant blanket exceptions for such earnings, for host countries would be encouraged to levy them. Exceptions should probably be made in specific cases (as they are now for branch earnings, where the identical problem occasionally arises).

37. Stobaugh, "The U.S. Economy and the Deferral of U.S. Income Tax on Foreign Earnings," esp. chap. 5.

if extrapolated into the future, suggest the same divergence between short-run and long-run effects, the projected turning point would not come nearly as early.

Calculating Foreign Credit by Per-Country Method

With the passage of the Tax Reform Act of 1976, all U.S. investors must use the overall method of calculating their allowable foreign tax credit. Because the overwhelming majority of manufacturers preferred the overall to the per-country method, this change will have a minimal impact on manufacturing investors. A case can be made, however, against the overall method: if a U.S. multinational has excess foreign tax credits from high-tax countries, it will have a tax incentive to allocate income to and locate production in countries with low tax rates, tax holidays, liberal depreciation allowance, or other tax incentives. In short, the overall limitations and deferral are objectionable for the same reasons.

The virtue of the overall limitation is that it is simpler to administer than the per-country limitation:[38] determination of a company's U.S. tax liability does not hinge on transfer prices for transactions between two foreign affiliates. However, the benefits of the per-country limitation could be had at a lower administrative cost if foreign-source income were put into two baskets, a high-tax basket and a low-tax basket, and if two separate foreign tax credit limitations applied. Then the only transactions whose transfer prices would need close monitoring would be those between high-tax and low-tax countries (like Irish exports to France).

Extending the Investment Tax Credit to Foreign Income

If deferral were eliminated, the realized rate of taxation on foreign affiliate earnings would climb to 48 percent. Because domestic investment was eligible for a 7 percent investment tax credit in 1975 and a 10 percent credit thereafter, the tax changes analyzed above would clearly tilt the tax incentives toward investing in the United States. If the objective of U.S. tax policy is to equalize the tax burden on foreign and domestic in-

38. Department of the Treasury, *U.S. Taxation of the Undistributed Income of Controlled Foreign Corporations* (April 1976), p. 61.

Table 6-4. *Estimated Effect of Extending a 7 Percent Investment Tax Credit to New Investments of Affiliates of American Manufacturing Multinationals, 1974*

Millions of dollars unless otherwise stated

Item	Initial value[a]	Change with tax credit alone		Change with tax credit plus elimination of deferral[b]	
		Amount	Percentage	Amount	Percentage[c]
Domestic investment	37,829	−1,182	−3.1	247	0.7
Foreign investment	16,751	2,103	12.6	554	3.0
Intrafirm flow of funds	244	1,776	727.9	−690	−25.5
Consolidated after-tax income	14,659	442	3.0	−92	−0.6
U.S. taxes	6,573	−457	−7.0	88	1.5
Foreign taxes	4,921	54	1.1	−24	−0.5

Source: See appendix B.
a. After elimination of deferral. For definition of each value, see table 6-3, note a.
b. See table 6-3.
c. Based on initial values, table 6-3.

vestment, the foreign tax credit must include a credit for new investment by the foreign affiliate.[39]

We use our microeconomic model to simulate the impact of extending a 7 percent investment tax credit to foreign manufacturing affiliates' investment in 1974, assuming that 40 percent of total investment would qualify under the definitions currently in use regarding domestic investment. Table 6-4 shows these effects (assuming that deferral were eliminated) and the combined impact of both tax changes. The primary impact of extending the investment tax credit would, of course, be to stimulate foreign affiliates' investment spending. We estimate that such expenditures would rise by $2.1 billion, which would be more than enough to reverse the impact of eliminating deferral. While this addi-

39. Capital-export neutrality could be achieved by eliminating the investment tax credit (and the asset depreciation range) altogether. This is a much larger step than extending it to foreign investment, however, and raises questions concerning U.S. domestic economic policy, which are not considered in this volume.

The original investment tax credit (1962) was viewed as temporary and, indeed, has been removed and restored twice since that time. More recently, however, it has come to be viewed as a permanent part of U.S. tax policy. In 1976 Congress did consider making it permanent, and President Carter proposed such a step in early 1978. Any future suspension, however, should apply to foreign as well as domestic investment.

tional change would depress domestic investment, it would still be higher than before the tax changes. Note that the combined impact of eliminating deferral and extending the investment tax credit is to expand global investment; the investment tax credit has a comparatively larger impact on investment spending than deferral has.

Extending the investment tax credit (even at 7 percent) to foreign investment income largely offsets the impact of eliminating deferral and on corporate income, U.S. taxes, and foreign taxes. The U.S. Treasury would have collected 1.5 percent more in corporate income taxes from manufacturing investors than it actually did in 1974, while corporate income after taxes and foreign taxes would each have fallen by less than 1 percent. The combined tax changes necessary to equalize the tax burdens on foreign and domestic investment income would, thus, have a minimal impact on the aggregate balance between foreign and domestic investment. While individual corporations or countries may feel more of the effects than others, the aggregate impact is apt to be small.

Repealing DISC

When the domestic international sales corporation legislation was passed in 1971, its primary justification was to promote U.S. exports and reverse a growing balance-of-payments deficit. Its supporters argued that DISCs are necessary to give American exporters tax advantages approaching those enjoyed by their foreign competitors and to offset the impact of deferral in encouraging American firms to produce overseas. As noted above, the use of a DISC effectively reduces the tax on income from exporting by one-fourth. Without the investment tax credit, the effective tax on export income would be reduced from 48 percent to 36 percent; with a 7 percent investment tax credit, the tax burden would be diminished to 34.5 percent.

The Tax Reform Act of 1976 limited DISC benefits to U.S. exports over and above a base value. This base value until 1980 is 67 percent of the average value of a corporation's exports during the four-year interval 1972–75; in 1980 the base period shifts forward by one year (1973–76) and continues shifting forward in each succeeding year. If a corporation's annual exports during the base period average, for example, 50 percent of its current exports, then the base value would be 33.5 percent (67

percent of 50 percent). Under the new legislation, the U.S. exporter would be deemed to have distributed dividends from its DISC equal to 33.5 percent of the DISC's earnings plus half of the remaining 66.5 percent, or a total of 66.75 percent. Under the original DISC legislation, only 50 percent of DISC earnings were deemed to be distributed and, thus, subject to U.S. taxation. Rather than trying to incorporate DISC into our microeconomic model, we drew on a similarly motivated analysis of the consequences of the old and the new DISC legislation.[40] Our conclusions are:

1. The rate of return on DISC-assisted export sales was 17.3 percent in 1974, more than twice the comparable 8.4 percent return on domestic sales. Because export income is taxed at a lower rate than domestic income, we have prima facie evidence that some portion of DISC tax savings were retained by U.S. exporters as profits after taxes, rather than passed on to foreign importers through lower export prices. Our best estimate is that one-half to three-fourths of the tax savings made available by DISC were passed on through lower export prices and that the remaining one-half to one-quarter was retained by U.S. exporters. (A primary source of uncertainty in this estimate is exporters' ability to allocate deductible expenses, such as interest, depreciation, even labor and materials, to domestic, rather than export, sales.)

2. The best available estimate of the elasticity of foreign demand for U.S. manufactured exports implies that a 1 percent reduction in export prices expands the volume of U.S. exports by 2.85 percent and the value by 1.85 percent. Combining that elasticity with our estimate that DISCs reduced export prices by 2.5 percent in DISC-year 1974 (roughly, calendar year 1973) and the fact that DISC-assisted exports amounted to $44 billion, we conclude that U.S. exports were $2.1 billion higher in DISC-year 1974 than they otherwise would have been. This gain represents less than 3 percent of contemporary U.S. exports. By contrast, the 15 percent depreciation of the U.S. dollar against foreign currencies between 1971 and 1974 would have contributed more than ten times the DISC contribution to U.S. export growth.

These conclusions characterize the immediate impact of DISCs, rather

40. Thomas Horst and Thomas Pugel, "The Impact of DISC on the Prices and Profitability of U.S. Exports," *Journal of Public Economics*, vol. 7 (February 1977), pp. 73–87.

than the long-run, general-equilibrium effects. In this instance, however, the long-run effects are particularly hard to ignore. Exchange rates have been far freer to fluctuate since 1971. Under a flexible exchange rate system, the DISC-induced increase in exports tends to appreciate the value of the dollar in foreign exchange markets, which makes it harder for DISC nonusers to export from the United States and easier for foreign producers (including the foreign subsidiaries of U.S. companies) to export to the United States. Exchange-rate adjustments may partially or fully offset the immediate impact of DISCs. Thus, we conclude that DISCs add far less to net U.S. production, investment, or the balance of payments than proponents claim, and that DISCs overcompensate for the tax advantages of deferral, in most instances.

Increasing Charges for Joint Expenses

As noted in table 6-1, American investors report higher earnings and pay higher taxes abroad than they do in the United States. While the differential may be due to faster growth and less competition in foreign countries, it may also reflect intrafirm accounting practices. In 1973, for example, head-office, royalty, R&D, and all other such charges amounted to just over 1 percent of foreign manufacturing affiliates' total sales.[41] Determining what expenses should be prorated among foreign and domestic affiliates (all research and development? only basic research?) and what basis should be used in prorating such expenses (sales? assets? employment?) is fraught with peril, and we have no way of knowing exactly what such intrafirm charges should be.

The historically low charges for R&D and other joint expenses finally led the Treasury Department to issue new guidelines for sections 861 and 863 of the Internal Revenue Code. These sections guide the allocation of joint costs among foreign and domestic affiliates for the purpose of determining the overall limitation on the foreign tax credit. Unless an investor's total foreign tax credits are less than its allowable maximum, the new guidelines raise taxes paid to the U.S. Treasury.

The impact of the new guidelines on a corporation depend crucially on how much R&D and other such charges against foreign-source income

41. *Survey of Current Business*, vol. 55 (August 1975), p. 23; and ibid., vol. 55 (October 1975), p. 49.

can be increased. Once again, let us consider two very different scenarios: first, that the new guidelines succeed in inducing U.S. manufacturers to double their current charges for R&D, head-office expenses, and so on. (We do not mean to imply that a doubling of charges is likely or reasonable but to establish a benchmark for judging the possible significance of the Treasury Department guidelines.) Our microeconomic model indicates that the impact on foreign and domestic investments would be as indicated in table 6-5. As one can see, real capital formation at home and abroad would be affected only marginally. The primary impact would be to shift taxable income and, thus, tax payments from the foreign affiliates to the U.S. parents. Since the 48 percent U.S. rate exceeds the current realized foreign income tax rate, the global tax burden on American investors goes up slightly, and consolidated after-tax earnings fall by 1 percent.

Our second scenario assumes that foreign tax authorities will not permit any increase in R&D or other intrafirm charges.[42] If the U.S. parent must nonetheless reallocate expenses for U.S. tax purposes, its allowable foreign tax credit will fall. Unless the investor starts with a deficit of foreign tax credits (that is, is paying fewer foreign income and withholding taxes than the maximum that can be credited), its U.S. tax payment will increase. Whether we call this disputed income foreign or domestic, it will be subject to double taxation.

Since the tax increase is likely to be proportional to a firm's foreign investment, the new guidelines would have exactly the opposite effect to extending the investment tax credit to foreign-source income: U.S. taxes would increase in proportion to foreign investment. If the new guidelines doubled R&D and other such charges to foreign affiliates, but no new deductions were allowed overseas, we estimate that the changes shown in the last two columns of table 6-5 would have occurred. Because foreign investment is subject to implicit double taxation, it falls by $3 billion (17 percent of its 1974 value), and U.S. tax collections increase by almost $1 billion, but the gain comes at the multinationals' expense rather than the foreign governments'. Foreign governments can thus protect their tax base only at the cost of discouraging American-owned investments.

42. For example, Canada in the early 1970s disallowed deductions for interest paid to related companies whenever the debt-equity roster of the affiliate exceeded 3:1. Similar limits might be placed on the other types of intracompany transfers.

Table 6-5. *Estimated Effect of Doubling Head-Office, R&D, and Other Intrafirm Service Charges by American Manufacturing Multinationals, 1974*

Millions of dollars unless otherwise stated

Item	Initial value[a]	Higher deductions allowed by foreign tax authorities		Higher deductions not allowed by foreign tax authorities	
		Amount change	Percentage change	Amount change	Percentage change
Domestic investment	36,400	149	0.4	1,393	3.8
Foreign investment	18,300	−332	−1.8	−3,087	−16.9
Net capital outflow	2,710	444	16.4	−2,718	−100.3
Consolidated after-tax income	15,194	−142	−0.9	−992	−6.5
U.S. taxes	6,005	688	11.5	981	16.3
Foreign taxes	5,001	−592	−11.8	−84	−1.7

Source: See appendix B. Table previously appeared in Thomas Horst, "American Taxation of Multinational Firms," *American Economic Review*, vol. 67, p. 384.

a. For definition of each value, see table 6-3, note a.

b. Assumes that charges are raised from 1.1 percent to 2.2 percent of foreign subsidiaries' total assets and that the foreign government allows higher deductions from the subsidiaries' taxable income.

c. Assumes that charges are raised from 1.1 percent to 2.2 percent of foreign subsidiaries' total assets.

Replacing Foreign Tax Credit with Simple Deduction

The AFL-CIO advocates eliminating the foreign tax credit altogether and merely allowing American investors to deduct foreign income and withholding taxes from their foreign-source income. Foreign-source income would, thus, be taxed twice (first by the foreign government and then again by the United States), achieving national neutrality. We use our microeconomic model to determine what would have happened in 1974 in the absence of the foreign tax credit; our tentative conclusions are tabulated in table 6-6.

Our analysis indicates that U.S. manufacturing investors would not only stop sending new capital overseas but also repatriate substantial sums already invested. While the rate of new investment by overseas affiliates would be slashed by more than half, foreign operations would continue to expand, albeit at a greatly reduced rate, as long as the subsidiaries could tap local capital markets. Domestic investment by the U.S. parents would increase by $9 billion, or just over 25 percent of the parents' current rate. Despite the substantial substitution of domestic for

Table 6-6. *Estimated Effect of Repealing Deferral and the Foreign Tax Credit and Allowing a Deduction for Foreign Taxes Paid by American Manufacturing Multinationals, 1974*
Millions of dollars unless otherwise stated

Item	Initial value[a]	Change	
		Amount	Percentage
Domestic investment	36,400	9,291	25.5
Foreign investment	18,300	−10,283	−56.2
Net capital outflow	2,710	−15,725	−580.3
Consolidated after-tax income	15,149	−2,983	−19.7
U.S. taxes	6,005	3,028	50.4
Foreign taxes	5,001	−504	−10.1

Source: See appendix B. Data previously appeared in Thomas Horst, "American Taxation of Multinational Firms," *American Economic Review*, vol. 67, p. 386.
a. For definition of each value, see table 6-3, note a.

foreign investment, the multinationals would still end up paying $3 billion in additional taxes to the U.S. government, which would reduce their consolidated after-tax income by almost a fifth.[43] It is worth noting that if U.S. investors are prevented from repatriating past capital outflows, by, inter alia, the unwillingness of host countries to accept such changes in their own balance-of-payments positions, the substitution of domestic for foreign investment would be greatly truncated. In fact, if net capital outflows must remain positive, domestic investment would actually fall: the higher U.S. taxes paid by the parent would have a greater impact on its domestic investment than the limited substitution of domestic for foreign investment. All of this is to say that the gain in domestic investment should not be taken for granted.

Because the tax consequences of the foreign tax credit are so large, the multinationals would doubtless seek other ways of minimizing the impact of its loss. Some corporations would surely reincorporate overseas.[44] Many would divest themselves of subsidiaries, although this might

43. Other analysts predict much larger effects: $7.5 billion (Department of Commerce); $3.3 billion in 1970, probably rising to about $7 billion by 1975 (Peggy B. Musgrave); and $6.7 billion (International Economic Policy Association, IEPA). These results are summarized in the IEPA testimony, *Tax Reforms*, Hearings before the House Ways and Means Committee, 94:1 (GPO, 1975), pt. 3, p. 2027.

44. J. L. Kramer and G. C. Hufbauer, "Higher U.S. Taxation Could Prompt Changes in the Multinational Corporate Structure," *International Tax Journal*, vol. 1 (Summer 1975), pp. 301–24.

be difficult with many erstwhile subsidiaries for sale. Most investors would search for ways to pare their equity investment to a minimum while maintaining effective control over their subsidiaries' operations. Management service contracts, which have become common in the resource extraction industries, could spread through other industrial sectors. The quantitative significance of these responses is impossible to estimate, but they might mitigate the impact of losing the foreign tax credit.

Summary and Conclusions

In theory, the United States taxes foreign-source income but in practice most U.S. manufacturing investors pay little or no U.S. taxes on income earned abroad. The foreign tax credit is usually sufficient to offset U.S. taxes tentatively due on foreign-source income. Foreign investment in some countries qualifies for tax holidays or is otherwise spared from taxation, but in Canada and most countries of Western Europe the combined income tax and dividend withholding tax produce an effective tax rate comparable to that of the United States. Although exact statistics are hard to find, the typical foreign manufacturing affiliate appears to pay 40–45 percent of its pretax income to foreign governments, a rate as high as or higher than the rate U.S. firms pay to the U.S. government on their domestic income. Despite the well-publicized exceptions, as a general rule multinationals do not escape taxation by investing overseas.

The broad objective of U.S. tax policy should be, we believe, to equalize the tax burden on foreign and domestic income (the standard of capital export neutrality). Although the full implications of repealing the foreign tax credit and striving for national neutrality are difficult to assess, the evasive tactics of the multinationals and the protective reactions of foreign governments are likely to deprive the United States of many of the expected benefits. At the other extreme, matching the exemption for foreign income offered by some foreign governments in the hope of achieving competitive neutrality seems clearly inconsistent with broad U.S. interests.

In the aggregate, U.S. tax policy is closer to capital export neutrality than commonly supposed. Deferral gives foreign investment only a small

advantage, which is offset by the denial of the investment tax credit and the ADR acceleration of depreciation. But when the retained earnings of an affiliate in a low-tax country avoid U.S. taxation through deferral, while its dividends are sheltered by excess tax credits from high-tax countries, assertions of aggregate neutrality have a hollow ring.

Neutrality at a low level of aggregation can be achieved by modifying the overall limitation (without necessarily reinstating the per-country limitation of the 1950s). Dividing countries into high-tax and low-tax categories and imposing separate limitations on the foreign tax credits in each category would correct the worst feature of the overall limitation. Only transfer prices involving transactions between a high-tax country and a low-tax country would need to be closely scrutinized, for reallocations of income among high-tax countries or among low-tax countries are of little concern to the Internal Revenue Service.

Although their aggregate effects are likely to be small, we nonetheless believe that these changes should be made. The political controversy over multinationals is heightened by the widespread belief that U.S. tax policy implicitly encourages American manufacturers to export jobs, and although that belief is largely unfounded, exceptions do exist. Some investors do have strong tax incentives to invest in low-tax countries, and those incentives would be largely eliminated by the tax changes we propose. Furthermore, the deferral of U.S. taxes on foreign-source income helps justify domestic international sales corporations, which serve little purpose in a world of flexible exchange rates. Finally, as long as deferral is granted, manipulative transfer pricing is encouraged, and tax havens must be attacked with the cumbersome rules defining base-company income.

Perhaps the messiest issue confronting policymakers is allocating taxable income within the multinational enterprise. Foreign affiliates tend to earn higher returns on sales and assets than their U.S. parents earn, and the differential may be partly due to low charges for R&D and other joint expenses incurred by the parent. Unfortunately, pinpointing this issue is easier than solving it. Increasing R&D and other such charges is a zero-sum or negative-sum game: U.S. tax gains must come from the multinationals or from foreign tax authorities. The new guidelines for sections 861 through 864 of the Internal Revenue Code are welcome steps in the right direction. Whether they have the desired effect of increased R&D and other such charges against foreign subsidiaries' tax-

able income remains, of course, to be seen. But some unilateral action by the United States was and is necessary. Without pressure from the United States, the multinationals have little incentive to propose (or foreign treasuries to accept) new or higher charges. As we note, foreign governments can protect their tax base by refusing to permit any new charges, but in doing so participate in the double taxation that makes local investment less attractive.

Ultimately, the only satisfactory solution to the problem of allocating income within the multinational firm may be international use of formulas based on national sales, assets, payrolls, or some other stable base.[45] Such formulas could be incorporated into bilateral tax treaties, and accepted by both home and host countries, if supported by agreement on accounting concepts and on standards against which the activities of the firms could be assessed. If foreign governments are not ready to accept formula allocations of income, the United States might still use such formulas in deciding when to apply new guidelines to sections 861–864 of the Internal Revenue Code. For example, a company whose transfer pricing system allocates global income in rough proportion to sales or assets might be spared new allocations in any one area, such as R&D expenses. By looking at the net outcome of all transactions, rather than the merits of each, the United States may have a better chance of collecting a higher share of the taxes on multinational income without producing double taxation in the process.

45. See Brannon, "National Shares of Multicompany Income"; and Peggy B. Musgrave, "International Tax Base Division and the Multinational Corporation," *Public Finance*, vol. 27 (1972).

JOINT MINISTERIAL COMMITTEE
OF THE
BOARDS OF GOVERNORS OF THE BANK AND THE FUND
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TRANSFER OF REAL RESOURCES TO DEVELOPING COUNTRIES

(Development Committee)

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January 25, 1980

TASK FORCE ON PRIVATE FOREIGN INVESTMENT

Attached is a paper by Mr. Bergsten dealing with host country performance requirements. The paper will be discussed at the meetings of the Task Force on February 19-20 in Washington.

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Host Country Policies: Performance Requirements

Prepared by the U.S. Representative

to the

Development Committee Task Force

on Private Foreign Investment

Host Country Policies: Performance Requirements

A host nation "performance requirement" is defined as any requirement placed by that nation upon a foreign controlled firm designed to further national policies or goals. The discussion in this paper is limited to those performance requirements which have a traceable effect upon world trade. Perhaps the most obvious generic example is one that the firm export some minimum portion of its output. Such a requirement may take several forms. For example, the firm may be required to export a minimum percentage of its shipments; or, the firm might be required to earn via exports enough foreign exchange to cover costs of imported inputs; or, the firm might be required to meet some absolute export target.

A second generic example of a trade-related performance requirement is import substitution. Again, import substitution requirements can take several forms, including ones in which the requirement is implicit: a) mandatory local assembly or final stage of manufacture of end-products previously imported; b) local content requirements, mandating local manufacture or purchase of intermediate products or

inputs which the firm might otherwise choose to import (an extension of this type of requirement would be mandatory local performance of research and developments); c) local value-added requirements, specifying a minimum percentage of value-added which must be local; and d) requirements that a firm create a minimum number of local jobs.

These examples of export and import substitution requirements are not exhaustive, and other variations can be cited. Additionally, other regulations or requirements placed by host governments upon foreign controlled firms may have indirect trade effects. For example, requirements for technology transfer or training of local workers might have these effects.

Performance requirements are often linked to other host nation policies or practices. For example, performance requirements can be attached as a condition of entry into a nation, so that an international investor must agree to abide by the requirements in order to receive host government authorization to conduct business in the nation. Also, performance requirements can be attached to investment incentives or other favorable treatment accorded by the host government.

Results of a 1978 U.S. Department of Commerce survey of investment incentives and performance requirements in 40 nations indicate that virtually all of these impose some form of performance requirements on at least some local affiliates of foreign corporations. Another Department of Commerce study shows that about 10% of overseas affiliates of U.S. corporations are subject to some sort of performance requirement. The most common requirements are for minimum local labor content and minimum local equity participation. This second study indicates that about 14% of affiliates operating in developing nations are subject to minimum local labor content or employment requirements, while only 2% of affiliates operating in developed nations are subject to similar requirements. About 12% of affiliates operating in developing nations are subject to minimum local equity participation requirements, against about 2% in developed nations. A small but significant number of subsidiaries are subject to minimum export or maximum import requirements. In developing nations, about 3% of the affiliates reported export requirements and about 4% import requirements. Under 1% of affiliates operating in developed nations reported either export or import requirements. The overall incidence of performance requirements would appear to be higher for subsidiaries operating in developing nations than in developed nations, and higher for Latin American nations

than for non-Latin developing nations. Because of a possible misinterpretation of the survey questionnaire used in this study, it is possible that these figures understate the true incidence of performance requirements.

Performance requirements, while most often applied to foreign-owned firms by host nations, are not infrequently applied to purely domestic firms as well. Most of the arguments developed in this paper apply equally to performance requirements placed on local firms and to those placed on foreign firms.

The position to be developed in this paper is that indiscriminate application of performance requirements by host governments may have undesirable economic effects, including both reduction of global allocative efficiency and (in some cases) reduction of welfare to the host nation itself. Additionally, it will be demonstrated that performance requirements raise serious issues of international comity.

Performance Requirements, Global Economic Efficiency, and Host Nation Welfare

According to a standard theorem of neoclassical economics, global economic efficiency - and hence gross wealth - are maximized if international trade is allowed to proceed unfettered by governmental interference. Governmental interference in this context can imply border taxes or other

restrictions on imports and restrictions on or inducements to exports. Numerous conditions are attached to the theorem, however, and it is worthwhile reviewing these.

The conditions attach to both the supply and demand side of the market and to the functioning of the market itself. With respect to the functioning of the market itself, the theorem holds only if there are no non-governmental barriers to trade which would cause price differentials for the same commodity to exist in different markets. Thus, there must exist, net of transport and transaction costs and taxes, one world price for each traded commodity. On the supply side, markets for factors of production must be competitive, as must be the structure of the producing industry. Additionally, all actual and potential producers worldwide must be able to employ identical technologies for the design and manufacture of traded goods.

On the demand side, the conditions necessary for the theorem to hold are complex and are not relevant to the arguments to be developed in this paper. Hence, they are not repeated here.*

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* For the sake of completeness, the principal conditions are that there must exist for each trading nation a community utility function, although it need not necessarily be the same function for each nation. Sufficient (but not necessary) conditions for the existence of such a function are that two out of three of the following hold: 1) all incomes of consumers within the nation be identical; 2) all consumers hold identical tastes; and 3) preferences of individual consumers be homothetic.

If all of these conditions were to hold, and trade were to be free of governmental interference, nations would specialize in the production of those goods in which they possessed a comparative advantage, determined by factor endowment. It follows that global economic efficiency would, in a static world, be maximized. Under these conditions, there would be no economic justification whatever for performance requirements.

Host nations which impose performance requirements, however, justify these on the grounds that not all of the conditions for static efficiency hold. Some of the most common cited justifications are as follows:

1) Noncompetitive producing industries: international investment has been shown to occur largely in industries marked by a significant degree of producer oligopoly.[1] Oligopolistic power as exercised by multinational firms, it is claimed, works to the disadvantage of host nations. Overt manifestations of this include practices which would not be sustainable in a competitive industry such as (a) transfer pricing at nonarm's-length prices between parent firm and subsidiary so as to reduce the latter's reported profits for host nation taxation purposes; (b) "tie-in" and other restrictive clauses imposed upon local subsidiaries as a

precondition for technology transfer, and (c) export restrictions being placed on local subsidiaries by parent firms.

While it is doubtlessly true that such practices do occur, it is difficult to justify performance requirements as a "best practice" solution to them. Transfer price abuses can be dealt with directly by enforcing that firms use established international prices in reporting intra-firm transactions, and, when such prices do not exist, requiring that the firm justify that the transfer price used is a reasonable approximation of an "arm's length" price.

In the long run, noncompetitive behavior among multi-national firms can be combatted by reduction of national barriers to entry to any given industry or sector. To some large degree this implies adoption and enforcement of strong

anti-trust measures. Nations which are predominantly host to foreign investment, by imposing entry conditions and other policies which discriminate against international investors, tend to create barriers to entry which serve to reinforce ologopolistic behavior of firms already participating in the local market. Nations which thus grant monopolistic or quasi-monopolistic status to one or a few firms and deny access to their domestic markets to other potential investors, foreign or domestic, tend to encourage undesirable behavior on the part of the favored firms. Therefore, for example, nations which impose performance requirements as a condition of entry to a foreign investor may be acting to reduce the long run efficiency of their domestic industries and, indeed, to increase the oligopolistic powers of multinational firms.

2) Non-identical technologies: a vast literature has been developed which indicates that comparative advantage among nations is at least as determined by differing levels of technological attainment as by differences in factor endowments.[2] Technology - the knowledge requisite to the production of useful goods and services - can, however, be transferred from one nation or region to another. Such transfer causes shifts of comparative advantage among nations.

Additionally, new technologies are constantly being created as entrepreneurs create new products and develop more efficient techniques for making older ones, and introduction into the market of new technologies can also alter comparative advantage.

A developing nation might possess a "latent" comparative advantage (i.e., one based on factor endowment) in some sector but might lack the technology requisite to capitalizing upon this latent advantage. By acquiring or developing the technology, the nation can shift comparative advantage in its favor, a move that would increase its own welfare. Additionally, under the premises of the neoclassical theorem presented above, the shift would enhance world welfare as well.

It is possible that performance requirements can, in principle, be used to create or accelerate such a shift. If a nation is able correctly to identify those sectors in which it holds "latent" comparative advantage, it might be able by judicious use of various performance requirements to induce foreign firms which hold necessary technologies to transfer these to the local economy. By requiring potential investors to export, the nation would tend to encourage investment in those sectors in which the nation potentially could become internationally competitive. Local content requirements might facilitate the development of

networks of supplier firms necessary for the emergence of a fully competitive sector. Technology transfer requirements might help to ensure that necessary knowledge is brought into the economy and that local personnel are taught the skills necessary to utilize this technology.

Several dangers, however, underlie this reasoning. The major danger lies in the possibility that performance requirements are imposed in the wrong sectors, ones in which no "latent" comparative advantage exists. If performance requirements are imposed upon firms operating in sectors in which the nation has no reasonable hope of becoming competitive internationally, and, consequently, these noncompetitive sectors expand, the result would be a misuse of the nation's resources. In order to remain in business and maintain employment, noncompetitive producers would have to be subsidized, either explicitly via an operating allowance from the government or implicitly via import restrictions. The result would be loss of potential welfare to the nation, manifesting itself in one or several forms: higher prices for consumers, persistent inflation, higher than necessary taxes, or retarded growth. Additionally, the economy may be saddled with obsolete or outdated end products produced by the inefficient sector.

The ill effects would not be confined to the host nation. By depriving other nations of the opportunity to expand their own efficient industries and export to the host nation, the misbegotten performance requirements would adversely affect these other nations' welfare. Global economic efficiency would be reduced.

From the host nation point of view, the problem is to place performance requirements only upon firms operating in sectors in which the nation can become competitive. If the sectors to which performance requirements are applied are properly chosen, then, arguably, these requirements could hasten shift of comparative advantage and result in more rapid development of the economy than would otherwise occur. If, however, the sectors are poorly chosen the performance requirements would be counterproductive.

These arguments for and against performance requirements are exactly the same as those for and against the "infant industry" case. It is argued by some development economists that developing nations must accord a high degree of protection to local industries in order to allow them to grow from an embryonic, internationally noncompetitive stage to one in which they can compete in world markets. The counterargument is that if the sectors accorded protection are poorly chosen, the transition from a noncompetitive to a competitive status

will never come. Additionally, even in sectors in which the nation possesses a latent comparative advantage, protective measures may actually retard or even prevent such a transition. This is because the local industry will be sheltered from the stimulatory discipline of having to compete with efficient firms.

The case can be made that, given the difficulty of determining sectors in which a nation has the potential of becoming competitive, it would be better for market forces to determine allocation of resources than for this to be attempted through a centralized, bureaucratic process. Host governments can facilitate selection by the market of sectors which can become competitive by maintaining open entry conditions as already outlined: by not pursuing policies which act as a deterrent to investment and by not granting to any firm - whether it be a locally controlled one or a subsidiary of a foreign firm - a monopolistic or otherwise privileged position in the local market.

This does not imply, however, that the role of the host government necessarily should be a neutral or passive one. The government can facilitate shifts in comparative advantage by means of building up physical and social infrastructure. In particular, it can provide to its citizens educational

services. The availability of workers who possess mechanical and technical skills is a prerequisite for the transfer of most industrial technologies, and the teaching of these skills in the nations or regions can be provided only by government. The same is true for transportation and telecommunication services, which in many regions can be provided more efficiently by the government than by private providers. In some instances the government must act as provider of health care and housing services as well. Adequate provision of such services is not irrelevant to the international investment process, nor indeed to any aspect of the process of industrialization.

Performance Requirements and International Comity

Two premises can be identified which underlie much of the principle of comity in world trade law. The first is that nations generally should not engage in policies or practices which serve to restrict or limit unduly international trade. The second is that nations should not engage in trade practices which are overly disruptive to the domestic industries of other nations. It is clear that these two premises are to some extent in conflict with one another, given that trade expansion necessarily must disrupt existing patterns of industrial production.

A doctrine of comity therefore must chart something of a middle course between these premises. Performance requirements can violate both premises.

Import substitution requirements frequently involve restrictions or limitations on imports into a nation. Even if overt restrictions do not exist, tacit or implicit restrictions are nearly always present. These requirements can also be disruptive to other nations' industries, most notably in the case of those nations which exported to the restricted market prior to the imposition of the requirements or which would commence to do so following a new investment.

Most import restrictions are, of course, in violation of the GATT. Prohibitive tariffs are in violation of signator nations' obligations with regard to tariffs as formulated under Article II of the GATT and the "bindings" that are an integratl part of the article. Most import quotas are prohibited under Article XI. Other non-tariff barriers to trade are limited under Articles VII, VIII, IX, and X.

To be sure, there exist exceptions to these GATT restrictions which apply to developing nations. Article XVIII of the GATT allows developing nations to raise tariffs above levels prescribed in the bindings for a variety of

reasons, including "infant industry" reasons. The same article also allows the use of quantitative restrictions on imports for balance-of-payments reasons, granting to developing nations more lenient criteria than those generally granted under Article XII. Part IV of the GATT, comprising Articles XXXVI through XXXVIII, grant additional powers to developing nations to implement selective trade restrictions.

Even without the exceptions, the GATT regulations designed to reduce or eliminate trade barriers would be difficult or impossible to apply to cases of import substitution requirements imposed singularly upon individual firms by a host nation. For example, if a foreign controlled firm is ordered by its host government to increase local value added, the government is de facto placing a restriction on imports even if de jure this restriction could not be demonstrated. Remedial measures could be difficult to apply by other nations.*

Export performance requirements are also thorny. Such requirements may be disruptive to other nations, especially if the requirements were imposed without regard to supply and demand conditions in world markets.** Extreme

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* But see discussion in the following section.

** Evidence of such disruption is presented in the case of Brazilian export requirements in the automotive industry in the mid-1970's in Kenneth Mericle, "The Brazilian Motor Vehicle Industry," MIT Sloan School of Management Working Paper, 1975.

disruption resulting from export performance requirements presumably would be met by remedial action by the affected nations through escape clause action, or if the case warranted, remedies prescribed under the subsidies/ countervailing measures code, or other measures. Such action, however, would most likely be undertaken only after the disruption reached high levels, and could not be applied by aggrieved nations in third market situations.

Nations which impose export performance requirements are thus most likely to be able to do so with impunity so long as the consequences are not extremely disruptive or import restrictions are implicit rather than overt. Extreme disruption would not likely occur even if several nations were to impose similar requirements as long as the total of such nations was not large. It is thus possible to conceive that a small number of nations could enjoy something tantamount to a "free rider" status by imposing such requirements. If, however, increasing numbers of nations were to impose export performance requirements in any given sector, disruption would mount. Efforts by each exporting nation to increase its exports would place considerable stress on the world trading system and would almost certainly lead to countervailing efforts by importing nations.

One fundamental issue raised by performance requirements thus is that of international comity. One nation's requirements, carried out in isolation, might tilt slightly the benefits of international investment and trade in its direction, at the expense of other nations. Although it would in some sense be unfair for the one nation to do so, its actions alone would generally not be sufficiently harmful as to pose problems to thw world order. However, as more nations attempted to pursue similar policies, the level of disruption would rise until it became great enough to cause severe stress on the entire system. Historical evidence suggests that when one nation actively pursues a policy designed to tilt benefits in its direction, emulation of that policy by other nations can rapidly follow. The results can be disasterous. For example, worldwide emulation of tariff escalation by the United States under the infamous Smoot-Hawley Act of 1930 doubtlessly deepened and prolonged the Great Depression. The United States suffered greatly during the Depression, and it is now generally acknowledged that whatever short-run benefits the nation might have obtained from the Smoot-Hawley Act were swamped by ill effects spawned by the Act. While no suggestion is being made here that the present stituation

is quite so serious, the example does demonstrate that the case against a nation's unilaterally pursuing policies to tilt benefits in its direction is not simply a theoretical one. The cumulative effect of many nations' performance requirements is bound to have a depressing effect on the world economy at some point.

International Policy Considerations

The previous section suggests that practices associated with performance requirements may be inconsistent with the spirit of the GATT and that the effects of these practices may negate some of the benefits of freer world trade. At the same time, however, it is noted that these practices may not be in direct violation of any specific GATT provision, or that violation may be difficult to demonstrate even when it occurs.

Nonetheless, the GATT mechanism provides some opportunity for drawing attention to practices which are unsettling to international comity. The GATT notification and consultation procedures and the dispute settlement mechanism are ones which could be used on a test case basis to establish precedents with regard to what specific practices are inconsistent with GATT obligations. Some danger lurks in the use of these mechanisms. The disputes settlement

mechanism in recent years has tended to function clumsily, with the result that specific disputes have dragged on interminably without effective settlement. Non-resolution of disputes can be tantamount to an implicit GATT condoning of acts or practices which are clearly inconsistent with the language or spirit of the GATT itself. Nonetheless, the GATT mechanisms can and should be used as one means to settle international disputes, and it would be useful if nations holding specific grievances against other nations relating to performance requirements were to utilize these mechanisms.

Article XIII, Section 2, provides a basis for raising complaints. This section allows a GATT member to bring action against any practice which nullifies or impairs any benefit accruing to the member directly or indirectly. The practice need not necessarily violate a specific provision of the GATT. At a minimum, all that is needed is a demonstration that the practice has the effect of undermining the benefits of tariff concessions on a particular product. Thus, for example, one nation's practices which implicitly create import barriers to a product can be challenged by exporters of the product.*

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* In fact, depending upon the specific practices, import restricting performance requirements could be in violation of any of four separate GATT provisions.

Article III, Section 1, which prohibits internal quantitative regulations requiring the use of products in specified amounts "so as to afford protection to domestic production."

(footnote continued on next page)

While the GATT mechanisms doubtlessly are useful for raising issues and settling disputes with regard to performance requirements, it is possible to conceive of situations where the GATT simply cannot work effectively to curtail practices unsettling to international comity. In the previous section, it was suggested that performance requirements applied individually to single firms would be difficult or impossible to police under GATT rules. It thus might be the case that new rules are needed to deal with the problem.

(continuation of the footnote from the previous page)

> Article III, Section 5, which prohibits internal quantitative regulations requiring that specified amounts of any product be supplied from domestic sources.
>
> Article XI, Section 1, which prohibits restrictions other than duties, taxes, or other charges whether made effective through quotas or other measures on the imports of any contracting parties.
>
> Article II, Section 1a, which prohibits import restrictions beyond those specified in the appropriate GATT schedule of the country for products on which the country has a GATT tariff binding.

FOOTNOTES

1. For evidence see S.H. Hymer, The International Operations of National Firms: A Study of Direct Foreign Investment 1960; (reprinted by the MIT Press, 1976);

   Raymond Vernon, Sovereignty at Bay (Basic Books, 1971);

   R. F. Caves, "Industrial Organization," in J.H. Dunning, editor, Economic Analysis and the Multinational Enterprise (George Allen and Unwin, 1974)

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TASK FORCE ON PRIVATE FOREIGN INVESTMENT

Attached are papers prepared for the Task Force by Mr. Narasimham and Mr. Levy. The paper by Mr. Narasimham deals with performance requirements from the host country point of view and will be discussed at the next meeting of the Task Force, to be held in Washington on February 19 and 20. The paper by Mr. Levy discusses some of the recent data on flows of direct investment to developing countries.

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ATTACHMENT I

PERFORMANCE CRITERIA STIPULATED BY HOST COUNTRIES

M. Narasimham

PERFORMANCE CRITERIA STIPULATED BY HOST COUNTRIES

Introduction: One of the issues identified by the Task Force as requiring further study is the stipulation of performance criteria by host countries on foreign firms investing in them. Such criteria constitute an aspect of host country regulation of foreign investment in the context of the macro objectives of their national economic policies which aim at augmenting national output and employment and attaining viability in balance of payments. Host countries naturally seek to weigh the benefits of additional income generation arising out of the foreign investment against its likely impact on balance of payments or on the growth of domestic (indigenous) industry so as to maximise what they regard the positive and minimise the negative aspects of foreign investment.*

Performance criteria can (and generally do) take several forms but this paper focuses attention on the two

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*Performance criteria have been stipulated "in order to shift benefits from trans-national corporations and home countries to host countries, to minimise the cost of private investment and to force investors (without, however, losing them) to contribute as much as possible to the achievement of the host country's development objectives". - K. Billerbeck & Y. Yasugi. Private Direct Foreign Investment in Developing Countries - World Bank Staff Working Paper No. 348 - Washington (July 1979) P. 19.

"The significance is their(performance oriented policies) clear intent to shift toward the host country the package of benefits brought by the foreign firms" C. Fred Bergsten: Coming Investment Wars? Foreign Affairs, October 1974.

most widely stipulated forms of regulation.* These require:

(i) that firms shift procurement of inputs to host countries as against importing such inputs; and

(ii) that they export a specified percentage of production either by volume or value.

2. The Rationale for Performance Criteria: The justification for the above mentioned types of performance requirements are based on the following objectives of national economic policy:

(i) Increasing national output and domestic employment and protecting domestic industry.

(ii) Strengthening the balance of payments.

(iii) Controlling transfer pricing practices.

(iv) Helping the transfer of technology.

The application of performance criteria as an instrument in the achievement of these objectives is discussed below.

3. Performance Criteria and National Output & Employment: The contribution of foreign investment to domestic output and employment in the recipient country, both directly and through forward and backward linkages, is a point that does not need to be laboured.** Nonetheless, a major concern of host countries

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*Some of the other types of performance criteria are requirements that over a period foreign firms indigenise management and/or that the share of local capital in the total equity be increased to a specified percentage or restricting access to local capital/money markets. For other types of performance criteria, please see K. Billerbeck & Y. Yasugi's Op. cit. PP 19-20

**There has, of course, been a lively debate, perhaps beginning with H.W. Singer's celebrated article (American Economic Review 1950) about the impact on host countries of private foreign investment

arises from what is perceived to be inadequate secondary processing of raw material in sectors where one of the motivations of foreign investment is securing raw material resources. This leads host countries to indicate a phased program for an increasing proportion of local value addition to the product designed for export as against material export in rawer forms. In many LDCs where labour is surplus and underemployment (or unemployment)is endemic, labour intensive processing clearly makes sense.

Even where the motivation for foreign investment is domestic market related, foreign investment tends to move into import substitute industries which invariably are built behind the shelter of tariff walls or quantitative import restrictions leading to generation of monopolistic/oligopolistic rents. If one accepts the logic of import substitution for the final product it follows that the import substitute argument can be extended to inputs as well. The stipulation of procurement of inputs locally thus widens the base of domestic economic activity and employment. It could raise the cost structure of production for the investor but this may not represent a greater 'tax' on the domestic consumer if its impact is only to cut monopoly rents. In any event,the externalities associated with such a stipulation of local inputs by way of its impact on domestic production and employment has to be set against a possible higher price to the domestic consumer. Especially in those LDCs which have large and expanding domestic markets and have a developed resources base and labour availability, the attractiveness

of domestic input stipulation is readily apparent.

A related aspect is concerned with the protection of indigenous industry in the light of the fear that foreign investment"tends to preempt the good investment opportunities, leaving only the marginal projects to domestic enterprise".* The other related concern is with the impact of foreign investment on indigenous small industry. In India, for instance, certain industries have been reserved for the (domestic) small scale sector broadly on the ground that such industries are labour intensive and can be promoted through economically viable small units with relatively low capital-labour ratios. If the foreign investor (or indeed even the domestic large scale sector) wishes to manufacture items reserved for the small scale sector, such investment is permitted only if the manufacturing activity has a strong export orientation so that the apprehension of the foreign investment (with, in several cases, well known brand names) swamping the domestic market to the disadvantage of the indigenous producer. The protection to the domestic small and medium sized industry derives from the viewpoint of enlarging employment opportunities, widening the base of economic activity and avoiding market domination by any single (or group of) concern. Export obligations thus fit into overall industrial policies by insulating, in varying degrees, the domestic market from the penetration of the foreign investor.

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*Bos, Sanders and Secchi: Private Foreign Investment in Developing Countries. P.25

4. Performance Criteria and the Balance of Payments: The balance of payments barrier to growth is a widely observed phenomenon and does not require much elaboration. The implications for inflow and outflow of foreign exchange constitute crucial elements in developing countries' planning of investment, especially industrial investment and approvals of foreign investment. Foreign investment in the extractive industries with an export motivation may pass the test though it may have other implications for national control and ownership of natural material resources. In service sectors, on the other hand, the foreign exchange outflow tends to make foreign investment in them comparatively unattractive to the host country.

As regards the manufacturing sector, experience in a number of developing countries indicates that much of such investment in the early phase of their industrialisation represents import substituting investment. In such a situation, most countries either prescribe entry criteria to cover these aspects or tend, at the time of considering foreign investment proposals, to scrutinise the foreign exchange implications of a proposed investment - weighing the outflow on account of imports of raw material and components, the payment of royalties, technical fees and dividends against the savings in foreign exchange as a result of the import substituting effects of the investment, and the earnings of foreign exchange as a consequence of exports of the product, in short to calculate (whether explicitly described as such or not) the foreign exchange cost benefit ratio.
Hence the attractiveness of stipulating

either domestic input procurement or exports in the hope that the sum of the benefits would outweigh the costs.

In several instances foreign investment is accompanied by restrictive clauses with regard to limiting exports either in quantum or to certain specified geographical areas as part of the foreign investors' global marketing strategy. LDCs have resisted this with varying degrees of success. The imposition of export obligations in some cases has gone hand in hand with such restrictive clauses.*

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*It is interesting to observe, in this connection, that among the ownership or firm specific advantages which Dunning mentions, two that figure in the list are "exclusive access to inputs, e.g., raw materials essential to the production of a product and/or control over market outlets"
Prof. John Dunning: Factors Influencing the Location of Foreign Direct Investment. Mimeograph (1979) P.21

5. Performance Criteria and Control of Transfer Pricing: One of the major areas of concern for host countries with regard to foreign investment is in respect of transfer pricing - to ensure that only "arms' length" prices are, in fact, charged. Stipulation of indigenous raw material procurement and local value addition stems from the desire to correct the distortions arising out of high transfer pricing. A tendency - perhaps less common now than previously - is for the foreign investor to write into the investment or collaboration terms the import of raw material, intermediates or components from specified sources - often from the parent firm or its affiliates - with its own implications for transfer pricing. The drug and pharmaceutical sector in several developing countries is a case in point. National policy in several cases has required that foreign investors not confine themselves to importing bulk drugs and converting them into formulations and packaging them but to go into production of intermediates and basic drugs. This follows from the perception that continued import of raw materials and equating manufactures with only conversion, assembly or packaging hardly represents acquisition of technology apart from providing the opportunity to the foreign investor to charge high transfer prices. Cases are not wanting where the foreign investor wishes to stipulate sources of procurement of inputs (from

the foreign parent or affiliate/subsidiary in third countries) and sometimes of capital equipment leading to suspicions about transfer pricing. The imposition by host countries of a local value addition stipulation acts as a defence mechanism.

6. Performance Criteria and Transfer of Technology: One of the considerations for the stipulation of export performance arises from the host countries' desire to ensure the adoption and absorption of technology and to help domestic manufacturers to conform better to international costs, standards and quality. The stipulation of export obligations (in the absence of export subsidisation) is expected to achieve this. In several cases, foreign investment takes place to obtain an 'export platform' to take advantage of a host country's resource base and its labour force and organisation. The stipulation of export obligation in such cases, though seemingly reundant, is a confirmation by the host country of this objective. Export obligations would help to ensure that the product manufactured satisfied the test of price competitiveness and quality. This explains also why some performance criteria set not only quantitative goals but also qualitative goals such as requiring export of processed and high technology exports. The imposition of such obligations also seeks to obtain the benefit for the developing country of access to the global marketing strategy of the foreign investor; a related aspect of this is the institution of buy-back arrangements between the parent firm and affiliate of the foreign investor and the host country enterprise, though this may have implications for transfer pricing.

Basically, the host country seeks to turn the foreign investments to advantage by obtaining a foothold in the international market. This assumes special significance in an environment of increasing protectionism in the international trade.*

7. Other Aspects of Performance Criteria:

An interesting use of export performance criteria is provided by Indian policy which seeks to relate the quantum of export obligations to the extent of foreign equity ownership. Indian regulations prescribe that a foreign investor exporting 60% or more of his production is permitted to retain ownership upto 74% . On a sliding scale basis, if the exports are above 40%, foreign equity ownership of upto 51% is permitted. Industries in what Indian policy refers to as 'core sector' and those that require sophisticated technology are permitted to have foreign equity upto 51% if their exports are at least 10% of their production.

8. Performance Criteria - Some General Observations:

The impact of performance criteria related to input procurement and export obligations on international trading patterns - in terms of distortions in the

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*"Intra-firm International trade does have anti-protectionist advantages" - K.Billerbeck & Y.Yasugi - op. cit. p iii

international trade flows - is difficult to quantify in the absence of adequate data; some qualitative observations may however be attempted. Performance criteria, as mentioned earlier, seem to serve the macro economic objectives of promoting domestic economic activity and strengthening the balance of payments of the host countries. In doing so there could be a conflict between these objectives and international economic objectives. To the extent that host countries require export obligations or domestic input use, there could be some reduction in such activity in other countries with resultant impact on economic activity in them. They could also lead to larger share in international trade of the exports of these countries than what competitive market trends might suggest. They could lead to demands in other countries for countervailing or protective action.* The stipulation of input procurement or of local value addition is an aspect of import substitution and its distorting impact on international trade is perhaps no greater than that of import restrictions through tariff and non-tariff barriers on the final product. One is not writing on a clean slate. The alternative to local input procurement by stipulation could be import restriction on the

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* Stipulations that an investing firm export a sizeable share of output "go directly to the location of world production, jobs and the most sensitive aspects of each country's external position"
C.Fred Bergsten loc. cit

inputs, which, of course, would have a more generalised impact than a covenant stipulating domestic procurement of inputs by a foreign investor.

In the case of export obligation also some distortion to trade patterns is likely but here again the measurement of its impact is difficult. To say that export performance criteria should be insisted on only where the product is basically export worthy in terms of costs and quality begs the question. If such were not the case, the stipulation can be complied with only by exporting on the basis of a subsidy, either overt or otherwise, with its own implications for distortion in the international trading pattern. The domestic resource cost of such products may not justify the export calling for subsidisation. Similarly, with respect to domestic procurement of inputs there is the danger of high cost industries being set up. Such distortion, it could be argued, would be deterimental to maximisation of global welfare as they negate the principle of comparative advantage. This calls for careful evaluation by a host country of the basic viability of the export and constant reappraisal of such stipulation. The necessity for obligation to export or use local inputs is itself an indication that, barring restrictive clauses, there is an economic cost in conforming to these stipulations. Whether this cost is justified or not depends on other objective of economic policy and particularly the foreign exchange situation. As the latter improves, there is a strong case for reviewing and reappraising the need for such obligation.

While the impact on international trade both as between LDCs and the developed countries and as between LDCs themselves would be adversely affected to some degree, the stipulation of local input procurement and of exports have helped domestic economic activity and the establishment of an export base which over time could be sustained even in the absence of these requirements. In many developing countries, industries which started off as import substitute industries have now grown to a point where they do not require the earlier degree of protection and indeed have emerged as exporting sectors.

9. Conclusion: Performance criteria, in a sense, represent the obverse of incentives and constitute host countries' attempts to transfer to themselves what they perceive to be as much of the benefits of foreign investment without stretching these requirements to the point of positive disincentive to such investment*.

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*It should be added, in parenthesis, that such requirements are not necessarily confined to Direct Foreign Investment. Several countries impose such requirements in respect of industrial investment in general and these thus constitute aspects of industrial and trade policy rather than specific regulations governing foreign investment. India is a case in point.

Any impact of performance requirements on expansion of domestic economic activity and strengthening the balance of payments is clearly to the advantage of the host country but when such requirements begin to impinge on other countries - whether home countries or other developing countries - they have the same effect as protection or subsidies in altering international trade flows with possible consequences of affecting the international division of labour and going against the principle of comparative advantage. It is, of course, not always possible to determine at what point these regulations become 'excessive' or when the situation calls for attempts to resolve possible conflict situations between the interests of different countries and to harmonise to the extent possible performance requirements preferably on a multilateral basis. In this as in the case of competitive incentives, or of home country policies to prevent relocation of industry towards developing countries, the attempt must be to seek an international consensus and a generally accepted code of conduct.

Performance Criteria in terms of exports or import substitution

--Indian experience.

This paper seeks to set out the Indian policy and experience with respect to performance criteria in terms of exports or import substitution under its foreign financial and/or technical collaboration policy. The rationale for stipulating expert performance or import substitution criteria has been explained and the manner in which the foreign exchange situation, in particular, influences the policy has also been highlighted.

2. At the outset, it may be relevant to refer briefly to the foreign investment policy of India. Foreign Investment has always been regarded more as a vehicle for the acquisition of advanced technology that is needed by the country but is not available indigenously than as a source for foreign capital to supplement domestic savings. It may be said that foreign money capital has not played any significant part in India's industrial development. Over the years, the country has built up a reasonably strong and diversified industrial base and has developed domestic technological capabilities to a significant extent. More importantly, it has built up a vast reservoir of scientific and technological manpower and skilled and semi-skilled labour. As a result, the areas where foreign technology needs to be imported either as a new technology not yet available indigenously or to upgrade existing local technology are increasingly becoming selective and sophisticated. Apart from the acquisition of advanced technology, the other pillar on which the

foreign investment policy rests is export oriented production. Foreign investment is welcomed in ventures which are predominantly export oriented, and in such ventures majoirity ownership is also permitted depending on the extent of exports. A hundred percent export oriented venture can have even hundred percent foreign ownership.

3. Coming now to the rationale for imposing export obligations or import substitution when a new foreign collaboration is approved or an existing foreign company (that is, a company with more than 40% foreign equity) is given an industrial licence for the manufacture of a product, it needs to be made clear at the very beginning that an export obligation is not imposed as a matter of course in each and every case. Where such an obligation is stipulated, it is generally on account of one or other of the following factors: (a) the foreign exchange situation (b) the impact on domestic industry and market (c) transfer pricing and (d) transfer and absorption of technology. These are explained in the following paragraphs.

4. From the late 1950s till early 1970s, the foreign exchange situation of the country was so stringent that the inflow and outflow of foreign exchange acted as a crucial factor in industrial approvals and investment decisions. The foreign exchange balance in terms of the inflow of foreign exchange through export earnings or saving on current imports and the outflow on account of royalties, lumpsum payments, technical know-how fees, capital goods and raw material imports, and dividends thus assumed considerable significante under industrial licensing or foreign collaboration

approvals. Since export earnings improved the balance and made the proposals acceptable from the foreign exchange angele, the export obligation was either offered by the parties themselves or was stipulated as a condition of the industrial licence or foreign collaboration approval. It needs, however, to be stated that the export obligation was seldom unduly excessive or for unlimited duration.

5. The significant improvement in the country's foreign exchange position since the early 1970s has led to a reappraisal of this policy. Experience showed that in many cases, the export obligation had come to be imposed in a routine manner for the sake of "window dressing" the foreign exchange balance, although the products were not economically export worthy or were required on the domestic market. It was also found that such exports had resulted in loss to the company concerned on the one side and had absorbed governmental subsidies for exports on the other. With the improvement in the foreign exchange situation, the present policy is, therefore, that export obligations should not be imposed merely for the sake of earning foreign exchange or improving the foreign exchange balance of the foreign collaboration proposal. Such obligation should be stipulated only if the product is export worthy and the export is economically viable or if it is essential as a part of the industrial policy to safeguard the interests of domestic enterprises in thesmall or medium sector. In other words, export obligation will be a relevant factor under industrial licensing policy only and not under foreign collaboration approvals. In the light of this position, past cases where export obligation had been imposed in a routine way are also being reviewed and the obligation removed wherever they

were unjustified on economic or industrial policy considerations. Thus, the earning of foreign exchange is no longer a determining factor in approving of foreign collaboration proposals but it must be noted that this change of approach is the result of the comfortable foreign exchange position of the country. Such an approach may not be valid for a developing country in the throes of acute balance of payments difficulties, as India itself was until a few years ago.

6. The main consideration in stipulating export obligation now is the protection of the domestic industry, especially in the small or medium sector. Under the industrial development policy, certain industries have been reserved for in the small scale sector broadly on the grounds that they are labour intensive and can be promoted through economically viable small units requiring very low capital investments. Similarly, the industries which are open to "Indian large business houses" and foreign companies have been listed, these are "core industries" considered to be vital to the national economy and requiring heavy capital investments and advanced technology. If an Indian large business house or a foreign company wants to manufacture items reserved for the small scale sector, it is permitted only if the manufacture is entirely export oriented. Likewise, if they want to take up the manufacture of items not included in the list of "core industries" and outside the items reserved for the small scale sector, they should export 60% of the production. It needs to be made clear that if a small unit takes up the manufacture of an item with foreign collaboration or if an Indian large business house or foreign company takes up the manufacture of an item specified in the list of "core industries", no

export obligation is imposed. The rationale is that the small and medium entrepreneurs should be protected in areas which is within their capabilities from the onslaught of large business houses and foreign companies. Such protection is essential from the point of view of enlargement of employment opportunities, diffusion of entrepreneurship, avoidance of market dominance and prevention of concentration of economic power. Thus, export obligation in these cases is an integral part of the overall economic and social policies of the country.

7. 'Transfer pricing' is also one of the factors - albeit not a decisive factor - influencing government policy in the matter of domestic production of the goods and avoidance of imports, especially from the parent companies. For example, in the drug sector, the present policy is that the manufacture must start from the basic or intermediate stage because experience has shown that the import of bulk drugs for conversion into formulations is leading to high prices being charged for them, apart from perpetuating the manufacture of ~~only~~ formulations, requiring no sophisticated technology, ~~in the country~~ Similarly, under foreign collaboration cases, the manufacturing plan is carefully gone into and a "phased indigenisation programme" is insisted upon. The reason for this is not only that domestic production capabilities should be strengthened and condinued dependence on external sources should be progressively minimised, but also that such tied imports run the risk of excessive prices being charged for equipment, components and spares. At the same time, it is ensured that domestic production or import substitution is not made a condition if domestic manufacture will be economically unviable (taking into account the demand and optimum state of manufacture) and imports will be a better proposition.

8. Lastly, export obligation - even if it is of a small magnitude - serves the purpose of ensuring that the domestic manufacture conforms to international quality and standards. Apart from gaining access to international markets, this enhances the possibility of current technology being transferred and absorbed under the collaboration arrangements.

9. There is yet another area where export obligation is currently in force. It is in terms of the guidelines issued under the Foreign Exchange Regulation Act (FERA) for association of domestic ownership in existing foreign companies. This is applicable only to those foreign companies which were already operating in India as on 1st January 1974. Under these guidelines, a foreign company exporting more than 60% of its own production can retain foreign equity upto 74%. Similarly, if it exports more than 40% of its own production, it can retain foreign equity upto 51%. Companies having more than 60% of their turnover from 'core sector industries' and sophisticated technology can also maintain their foreign equity at 51% if they exported at least 10% of their own production. Thus, the retention of foreign majority status has been linked to the export performance of the foreign companies. In fact, the FERA guidelines revolve around three fundamental factors, namely , "core sector industries", sophisticated technology, and exports, and existing foreign companies having or augmenting their activities predominantly in these areas have been made eligible to maintain their foreign subsidiary status with foreign equity of upto 74% or 51% depending on the exte nt of their turnover from them. It may be pointed out that such companies have established their capabilities to fulfil the stipulated level of exports.

10. There is little evidence to show that the export or import substitution requirements have adversely affected investment and trade flows. As observed earlier, with the improvement in the foreign exchange situation, export obligations are now not being stipulated as a part of the foreign investment policy irrespective of whether the exports are a viable proposition. Where they are considered necessary, it is mainly as a part of the industrial policy for protecting the interests of the small and medium sector of domestic industry. Such protection, experience has amply shown, is essential, especially in consumer goods industries, where the market dominance of foreign companies arises on account of trade marks and brand names. Experience has further shown that where export obligations tend to act as an inhibiting factor in foreign collaborations, it is due to the interest of the foreign investor in having predominant access to the huge domestic market. But it is precisely such predominant access to domestic market that will drive out existing domestic enterprises, particularly the small and medium units. It is, therefore, imperative that this issue is viewed not only from the point of view of foreign investment or technical collaboration but also from the angle of the implications for the growth of domestic industries. Where the foreign investor is interested in establishing a predominantly export oriented unit, such a conflict does not arise because the unit will be based on the factor endowments of the country and its being competitive in the export markets. In many cases, such units are based on "buy back arrangements" or established in "free trade zones". As stated earlier, foreign majority ownership is permitted in such cases, with even hundred percent

foreign ownership for entirely export oriented ventures. Thus, taking an over all view, it will be difficulty to say that such performance requirements for exports do not serve a significant purpose or impede desirable investment or trade flows into the country.

11. TNC investments in developing countries are commended on the plank that apart from offering a unique package of capital, technology, management and marketing skills, they give the developing countries a much needed access to international markets. While evaluating the costs and benefits of TNC investments, the generation of this export potential (or conversely the import substitution effect) is counted as a major benefit accruing to the developing countries. It has also been witnessed that the restrictions operated by the developed countries in the matter of imports from developing countries generally tend to apply more in the case of goods manufactured in the labour intensive domestic sector of the developing countries (for example, handloom garments in the case of India) and that the markets of developed world are generally more open to goods manufactured by multinationals. In such a situation, it is not unrealistic for the developing countries to explore the possibility of securing the benefits of TNC investments by obliging them to fulfil ~~xxx~~ certain minimum export performance. It may be argued that if the local production is internationally competitive, TNCs will on their volition export those products and it is therefore not necessary to stipulate such export obligation. Here also, experience has shown that the operations of the TNCs and the development objectives of the host developing countries are always not in harmony, and where a

conflict arises, the TNCs prefer to place their own global interests over those of the countries in which they operate. The restrictive practices followed by them in regard to exports from the local affiliates will also point to the need for some binding obligation on them. It would, therefore, be desirable to consider performance criteria, not only on the export front but also in other areas, as a measure necessary to enhance the positive contribution of TNC investments than in the context of their impact on investment and trade flows.

PERFORMANCE CRITERIA STIPULATED BY HOST COUNTRIES

SUMMARY

This paper is divided into two parts. The first discusses in general terms the rationale of performance criteria stipulated by host countries. The second part narrates the Indian experience.

Host countries stipulate performance criteria in an effort to maximise the positive and minimise the negative aspects of foreign investment. More specifically, they weigh the benefits of additional income generation arising out of foreign investment against its likely impact on the balance of payments or the growth of indigenous industry.

The two forms of performance criteria discussed are:

(1) Those that require that procurement of inputs be shifted to host countries; and

(2) Those that require that the foreign investor export a specified percentage of his production, either by volume or value.

Performance criteria can be related to the following objectives of national economic policy:

(i) Increasing national output and domestic employment and protecting domestic industries;

(ii) Strengthening the balance of payments;

(iii) Controlling transfer prising practices; and

(iv) Helping the transfer of technology.

The impact of performance criteria related to input procurement and export obligations on international trading patterns in terms of possible distortion of internal trade flows is difficult to quantify in the absence of adequate data.

However, the qualitative observations may be made that the imposition of performance criteria by host countries could lead to some reduction in economic activity in other countries and could lead to demands in the latter for countervailing or protective action. In this sense they have the same effect as protection or subsidies on international trade flows with the possible consequence of affecting the international division of labour. It is not possible always to determine at what point these regulations become excessive or when the situation calls for demands to resolve possible conflict situations. The attempt must be to seek an international consensus and a generally accepted code of conduct.

The Indian Experience:

This part of the paper explains the background to the stipulation in India of performance criteria in terms of export obligations and input procurement. Indian policy in this regard has taken into account the foreign exchange situation of the country, the impact on domestic industry and markets of foreign investment as well as issues of transfer pricing and technology transfer. It is pointed out that in the period between 1950 and 1970 when the foreign exchange situation of the country was under severe strain export obligations were imposed, but with the improvement in the country's foreign exchange position there has been some reappraisal of this policy and that export obligations are stipulated only if the product is export worthy and the export economically viable or if it is necessary to safeguard the interests of domestic enterprises in the small and medium sectors.

Export obligation is increasingly becoming an aspect of industrial licensing policy rather than foreign collaboration/ investment approvals.

ATTACHMENT II

SOME THOUGHTS ON PRIVATE FOREIGN INVESTMENT IN THE DEVELOPING COUNTRIES

Ph. Lévy

SOME THOUGHTS ON PRIVATE FOREIGN INVESTMENT IN THE DEVELOPING COUNTRIES

One gets the impression that private foreign investment in developing countries is stagnating in real terms, and even declining in some regions. Yet the figures available suggest the contrary. This seeming contradiction is due to two things: the lack of precise figures and the vast differences in situation observable among regions, among countries and also among investment sectors. This paper will first of all recapitulate the most significant figures and then attempt an interpretation of them.

1. The facts

1.1 Total flows

Between 1971 and 1976, although private foreign investment originating in the market-economy developed countries increased from US$12.8 billion to US$24.4 billion,1/ these flows remained stable in relation to GNP (accounting for 0.59% in 1971 and 0.60% in 1976). Total real private investment originating in the developed countries has therefore not declined over the past few years. According to some authors,2/ the contrary may well be true: there was an apparent growth in real terms, at least among the seven most important industrial countries, which would appear to have increased their foreign investment by 34% between 1968-72 and 1973-76.

1.2 Geographical distribution of private investment

In recent years, certain regions have been the major beneficiaries of private investment flows. The figures in the table in Annex 2 show that between 1968-72 and 1973-76 the United States, Asia and Latin America received an increased share of foreign capital flows (albeit with substantial variation as to origin). The share of Europe, Africa and the Middle East dropped for reasons which varied greatly from one region to another (decrease in profit rates, political risks, nationalizations, etc.).

1.3 The share of the developing countries

In any event, the share of total private foreign investment received by the developing countries has grown. This is brought out clearly in the table in Annex 3, which shows that their share rose from 30 to 36% between 1969/70 and 1975/76--an increase not only in relative but also in absolute terms, since the foreign investment they received in 1977 had risen in real terms by 40% compared with 1970. 3/

1/ See Annex 1 (figures cover all recipient countries, including developed countries).

2/ "Recent Trends in Direct Investment Abroad", Problèmes Economiques, No. 1599, November 29, 1978, pp. 19 to 22.

3/ See table, Annex 4.

The table in Annex 5, however, shows clearly the differentiation that has appeared among the developing countries over the last few years. Asia today is at the head of the list of regions receiving foreign private capital; South America, now in second place, its relative share having decreased significantly, is followed by Central America/Caribbean, whose share has increased appreciably. There has been a marked decrease in Africa's share, while Europe and the Middle East, coming last, show a slight increase.

Asia's newly acquired preeminence is doubtless the result of its expanding role in international trade, although some countries in the region--those in fact whose international trade has grown most in recent years--received only a relatively small amount of foreign investment. The reasons for the drop in South America's share are difficult to explain and are worth studying further. As to the reduction in the African share, this can no doubt be attributed to a sizable drop in primary sector investments and also to the tense situation prevailing in the region.

1.4 Distribution of private foreign investment by field of activity

The target of private capital exports varies according to the country of origin. While one country may concentrate its foreign investment on industry, another may focus on services and a third on raw materials. Thus, 4/ extractive industries attracted a gradually decreasing volume of capital from the United States between 1971 and 1974, this applying for all recipient regions, but particularly for the developing countries. Japan and West Germany, on the other hand, increased their investment in this type of activity during the same period. It is generally true, however, that the trend is for a very rapid increase in foreign investment in the area of services.

We get a slightly different picture if we take a few significant examples among the developing countries. 5/ In the case of some of the semi-industrialized developing countries, the share of foreign investment in industry is stagnating. In others, however, which are still at the import substitution stage or are successfully expanding in the direction of outside markets, the share of foreign investment in industry is increasing. It is interesting to note that the share of foreign investment directed to the primary sector is rising in those countries that are making a major effort to expand the use of their natural resources. This, of course, is also the case of those countries that have benefitted from important oil discoveries while not extracting the oil themselves.

1.5 Private investment and other flows to developing countries

Private foreign investment in developing countries has therefore not been declining in recent years. The most recent figures published by OECD 6/ show that private investment from DAC member countries increased from an annual average of US$2,639 million in 1967-69 to US$11,463 million in 1978 (US$9,498 million in 1977). Allowance should be made, however, for delays in investment

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4/ See table, Annex 6.

5/ See table, Annex 7.

6/ See table, Annex 8.

operations, and for the fact that 1977/78 figures therefore reflect investment decisions taken well beforehand. For this reason, the trend may very possibly not be the same in 1979 and the following years, but we cannot be certain at this point.

Yet if it does appear at times that private foreign investment in developing countries is dropping, there would be two reasons for this. The first, as we said, is that investments tend to be concentrated in some countries and in certain fields of activity. The result is that whole regions and sectors of activity seem to have been left out. The second reason is that foreign investment suffers by comparison with other forms of private capital transfer, which have grown far more rapidly. In fact, while private investment by DAC member countries of OECD in developing countries increased more than four times between 1967-69 and 1978 (in nominal terms), total privately arranged transfers under market conditions went up nearly eight times. During this period, bilateral portfolio investments went up 24 times, from US$870 million in 1967-69 to US$20,971 million in 1978-79! This new development, which has without question completely transformed the nature of financial relations between developed and developing countries, is an indication that over the last ten years the methods of capital transfer to developing countries have changed radically. It is this change that will be discussed in the second part of this paper.

2. Interpretation

The data set out in the foregoing section indicated three major trends in private capital transfers to developing countries: geographical concentration, concentration by field of activity and a growing preference for indirect transfers (credit operations). We should now add a fourth, which is not brought out by these figures, namely the new forms of direct investment (joint ventures, management contracts, franchising, etc.).

2.1 Geographical concentration

The tables in Annex 9 give an idea of the disparities in the extent of private foreign investment in the developing countries. We see that the OPEC countries in 1977—the last year for which figures are available—received 15.9% of total foreign investment in the developing countries (US$13,500 million out of a total of US$85,000 million).

Yet the OPEC share would appear to have decreased appreciably, if we accept other sources, which state that it accounted for 26.8% of all private foreign investment in the developing countries in 1971. 7/ Furthermore, still in 1977, Brazil's share amounted to 12.6% (US$10,700 million), that of Mexico to 5.9% (US$5,000 million), that of Malaysia to 3.2% (US$2,700 million). India's share, on the other hand, amounted to only 2.8% (US$2,400 million), while private foreign investment in Mali amounted to only US$10 million.

7/ Transnational Corporations in World Development: A Re-examination, Commission on Transnational Corporations, United Nations, New York, 1978, p. 254 (Doc. E/C.10/38).

There are many reasons for this concentration. In the first place, a number of countries are unwilling to accept foreign investment, although more detailed study would no doubt confirm some reversal in that trend, since it seems that certain countries with a traditionally reserved attitude to foreign investment have in fact become more flexible. Other countries do not encourage foreign investment because they already have a balance of payments surplus and therefore prefer to modernize their production structure while keeping financial control over new enterprises. In yet other countries, the lack of infrastructure, or uncertainty as to the general economic situation or the political outlook, leads to some holding back on the part of foreign investors. Conversely, countries with a vast and/or dynamic domestic market, or which have successfully penetrated international markets, do succeed in attracting foreign capital. It should also be noted that new forms of investment, discussed below, lead automatically to a reduction in the foreign component of total investment.

2.2 Concentration in certain sectors of activity

Although reliable data are harder to come by here, the tables in Annexes 6 and 7 at least give an idea of the diversity of situation to be observed in both capital-exporting and capital-importing countries and enable general trends to be discerned. It is clear that private foreign investment is stagnating or declining in the extractive industries and agriculture. There are many reasons for this, among them no doubt the introduction of local restrictive regulations, the acquisition of necessary technology by the developing countries themselves (especially in agriculture), the uncertain rate of return on investments owing to the instability of raw materials markets, and the takeover by the State of extractive industries (which in many cases are the economic backbone of the developing countries). Thus, for example, some developing countries are making very substantial investments in the oil sector without any resulting increase in foreign investment (while conversely their foreign debt may be increasing vastly).

Annexes 6 and 7 also show that the situation varies considerably as regards private foreign investment in the industrial sector. Although such investment is very active wherever the general investment climate is not unfavorable and domestic or export market prospects are attractive, if one of these two conditions is lacking, there is stagnation or a decline in direct private foreign investment.

Finally, note should be taken of the substantial private foreign investment activity in the services sector. Developing countries generally have no other means of acquiring the technology the services sector provides and have to accept this mode of obtaining it if they wish to modernize their way of life. It is interesting, however, that some countries impose substantial restrictions against foreign incursion in certain types of services (banking and insurance).

2.3 New forms of direct and indirect investment

2.3.1 New forms of direct investment

Foreign investors have everything to gain in terms of security by forming associations with local partners (either public or private). From the point of view of the recipient countries, there is a growing desire to get involved in business. This desire is due in part to the need to find as profitable and secure an outlet as possible for the often abundant local capital which they have now succeeded in accumulating, and for many investors, the preferred avenue is association with a foreign partner. In addition, there is the existence of an already quite substantial number of young local managers and university graduates increasingly capable of playing an active role in business operations.

Thus today the concept of "private foreign investment" has broadened considerably. It is now no longer simply a form of financial participation, above a given percentage, in a local enterprise but more generally consists of building up a lasting stake involving long-term agreements on management, production sharing, supply or technical assistance. It is evident that such forms of foreign participation, to the extent they create close and enduring links, do not show up in the statistics, and thus contribute to the apparent sizable reduction in the share of private investment in total private flows to developing countries. In any event, major foreign investors today are virtually forced to accept this system, at least in the ten or so most important recipient countries, which use very similar systems characterized principally by a closed domestic market and the establishment of limitations on foreign participation in local enterprises. It should be noted that this applies in particular to investments geared to supplying the domestic market.

2.3.2 Indirect investment

As the table in Annex 8 shows, there has been a striking increase in foreign loans, a form of indirect investment which has now become the principal means of private capital transfers to developing countries. This reversal is in part due to changes at each end of the financial chain linking developed with developing countries. As regards the former, the major holders of capital are no longer only production enterprises but also include investors whose sole object is to find a profitable and secure outlet for their funds. These investors merely place their funds with international banks, leaving questions of financial management to them. These banks, which are not involved in direct production activities, make contact at the other end of the chain, at the developing country end of things, with producers anxious to acquire capital. Such producers may be either private or public; they may be exclusively local, or an association of local and foreign interests or even exclusively foreign (although the last case is certainly not the most frequent); finally, they will be located in countries where, for a number of reasons, the rate of return has not decreased as much since 1973 as in the developed countries, and where it is sufficiently high to compensate for any lack of security, which in any event is relative.

3. Conclusions

The relations between foreign private enterprises and developing countries can be defined in terms of placements. These placements for a long time were combined with direct control by the foreign enterprise: this is direct investment. Control of this type seems to be becoming relatively less frequent--which does not mean that foreign private enterprises are losing interest in developing countries but that their operations are becoming increasingly varied, involving associations with local enterprises, both public and private. There is no reason to believe that foreign private enterprises will turn away from the developing countries; on the contrary, it is probable they will accept having to give up centralized, exclusive control in order to move toward more flexible formulas.

It is nonetheless true that the relations between foreign private enterprises and developing countries tend to be concentrated in certain countries and fields of activity. This may have unfortunate consequences for some developing countries which see themselves as neglected, and for certain areas of activity where there may be no locally generated investment funds, either public or private, to compensate for the lack of foreign investment.

Table III-31. Developed market economies: gross national product and outflow of direct investment, 1971-1976

Year	Gross national product	Outflow of direct investment a/	Outflow of direct investment as share of GNP
	(Billions of dollars)		(Percentage)
1971	2 181.2	12.8	0.59
1972	2 512.8	14.5	0.58
1973	3 061.2	22.7	0.74
1974	3 380.0	21.0	0.62
1975	3 757.1	25.0	0.67
1976	4 093.4	24.4	0.60

Source: United Nations Centre on Transnational Corporations, based on Organisation for Economic Co-operation and Development, Development Co-operation (Paris, various issues); International Monetary Fund, Balance of Payments Yearbook (Washington, D.C., various years).

a/ Including reinvested earnings.

Annex 2

TABLE 1. - GEOGRAPHICAL SPREAD OF DIRECT FOREIGN INVESTMENT BY PRINCIPAL COUNTRIES OF ORIGIN (% of total)

Recipient Country	North America		United States		Europe		C.E.		South & Central America		Asia		Africa		Middle East	
Country of Origin	1968-1972	1973-1976	1968-1972	1973-1976	1968-1972	1973-1976	1968-1972	1973-1976	1968-1972	1973-1976	1968-1972	1973-1976	1968-1972	1973-1976	1968-1972	1973-1976
United States	22.1	19.4			37.0	43.6	31.9	33.5	13.6	15.9	9.2	7.4	5.3	1.5	1.0	2.6
Japan	21.5	24.7	17.5	22.2	30.1	9.5	29.5 (e)	6.9 (e)	11.5	18.3	16.5	32.3	2.4	5.0	6.9	5.2
West Germany	18.2	20.8	8.9	15.6	61.3	54.9	38.0	33.0	12.8	13.7	3.8 (a)	5.2 (a)	7.4	5.1	(a)	(a)
UK (b)	24.3	29.4	18.2	21.2	33.1	31.0	27.4	24.1	2.5	5.6	5.4	4.9	18.5	18.0	--	0.1
France (c) (d)			7.8	18.0			25.8	31.2								

(a) Asia, including Middle East

(b) Excluding oil sector

(c) Excluding banking sector

(d)

	1968-1972	1973-1976
Other OECD Countries	24.5	20.2
Rest of the world	41.7	30.5

(e) Leaving aside investment financed through the London capitals market and a substantial project ... (illegible) ... in the UK, the EC share was 4.4% and 5.2%, respectively.

Comments concerning the countries of origin: United States: (1) net capital outflows plus retained earnings. (2) statistical series which is adjusted from time to time. Japan: authorized direct foreign investment (shares and long-term loans). West Germany: net capital outflows. United Kingdom: net capital outflows plus retained earnings. France: net capital outflows. General comment: the method of calculating net capital outflows varies from country to country.

Sources: United States: USDC, Survey of Current Business. Japan: Bank of Japan. West Germany: Der Bundesminister für Wirtschaft, Vermogensanlagen Gebietsansässiger in fremden Wirtschaftsgebieten. United Kingdom: Business Monitor, a publication of the Government Statistical Service. France: the Notes Bleues of the Service de l'Information of the Ministry of Economic Affairs and Finance.

Annex 3

TABLE 7. THE SHARE RECEIVED BY DEVELOPING COUNTRIES OF TOTAL DIRECT INVESTMENT ABROAD BY THE PRIVATE SECTOR OF DAC MEMBER COUNTRIES

	Annual Averages			
	1969-1970		1975-1976	
	Total direct investment in millions of dollars	of which developing country share in %	Total direct investment in millions of dollars	of which developing country share in %
Australia	110	61	163	38
Belgium	85*	32	224*	68
Canada	321*	17	599*	61
France[1]	283	80 (est.)	1127	23
Germany	790	32	2230	35
Italy	196*	61	251*	72
Japan	280	66	1878	35
Netherlands	512*	29	1104*	21
Sweden	225	14	513	20
UK	1314	20	2938	26
US	6662	27	13300	39
Others[2]	57	40	304[3]	27
All DAC member countries	10835[4]	30	24631[4]	36

* These figures do not include retained earnings, which add up to very large amounts, but for which no estimates are available.

1. Including overseas departments and territories.
2. Austria, Denmark, Finland, Norway and New Zealand.
3. Norway accounting for 180.
4. Excluding Switzerland (figures not available).

Source: Balance of Payments Yearbook, Volume 28; OECD: DAC Statistics on financial resources contributed to developing countries.

Annex 4

TABLE 2. DIRECT PRIVATE SECTOR INVESTMENT (NET) IN DEVELOPING COUNTRIES 1970 TO 1977 AT EXCHANGE PRICES AND RATES FOR 1976

(millions of dollars)

	1970	1971	1972	1973	1974	1975	1976	1977p
Australia	236	99	187	145	129	50	75	78
Austria	11	--	7	7	9	7	33	17
Belgium	98	54	98	66	60	69	236	-25
Canada	117	127	278	184	237	336	430	(360)
Denmark	18	53	19	23	32	31	30	--
Finland	2	2	1	1	1	3	1	2
France	451	311	370	372	269	261	245	245
Germany	620	623	923	959	772	837	765	780
Italy	223	359	419	318	118	141	213	150
Japan	506	416	323	1589	739	234	1084	668
Netherlands	415	259	552	125	294	237	245	450
New Zealand	--	--	-3	2	3	1	1	8
Norway	43	23	13	21	19	18	43	14
Sweden	74	74	70	31	62	87	125	116
Switzerland	126	132	124	106	149	209	226	203
UK	617	383	575	897	808	754	954	(560)
US	2171	1829	1815	880	-1907	5626	3119	4500
All DAC member countries	5728	4744	5771	5726	1794	8901	7824	(8130)

1. See notes for Table 1.

Source: Figures from DAC, OECD.

Annex 5

TABLE 10. DISTRIBUTION BY RECIPIENT REGION OF STOCKS OF NET ASSETS OBTAINED OUT OF DIRECT INVESTMENT BY PRIVATE SECTOR OF DAC MEMBER COUNTRIES IN DEVELOPING COUNTRIES

Recipient region	End 1970		End 1976	
	Billions of dollars	% of total	Billions of dollars	% of total
Europe	2.7	6.2	6.9	9.1
Africa	7.9	18.3	9.7	12.7
Central America	8.6	19.8	18.5	24.3
South America	13.8	31.7	19.2	25.2
Middle East	3.4	7.8	2.2	2.9
Asia[1]	7.0	16.2	19.7	25.8
Total	43.4	100.0	76.2	100.0

1. South Asia, Far East and Oceania

Source: Figures from DAC, OECD.

Table III-38. Selected developed market economies: stock of direct investment abroad by major industrial sector, total and in developing countries, 1971 and latest available year

Country and industrial sector	Total stock				Stock in developing countries			
	1971 a/		1974 a/		1971 a/		1974 a/	
	Millions of dollars	Percentage	Millions of dollars	Percentage	Millions of dollars	Percentage	Millions of dollars	Percentage
United States								
Total industry	101 313	100.0	137 244	100.0	22 904	100.0	29 050	100.0
Extractive b/	30 989	30.6	36 771	26.8	8 339	36.4	5 191	17.9
Manufacturing	44 370	43.8	61 062	44.5	7 820	34.1	11 362	39.1
Services	25 954	25.6	39 411	28.7	6 745	29.5	12 497	43.0
Banking and insurance	9 726	9.6	16 392	11.9	2 309	10.1	5 986	20.6
United Kingdom c/								
Total industry	23 717	100.0	31 277	100.0	4 511	100.0	5 059	100.0
Extractive	8 051	33.9	8 747	28.0	1 159 d/	25.7	989 d/	19.6
Manufacturing	10 043	42.3	14 131	45.2	1 828	40.5	2 409	47.6
Services	5 633	23.8	8 399	26.8	1 524 d/	33.8	1 661 d/	32.8
Banking and insurance	1 212	5.1	1 410	4.5	...	...	...	...
Canada								
Total industry	6 524	100.0	9 390	100.0	1 575	100.0	2 214	100.0
Extractive b/	938	14.4	1 963	20.9	...	...	...	...
Manufacturing	3 437	52.7	4 729	50.4	...	...	...	...
Services	2 149	32.9	2 698	28.7	...	...	...	...
Banking and insurance	405	6.2	622	6.6	...	...	...	...
Germany, Federal Republic of								
Total industry	7 277	100.0	19 915	100.0	2 044	100.0	6 015	100.0
Extractive	350	4.8	1 419	7.1	92	4.5	569	9.5
Manufacturing	5 796	79.6	14 032	70.5	1 605	78.5	3 633	60.4
Services	1 131	15.6	4 464	22.4	347	17.0	1 813	30.1
Banking and insurance	494	6.8	1 941	9.7	161	7.9	520	8.6
Japan e/								
Total industry	3 962	100.0	10 620	100.0	...	...	5 678	100.0
Extractive f/	892	22.5	2 778	26.2	...	...	1 362	24.0
Manufacturing	1 092	27.6	3 723	35.0	...	...	2 887	50.8
Services	1 978	49.9	4 119	38.8	...	...	1 429	25.2
Commerce, banking and insurance	843	21.3	2 376	22.4	...	...	603	10.6

Table III-38 (continued)

Country and industrial sector	Total stock				Stock in developing countries			
	1971 a/		1974 a/		1971 a/		1974 a/	
	Millions of dollars	Percentage	Millions of dollars	Percentage	Millions of dollars	Percentage	Millions of dollars	Percentage
Italy								
Total industry	3 343	100.0	2 864	100.0	1 208	100.0	1 078	100.0
Extractive	849	25.4	861	30.1	642	53.9	616	57.1
Manufacturing	881	26.4	907	31.7	292	24.2	345	32.0
Services	1 613	48.2	1 096	38.2	274	22.7	117	10.9

Note: Extractive industries include agriculture, mining and petroleum.

a/ Years for United States are 1973 and 1976; for Federal Republic of Germany, 1971 and 1976; for Italy, 1972 and 1976.

b/ Refers to mining and smelting and petroleum.

c/ Total and the relevant sectoral stock data include investment in the petroleum and insurance sectors which are not included in the corresponding items for developing countries.

d/ Refers to agriculture and petroleum only; mining and quarrying is included in manufacturing.

e/ Developing country totals are calculated by adding figures for Asia, Africa, Oceania (except Australia) and the Middle East.

f/ Refers to mining, agriculture and fishing.

Source: United Nations Centre on Transnational Corporations, based on: for the United States: Department of Commerce, Survey of Current Business (various issues); for the United Kingdom: Department of Industry, Trade Prices and Consumer Protection, Trade and Industry (various issues); for the Federal Republic of Germany: Ministry of Economic Affairs, Runderlass Aussenwirtschaft (various issues); for Japan: for 1967, 1971, 1973 and 1975, data based on Ministry of Finance, Annual Report of the International Finance Bureau, 1977; for 1976, Toyokeizai shinpo sha, Japanese Multinationals: Facts and Figures, 1977/1978; for Switzerland: Union Bank of Switzerland, Switzerland in Figures, (unofficial estimate); for France: for 1967, H.E. Scharrer, ed., Förderung privater Direktinvestitionen (Hamburg, 1972); for 1975, H. Krägenau, ed., International Direktinvestitionen 1973-1975 (Hamburg, Institut für Wirtschaftsforschung, 1977), (unofficial estimate); data for 1971, 1973 and 1976 estimated on basis of cumulative annual flows of direct investment as reported to the International Monetary Fund; for Canada: Ministry of Industry, Trade and Commerce, Statistics Canada (various issues); for the Netherlands: for 1967, source as for France; for subsequent years, 1967 stock plus cumulative annual flows of direct investment abroad; for Sweden: for 1965 and 1970, total assets of majority-owned manufacturing affiliates; data for subsequent years derived by addition of annual flows of direct investment abroad; for Belgium-Luxembourg: for 1967, estimate based on number of foreign affiliates and average book value per affiliate; stock data for subsequent years estimated on basis of annual flows of direct investment abroad; for Italy: information supplied by Italian Foreign Exchange Office. Data for other countries estimated by the United Nations Centre on Transnational Corporations. For further information on data, see annex VII.

Table III-50. Stock of direct investment in selected developing countries and territories, by major industrial sector, selected years

Country or territory and year	Total stock of foreign direct investment (Millions of dollars)	Share of distribution			
		Extractive sector a)	Manufacturing sector	Service sector	Other
		a) Including agriculture	(Percentage)		
Latin America:					
Argentina . . 1973	2 275.2	5.6	65.0	24.5	4.5
Brazil . . . 1971	2 911.0	0.9	81.8	14.9	1.4
. . . 1976	9 005.0	2.5	76.5	18.6	2.0
Colombia . . 1971	692.0	27.3	50.0	19.0	3.7
. . . 1975	965.0	36.0	44.2	18.3	1.5
Mexico . . . 1971	2 297.4	5.9	75.2	16.4	2.5
. . . 1975	4 735.8	4.1	77.5	18.1	0.2
Panama . . . 1969	214.1	21.1	27.0	51.7	-
. . . 1974	353.5	16.1	37.4	46.4	-
Asia:					
Hong Kong . . 1971	759.5	-	100.0	-	-
. . 1976	1 952.4	-	100.0	-	-
India . . . 1974	1 682.8	4.2	92.0	3.7	-
Indonesia . . 1970	1 581.4	74.9	19.2	5.5	-
. . 1976	7 077.0	37.5	57.0	10.3	-
Philippines . 1973	146.0	5.7	39.2	52.5	2.6
. 1976	513.0	12.6	48.7	34.0	4.7
Korea, . 1973	582.2	1.3	76.9	21.8	-
Republic of. 1975	926.9	1.4	80.1	18.5	-
Singapore . . 1971	1 575.0	47.7	52.2	-	-
. . 1976	3 739.0	40.6	59.3	-	-
Thailand . . 1969	70.2	0.1	97.3	2.5	-
. . 1975	174.7	-	93.1	6.8	-
Africa:					
Nigeria . . . 1968	999.2	53.7	24.5	18.8	2.0
. . . 1973	1 998.6	63.3	25.2	10.3	1.2

Source: United Nations Centre on Transnational Corporations, based on: for Argentina: information supplied by Subsecretaría de Inversiones Extranjeras, Government of Argentina; for Brazil: Banco de Brasil, Relatorio Anual, 1977; for Colombia: Banco de la Republica, Reporte Anual, 1975; for Hong Kong: information supplied by Trade, Industry and Commerce Department; for India: Department of Company Affairs, Ministry of Justice, Research Statistics, 1976; for Indonesia: Bank of Indonesia, Indonesian Financial Statistics, 1977; for Mexico: Banco de Mexico S.A.; information supplied to the United Nations Centre on Transnational Corporations; for Nigeria: Central Bank of Nigeria, Economic and Financial Review (various issues); for Panama: Estadistica Panamaña, Balanza de Pagos (various issues); for the Philippines: Central Bank of the Philippines, Philippines Business Review 2 (1977); for the Republic of Korea, Economic Planning Board; Economic Survey (various issues); for Singapore: Economic Development Board, Annual Report, 1976; for Thailand: Board of Investment Planning Division, "Report for 1976".

Table A.19 THE FLOW OF FINANCIAL RESOURCES TO DEVELOPING COUNTRIES AND MULTILATERAL AGENCIES

TOTAL DAC COUNTRIES

NET DISBURSEMENTS

	1967-1969 AVERAGE	1970	1975	1976	1977	1978
OFF.DEV.ASSIST.(ODA)	6446.3	6786.5	13582.2	13665.5	14695.9	19881.8
ODA AS % OF GNP	0.38	0.34	0.35	0.33	0.31	0.35
BILATERAL ODA	5624.1	5662.7	9815.1	9574.7	10243.8	13122.6
ODA GRANTS	3282.5	3409.2	6267.9	6541.9	7212.7	9410.2
TECHNICAL CO-OPER.	1427.4	1520.7	2921.6	2887.3	3.60.5	3779.6
FOOD AID	425.4	555.9	826.3	846.1	795.3	742.6
DEBT FORGIVENESS	0.5	10.7	32.1	172.9	167.6	656.2
OTHER GRANTS	1466.1	1221.9	2497.7	2795.6	3265.2	4220.2
ODA LOANS	2240.1	2353.4	3547.2	2962.7	2881.1	3722.8
NEW ODA LOANS	2157.6	2296.9	2718.5	1827.8	1986.9	2855.1
FOOD AID LOANS	...	...	805.1	674.8	720.6	652.3
DEBT REORGANISATION	75.6	35.9	495.6	508.3	201.3	199.8
OTHER	8.1	20.7	38.6	26.6	18.9	15.3
MULTILATERAL ODA	824.2	1123.8	3772.1	4089.8	4612.1	6759.3
GRANTS	384.9	551.2	2028.7	1932.9	2235.6	2434.4
UN AGENCIES	281.6	367.8	1197.0	1152.8	1313.6	1596.5
EEC	88.3	157.6	672.4	622.6	716.7	536.4
OTHER	15.5	27.1	159.3	157.5	213.5	301.6
OF WHICH:FOOD GRANTS	22.3	59.3	498.0	342.3	507.1	567.9
CAP.SUBSCRIP.PAYMENTS	399.5	540.6	1734.6	2166.5	2338.2	4313.6
IBRD	6.1	3.9	3.6	27.1	74.9	179.2
IDA	253.1	288.7	1109.1	1358.8	1414.5	3048.1
REG.DEV.BANKS	140.2	247.6	525.2	729.5	795.3	909.2
OTHER INSTS.	0.7	1.3	25.1	51.1	53.4	167.1
MULT.CONCESS.LOANS	39.8	31.5	9.4	61.5	38.9	21.2
OTHER OFF.FLOWS (OOF)	598.9	1208.7	3323.7	3313.3	3812.2	5214.3
BILATERAL OOF	592.9	818.1	2944.1	3185.1	3185.5	5057.6
OFF.EXPORT CREDITS	516.6	547.8	1370.9	1822.8	2285.8	3497.2
OTHER	84.4	290.3	1573.7	1363.4	899.7	1559.7
MULTILATERAL OOF	-2.1	270.6	79.1	127.1	126.7	156.7
OF WHICH:IBRD	-1.1	296.6	-52.3	26.3	100.2	99.8
TOTAL OFF.FLOWS	7047.2	7895.4	16611.9	16978.8	18508.1	25096.1
GRANTS BY VOLUN.AGENC.	18.4	857.5	1341.8	1394.7	1498.7	1665.5
PRIVATE FLOWS	5686.7	7802.1	22427.5	22189.2	31227.7	44621.2
DIRECT INVESTMENT	2639.8	3689.1	13493.8	7823.9	9498.9	11439.4
BILAT.PORTFOLIO	870.6	696.9	5238.8	5233.8	10749.3	20971.8
MULTIL.PORTFOLIO	555.6	474.1	2552.9	3096.8	2642.4	2515.1
EXPORTS CREDITS	1540.2	2141.9	6141.9	6025.8	8337.1	9697.0
OF WHICH:MONET.SECTOR	353.0	174.6	4539.6	(4900.0)	6589.6	20280.1
CHANGE MTL.CLAIMS	188.4	226.8	4353.3	(4182.6)	5746.6	12736.1
IN FOREIGN CURR.	0.0	0.0	0.0	0.0	0.0	10894.4
IN DOMESTIC CURR.	0.0	0.0	0.0	0.0	0.0	555.1
MUL.MONET.PORTFOLIO	93.5	-52.2	186.3	717.6	842.4	1044.2
TOTAL RESOURCE FLOWS	12750.5	15754.8	40380.3	39159.0	50724.5	71384.9
TRF AS % OF GNP	0.75	0.78	1.05	0.97	1.08	1.26
PARENT BANK & AFFIL. ADJUST.RESOURCE FLOW						5694.2

GROSS DISBURSEMENTS

TOTAL OFFICIAL	8796.2	9998.9	21212.7	21 5659	23473.1	31969.2
OFFICIAL DEV.ASSIST.	7366.7	7590.4	14997.8	15305.6	16661.6	22575.1
OTHER OFFICIAL FLOWS	1431.5	2398.5	6215.1	6260.3	6811.5	9394.9
NEW DEVELOPMENT LOANS	256.8	2785.3	3316.9	3.93.7	3234.6	4673.3
TOTAL DEBT REORGANIST.	190.3	225.4	715.6	792.1	667.6	1285.2
TOTAL FOOD AID	447.7	(620.4)	2284.4	1668.2	2014.7	2179.7
OFFICIAL EXP.CREDITS	1155.9	1512.9	3219.9	3776.2	4705.2	5947.7
PRIVATE EXP.CREDITS	3245.2	5216.8	1698.4	13340.5	13373.2	...

COMMITMENTS

OFF.DEV.ASSIST.(ODA)	8224.6	8139.8	16470.4	19418.1	21412.7	26164.1
BILATERAL ODA	6786.1	6705.7	12756.2	14168.8	15267.9	18796.3
OF WHICH: GRANTS	3615.7	3761.1	7693.5	8307.5	9156.2	11915.7
MULTILATERAL ODA	1237.8	1453.7	3764.2	5249.3	6334.8	7367.9
OTHER OFF.FLOWS (OOF)	1319.4	2436.3	9035.8	9.55.9	8662.6	13266.3

MEMO ITEMS

FLOWS TO MUL.AGENCIES	1159.6	1506.6	6494.1	7384.7	7586.1	9831.3
OFF.SUPP.PRIV.EXP.CRED	101.4	0.0	165.4	456.1	813.2	777.7
OFF.SUPP.PRIV.INVEST.	0.0	0.0	1012.2	779.4	436.1	732.2
INTEREST ON ODA	376.6	448.0	815.5	871.5	927.6	1076.4
INTEREST ON OOF	239.7	245.2	(81.1)	(491.2)	784.2	888.3
ADMINIST.EXPENSES	89.6	119.3	(44.9)	(144.4)	201.7	217.7

Table E.1 STOCK OF EXTERNAL RESOURCES AT END 1977 AND DEBT SERVICE IN 1977

$ million

Country or Territory	Cumulative grants 1960-1977	Overseas Direct Investments (PODI) stock end 1977	Debt (disbursed) end 1977		Debt Service in 1977	
			Total	of which DAC/ODA	Total	of which DAC/ODA
	(1)	(2)	(3)	(4)	(5)	(6)
TOTAL	100,657	84,996	264,422	40,904	41,227	1,965
Afghanistan	605	20	1,059	180	38	10
Algeria	2,903	360	10,065	344	1,409	14
Angola	90	(100)	120	3	28	-
Antilles (Netherlands)	223	2,000	270	150	28	6
Argentina	200	2,850	6,160	120	1,386	8
Bahamas	6	1,470	39	-	50	-
Bahrain	203	(200)	217	-	39	-
Bangladesh	1,849	80	2,305	1,290	83	16
Barbados	22	160	60	13	11	1
Belize	79	70	9	5	2	x
Benin	365	33	137	50	12	3
Bermuda	x	4,065	211	-	60	-
Bhutan	7	-	-	-	-	-
Bolivia	383	130	1,446	276	161	10
Botswana	269	55	294	90	39	x
Brazil	1,175	10,700	32,100	1,474	6,330	73
Brunei	2	270	20	-	3	-
Burma	470	60	515	201	34	8
Burundi	343	25	40	3	3	x
Cameroon	783	355	825	165	79	8
Cape Verde	60	-	-	-	-	-
Central African Empire	404	65	137	42	7	2
Chad	554	25	115	15	12	1
Chile	522	1,215	3,773	888	857	75
Colombia	579	1,410	2,956	889	399	39
Comoro Islands	119	-	39	6	1	x
Congo	401	165	581	71	73	3
Costa Rica	155	270	752	73	106	2
Cuba	112	-	2,906	25	304	x
Cyprus	315	85	222	15	34	1
Djibouti	187	12	27	26	4	1
Dominican Republic	316	370	864	204	99	12
Ecuador	257	580	1,345	145	158	9
Egypt	4,722	217	8,140	1,504	1,058	63
El Salvador	157	140	303	61	71	3
Ethiopia	649	(99)	472	187	32	8
Falkland Islands	15	-	x	x	-	-
Fiji	147	200	88	19	10	2
Gabon	338	740	1,281	55	240	8
Gambia (The)	71	14	28	11	1	x
Ghana	364	275	791	395	38	18
Gibraltar	34	28	8	4	1	x
Gilbert Islands	38	-	-	-	-	-
Greece	225	950	4,267	159	866	23
Guadeloupe	983	50	172	122	21	11
Guatemala	270	270	376	69	47	3
Guinea	137	198	817	113	155	6
Guinea (Equatorial)	5	20	-	-	1	-
Guinea-Bissau	46	-	3	1	x	-
Guiana (French)	388	35	29	26	3	2

Table E.1 (cont'd): STOCK OF EXTERNAL RESOURCES AT END 1977 AND DEBT SERVICE IN 1977

$ million

Country or Territory	Cumulative grants 1960-1977	Overseas Direct Investments (PODI) stock end 1977	Debt (disbursed) end 1977		Debt Service in 1977	
			Total	of which DAC/ODA	Total	of which DAC/ODA
	(1)	(2)	(3)	(4)	(5)	(6)
Guyana	91	210	428	109	46	6
Haiti	200	75	122	24	10	x
Honduras	174	250	475	67	53	2
Hong Kong	45	1,730	776	3	102	x
India	7,365	2,450	14,928	8,105	935	366
Indonesia	1,857	5,160	12,041	4,173	1,371	149
Iran	357	(1,000)	8,311	187	1,987	25
Iraq	144	(130)	1,625	110	668	4
Israel	2,284	920	5,105	1,382	664	68
Ivory Coast	806	500	2,132	194	299	11
Jamaica	129	900	932	83	150	5
Jordan	2,162	(70)	864	262	51	8
Kampuchea	686	-	36	31	x	x
Kenya	872	510	1,142	325	99	20
Korea (Republic of)	2,455	1,280	9,066	2,185	1,254	106
Kuwait	11	(160)	194	-	109	-
Laos	946	-	48	44	3	1
Lebanon	383	(100)	144	16	49	3
Lesotho	238	4	22	1	1	x
Liberia	199	1,035	514	105	86	5
Libyan Arab Republic	265	530	594	-	458	-
Macao	1	-	5	-	3	-
Madagascar	836	180	217	71	23	4
Malawi	324	100	357	178	18	6
Malaysia	398	2,700	2,645	332	500	18
Maldives	11	-	1	1	x	x
Mali	677	10	459	54	12	2
Malta	279	103	51	21	3	2
Martinique	1,164	-	131	92	18	10
Mauritania	543	25	457	26	42	5
Mauritius	125	23	75	21	15	2
Mexico	254	5,070	25,500	108	5,219	13
Morocco	1,283	325	3,608	749	307	32
Mozambique	148	(100)	87	4	17	-
Nepal	435	10	72	14	2	1
New Caledonia	400	140	152	140	18	10
New Hebrides	102	35	7	7	x	x
Nicaragua	135	90	868	134	101	4
Niger	767	80	209	102	17	3
Nigeria	738	1,040	1,764	384	735	22
Oman	303	(50)	578	-	128	-
Pacific Islands	738	-	x	-	x	-
Pakistan	2,959	760	6,850	3,816	391	160
Panama	194	2,750	1,453	108	173	3
Papua New-Guinea	2,190	800	355	26	51	6
Paraguay	146	100	356	88	36	4
Peru	523	1,930	5,148	255	696	16
Philippines	1,206	1,620	4,711	561	533	24
Polynesia (French)	360	40	66	53	6	3
Portugal	49	450	2,549	151	299	13

Table E.1 (cont'd): STOCK OF EXTERNAL RESOURCES AT END 1977 AND DEBT SERVICE IN 1977

$ million

Country or Territory	Cumulative grants 1960-1977	Overseas Direct Investments (PODI) stock end 1977	Debt (disbursed) end 1977		Debt Service in 1977	
			Total	of which DAC/ODA	Total	of which DAC/ODA
	(1)	(2)	(3)	(4)	(5)	(6)
Qatar	7	(100)	371	-	143	-
Reunion	1,716	-	174	130	29	16
Rhodesia	43	(350)	71	11	5	-
Rwanda	475	25	78	14	2	x
Sao Tomé and Principe	3	-	-	-	-	-
Saudi Arabia	56	(215)	1,537	9	1,046	-
Senegal	1,060	350	479	100	66	4
Seychelles Islands	73	11	4	1	x	x
Sierra Leone	136	80	207	49	28	2
Singapore	103	1,500	1,087	92	135	6
Solomon Islands	139	-	14	9	2	x
Somalia	663	98	422	38	12	1
Spain	176	5,114	10,963	132	1,598	24
Sri Lanka	506	65	799	450	137	20
St. Helena & Dependencies	24	-	-	-	-	-
St. Pierre & Miquelon	74	-	13	10	3	x
Sudan	674	55	2,035	161	136	5
Surinam	453	380	117	113	x	-
Swaziland	123	45	55	28	5	3
Syrian Arab Republic	1,812	(70)	1,551	97	137	1
Taiwan	530	1,720	2,955	102	567	23
Tanzania	1,122	160	1,173	412	42	9
Thailand	874	400	1,815	297	401	21
Timor	x	-	-	-	-	-
Togo	328	95	331	73	27	2
Tonga	18	-	2	2	x	x
Trinidad & Tobago	61	1,260	261	17	16	1
Tunisia	1,170	260	2,005	800	190	31
Turkey	1,019	500	5,300	1,758	448	100
Uganda	274	(7)	247	88	28	4
United Arab Emirates	57	(150)	1,188	1	310	-
Upper Volta	617	20	133	52	7	2
Uruguay	103	290	748	72	249	4
Venezuela	174	3,300	5,724	28	1,160	8
Vietnam	6,808	-	535	204	20	x
Wallis & Futuna	13	-	x	-	x	x
West Indies	399	830	52	31	8	1
Western Samoa	35	-	37	1	3	x
Yemen Arab Republic	734	-	315	74	8	1
Yemen (PDR)	441	-	307	10	6	x
Yugoslavia	455	140	8,589	605	1,583	66
Zaire	2,017	(1,110)	2,759	205	160	8
Zambia	490	315	1,481	113	205	6
TOTAL	87,559	84,996	260,648	40,780	41,068	1,956
plus: Unallocated	13,098	-	3,774	124	159	9
GRAND TOTAL	100,657	84,996	264,422	40,904	41,227	1,965

Source: Calculs du CAD de l'OCDE

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Document Date	Document Type	
June 20-21, 1979	Agenda	

Correspondents / Participants

Subject / Title
Development Committee Meeting
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Development Committee - Task Force on Private Foreign Investment - 1979 through 1981 - Volume 02	30021229

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16 February, 1978	Report	

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Subject / Title
Development Committee Report
Specific Economic Inventive Policies of LDCs and their Impact on the Flow and Net Benefits of Private Foreign Investment

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26 December, 1979	Memorandum	

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Development Committee
Secretariat summary of discussion of meeting December 10-11, 1979

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20 November, 1979	Report	

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Development Committee Report prepared by Bernardo Sepulveda
Foreign Investment: Home-Country Policies as Seen by Host Countries

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14 November, 1979	Report	

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Development Committee Report prepared by Bautista and Mueller-Thuns
New Forms of Foreign Investment Host Country Viewpoint

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