ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE MEETING

AGENDA
8:30 a.m.
Roosevelt Room

November 18, 1975

1. Report on the International Economic Summit
2. Report of the Task Force on International Tax Policy — Treasury
3. Poland grain alternatives (tentative)

November 1, 1975

EPB TASK FORCE REVIEW OF TAX POLICY AND INTERNATIONAL INVESTMENT

SUMMARY OF TASK FORCE POSITIONS

This paper is intended to summarize the positions of the Task Force with respect to issues of international tax policy and to identify areas of agreement or dispute.

I. General Observations

The Task Force members indicated general agreement that the policy objectives of the 1974 CIEP statement of "U.S. Policy and Objectives on International Investment" are appropriate as a basis for current policy and as a standard for measuring U.S. rules on international taxation.* The CIEP statement points out that reliance on market forces to determine the flow of trade and investment generally results in optimal economic efficiency and it supports that approach as promoting the international investment objectives of the U.S. In particular, the consensus of Task Force members was that the present regime of flexible exchange rates facilitates the operation of market forces and is consistent with the stated policy of the United States to allow the value of the dollar to be established by international supply and demand.

With respect to U.S. controlled investment abroad, policy recommendations ranged from the approach that we need do nothing under our own tax laws to offset foreign tax advantages to the position that we should act in most instances to neutralize tax advantages that could be obtained by foreigners or foreign investment by U.S. investors. The consensus appears to be that our tax laws should avoid major distortions either in favor of U.S. investment or in favor of foreign investment, so that the over-all rules would reflect the economic objective of permitting market factors to determine investment decisions.

Arguments for using taxes to influence investments across national borders can be political rather than economic in nature and to the extent that political factors determine policy they may divert investment away from that which would be dictated by market incentives, entailing a corresponding reduction in productive use of capital.

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* The general premises and investment objectives of that statement appear as Annex A.

An important over-all observation is that the popular opinion that our present tax laws are a major influence on foreign investment decisions by U.S. investors is out of perspective and greatly exaggerated. This observation is based on empirical data as to the present level of world-wide tax rates on U.S. income from investment abroad, the relatively greater influence of other economic and political factors, and takes into account the advent of more flexible exchange rates and potential greater use of unilateral and multilateral trade rules with respect to subsidies, tariff and non-tariff barriers, as an alternative tool for implementing policy.

II. Tax Policy Issues

A. General

1. What is the relative impact of tax factors on investment decisions?

There was general agreement that tax factors can affect investment decisions and the rate of growth of specific investments. In the absence of empirical data, several agencies did not attempt to suggest the impact of tax factors relative to other factors. The relative influence of tax factors depends upon the nature of the business activity, the contemplated investment, and the alternative choices available.

While taxes are significant they are only a part of the investment decision process. Tax factors are more likely to influence methods of financing and the establishment of intermediary holding companies. They are less likely than other factors to influence investment in manufacturing facilities. A typical manufacturing investment decision is made on the basis of whether a given market can best be served with a favorable return on investment by production in a given location. Costs of capital, labor, transportation, tariffs and non-tariff barriers, access to resources and to customers, and political and economic conditions are generally more important than income taxes. The practical factor that makes this true is that among most countries suitable for manufacturing there are generally comparable corporate income tax rates.* After a basic decision has been made to establish a manufacturing plant in a particular geographic area, tax considerations may influence the exact location. For example, where a decision is made to manufacture and sell in Western Europe on the basis of market factors,

* In 1972, the foreign income tax rate on U.S. controlled foreign subsidiaries (distributed and undistributed earnings) was approximately 46 percent: $6.7 billion in foreign taxes was paid on $14.5 billion in foreign earnings (earnings being determined under U.S. tax accounting rules). Total foreign taxes on distributed and undistributed income include both taxes imposed at the corporate level and withholding taxes imposed on dividend distributions. Oil and gas extraction income, which is heavily taxed abroad, is ordinarily earned through foreign branches of U.S. companies and not through foreign subsidiaries.

the tax element enters into the cost and may influence the choice of a particular site for location of the plant.

Taxes appear to assume a more significant role with respect to manufacturing investment in those tax havens, such as Ireland, Hong Kong, Singapore and various islands in the Caribbean, that combine low wage costs with tax holidays. According to a 1973 Tariff Commission study, these investments are, however, a very small portion of all U.S. overseas investment. Even in these cases, wages are probably more important than taxes.*

Given the present existence among countries of generally comparable corporate tax rates with respect to manufacturing income, and given existing U.S. tax rules on certain forms of tax haven income, the tax element is not a primary motive for most foreign investment by U.S. companies.

2. Tax Neutrality

Should United States tax policy tilt in favor of domestic or foreign investment or should the policy objective be to minimize the influence of tax factors on investment decisions? Do present U.S. tax rules favor foreign investment, U.S. investment, or are they relatively neutral?

Although absolute neutrality is not possible because of differences in tax rates and the application of tax rules throughout the world, the consensus of the Task Force was that the United States should design its tax system to minimize the influence of tax factors on choices between U.S. and foreign investment.

In discussing neutrality it is helpful to distinguish between two types of neutrality, capital export neutrality and capital import neutrality.** Capital export neutrality would exist if U.S. firms were indifferent between domestic and foreign investments with the same before tax return. This would be the case only if the same total tax rate (U.S. and foreign) were applicable to domestic and foreign investments. Capital import neutrality would exist if U.S. firms abroad paid the same taxes as their foreign competitors.

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* U.S. Tariff Commission Report to Senate Committee on Finance on Implications of Multinational Firms for World Trade and Investment and for U.S. Trade and Labor (1973) pp. 114-119.

**A third concept of "neutrality" is national neutrality, where the return on capital which is shared between the national government and the taxpayer remains the same whether the capital is located at home or abroad. Theoretical neutrality concepts based upon private investors' rates of return do not provide assurance that social rates of return will be brought into equilibrium, because such things as externalities do not enter into private investors' calculations.

It is not possible to achieve both capital export neutrality and capital import neutrality without adopting a single world-wide tax system. However, it is possible for the U.S. to move toward either capital export neutrality or capital import neutrality.

Capital export neutrality would require the U.S., for instance, to tax currently the earnings of foreign subsidiaries (ending deferral), to extend the investment credit to foreign investments, and to refund the excess of foreign taxes over U.S. taxes on the same income. However, moves like these in the direction of capital export neutrality may decrease capital import neutrality. It must be borne in mind that a U.S. investment abroad competes with foreign competition taxed at different rates and under different rules from those applicable in the U.S. Therefore, if a U.S. company pays the same taxes on a foreign investment as it would pay on a U.S. investment, the U.S. company will sometimes be disadvantaged by paying more taxes than the competition.

Capital import neutrality would require income from investment abroad by U.S. firms to be exempt from U.S. taxation. Capital import neutrality may be the justification for the deferral of U.S. taxes on unrepatriated income. However, moves in the direction of capital import neutrality tend to decrease capital export neutrality because, if U.S. firms doing business abroad pay the same taxes as the foreign competition, they sometimes pay lower taxes than U.S. firms doing business in the U.S.

U.S. tax rules do not operate in isolation. The question is whether the inter-action of U.S. and foreign rules operate to give an advantage to foreign investment or domestic investment or otherwise has a distorting influence on investment. Theoretically, U.S. investors incorporating a subsidiary abroad that is not taxed by the U.S. have the prospect of obtaining a major tax exemption on current operating profits. The Department of Labor suggests that U.S. tax rules should be characterized as favoring foreign investment because of the ability of U.S. firms to defer U.S. tax on unremitted foreign subsidiary profits, which leads to inefficient allocation of investment to countries with a lower pre-tax return and encourages distortions in transfer pricing. While that is possible in theory, the available empirical data does not confirm it.* U.S. controlled foreign manufacturing subsidiaries generally pay comparable and sometimes higher income taxes abroad.

It is often argued that to the extent tax deferral for U.S. investment abroad permits U.S. capital to move abroad to earn income taxed at a lower rate, the United States loses the investment, the tax revenues on the investment (which may go as a creditable tax to a foreign jurisdiction), and may never receive the deferred income which is reinvested abroad. Thus, foreign investment operates to the detriment of the U.S. This argument seems based upon the questionable assumptions

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*See footnote on page 2.

that there is only a limited amount of capital available at home or abroad and that raising the tax cost abroad means that the potential investor will necessarily invest in productive activity in the United States. It is not clear that financing is not ordinarily available to permit investment both at home and abroad if these investments otherwise appear profitable. There has in fact been a net inflow of income from direct investment over the outflow for the past 20 years. Furthermore, a considerable portion of foreign investment is financed out of retained foreign earnings and foreign borrowings. Most significantly, inhibiting foreign investment abroad by increased taxes does not mean that the potential investor will then invest in the U.S. He may, for example, increase imports or take other action.

The Department of Labor commented on this question as follows:

> "Our international tax rules may discourage domestic capital formation in that the deferral results in more investment abroad than would take place in a no-tax world system. The extent to which domestic investment is diminished depends on the responsiveness of domestic saving to the rates of return. If domestic saving is completely inelastic with respect to rate of return, any increase of investment abroad will come at the expense of domestic investment. In fact, there is very little evidence on the relationship between foreign and domestic investment. It is difficult to detect any diminution in the rate of domestic capital formation associated with the increase in foreign direct investment in recent years. One would ordinarily expect that a real transfer of capital abroad is accomplished by a U.S. export surplus. In fact, the large increase in foreign investment in the late 1960's coincided with declining surpluses. The United States may have in fact acquired part of its foreign capital free because of foreigners' willingness to hold dollars in the period of fixed exchange rates."

While the tax impact is difficult to measure, on the whole, the current tax structure--taxing foreign source income when received by United States taxpayers and granting a foreign tax credit--can be described as relatively neutral in the sense that tax factors are generally not a primary factor in decisions to invest in the U.S. or abroad, particularly with respect to manufacturing investment. While the general goal is neutrality, the U.S. system interacts with other systems and the U.S. need not, and cannot as a practical matter shoulder the full burden of creating neutrality under all circumstances.

The U.S. does tax currently the unremitted income of foreign selling and service subsidiaries and holding companies located in tax havens. This policy was adopted to foster greater equity and to reduce tax avoidance and distortions. The pragmatic decision made to date to tax currently the income from transshipment profits and tax haven service and investment income and not tax haven manufacturing income has been based on the fact that manufacturing income tends to bear a more uniform world-wide tax burden.

Despite frequent claims that current U.S. tax rules favor foreign investment, it is a virtually unrecognized fact that manufacturing investment in the U.S. is often taxed at a lower rate than that imposed by foreign governments on present U.S. investment abroad.* The favorable U.S. tax regime arises from the generous provisions for a domestic investment credit, the DISC export incentive, and more favorable depreciation rules for U.S. investment, all of which are limited to U.S. investment. There is, in fact, a significant bias under U.S. law in terms of revenue dollars foregone for certain types of investment in the United States rather than abroad.**

U.S. rules applicable to foreign source income identified by Task Force members as being "non-neutral" include: DISC, WHTC, deferral, the lack of a refund for excess foreign tax credits, and minor LDC provisions.

The U.S. tax system has historically developed in a manner stressing capital import neutrality, i.e., the competitive position of U.S. industry abroad. Several task force members suggested that it is now appropriate to give greater weight to capital export neutrality; particularly as demands for capital increase. The CEA and OMB suggested that capital export neutrality should be the primary goal, but that the competitive position abroad should not be ignored, particularly with respect to U.S. controlled foreign investment already in place.

With respect to foreign investment in the U.S., our present withholding tax rate on gross payments of dividends and interest tend to discourage securities issues (particularly debt obligations) by United States companies in international markets because of the

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* See footnote on page 2.
In the same year, the U.S. income tax rate on U.S. income of corporations was about 42 percent.

** Present Treasury estimates show revenue losses of $8.7 billion in 1976 for the domestic investment credit for investment in capital equipment used in the U.S. and $1.3 billion for DISC. Revenue gains from taxing the net undistributed profits of all U.S. controlled foreign corporations are estimated at $365 million, i.e., if income is computed by U.S. standards and deemed taxable to the U.S. shareholders with a foreign tax credit.

30 percent tax burden on gross income, the cumbersome nature of varying reductions by tax treaties, and the varying international rules for tax credits in the countries of residence of investors. Elimination of these taxes, with maintenance of a system of tax return information to reduce international tax avoidance, would be a preferable course of action.

3. Should our tax structure be based primarily on tax considerations such as revenue and equity or should tax policy be coordinated with international trade and monetary policy?

Ideally, tax policy toward foreign investment should be based on factors of neutrality, revenue needs and equity, and should also be framed in terms of economic efficiency. Only under exceptional circumstances should the tax rules be written to achieve a special result, such as deterring foreign investment, giving a preference to U.S. exports, or deterring the purchase of foreign securities by U.S. citizens. It should be recognized that the tax structure is hard to change or to have an impact within the time frame required to coordinate it with trade and monetary policy. Once inserted in the tax laws, special provisions become very difficult to change or eliminate, even after the original reason for their enactment has disappeared. Such special provisions should be subject to automatic termination dates or being phased out. Where non-neutral tax devices have been implemented, sudden termination can impose real losses.

In general, the United States should structure its tax laws to maintain the flow of free trade and investment and to limit where possible the complexity of the tax laws. Tax policy, however, should be framed not in isolation, but with awareness of developments in trade and monetary structure, which are basically more important than income taxes. Thus, review of U.S. tax policy today ought to take into account the changed international monetary system. In a world of flexible exchange rates, for example, it is more difficult for any country to obtain trading advantages through export or investment tax incentives, since they will tend to be offset by exchange rate adjustments.

4. Should the tax laws be used as an incentive for economic objectives, e.g., investment in developing countries, promotion of exports?

The laws should strive to minimize the tax factors in investment decisions and hence should not be basically designed to encourage or discourage either foreign or domestic investment. Only with extreme caution should tax laws be used as an incentive for particular types of economic activity and then only for long-term, relatively permanent objectives that could not be achieved as effectively and efficiently through a normal expenditure process.

Most members of the Task Force emphasized that tax laws should be as neutral as possible between exports and domestic sales, even though exports in some cases bear a heavier effective tax rate than goods produced abroad by U.S. controlled foreign subsidiaries; most members suggested that tax incentives for exports are unwarranted in a system of flexible exchange rates. One answer to trade distorting foreign investment and export incentives is to countervail against such incentives under existing law, including the strengthened Trade Act of 1974, when the subsidized products are sold to the United States and to obtain international agreement as to elimination of such incentives in the case of exports to third country markets.

This does not mean that existing programs, such as DISC, should be precipitously eliminated, since this would have a substantial impact upon existing investment and reliance by U.S. industry upon a government sponsored export program. The Department of Commerce emphasized employment opportunities and capital formation which flow from the DISC deferral provision. Any elimination of such programs should either be accompanied by other changes in corporate tax structure or be phased out over a period of time. While the bargaining impact of DISC in international consultations may be limited, it focuses attention on the general question of proper international rules for taxation of exports (including the tax treatment of sales through domestic and foreign selling affiliates) and the application of such rules to countries relying more heavily upon income taxes rather than value-added or other consumption taxes for revenues.

The Commerce Department argues that export incentives are appropriate in the tax structure, particularly to provide parity of treatment with foreign competition.

5. Should the tax laws be used in a punitive manner, e.g., to penalize foreign investment generally or investment in tax havens or "run-away" plants? How should the U.S. deal with tax havens?

(a) To what extent should U.S. laws offset foreign tax benefits?

The tax laws should not be used as a penalty for foreign investment. U.S. tax rules should be examined from time to time to determine whether some United States investors are able to employ tax haven shelters and whether tax factors are distorting investment decisions. This is basically a question of tax equity. There appears to be a consensus that appropriate changes should be made to correct major inequities or distortions. The standard, consistent with the general policy objectives, should generally be that of optimizing the allocation of capital internationally. Measures to attract capital abroad can distort this allocation, so that standards of neutrality in capital taxation must take this into account. A truly neutral tax policy that counters such distortion is not "punitive" in this sense, but merely attempts to counter misallocation of resources.

There was some suggestion that foreign tax investment incentives should be ignored. The concept of "penalizing" or even "neutralizing" tax advantages obtained by "run-away" plants was commented on specifically.

CIEP commented that:

> "From a different perspective, if taxes are viewed simply as a cost of doing business, it does not seem to be a desirable U.S. policy to have its tax policies account for differential overseas costs whether tax induced, labor or transportation related. For example, to the extent that transport costs are more heavily subsidized overseas, should our tax policy attempt to account for this in the name of neutrality? If labor costs are lower due to a more competitive labor market or greater availability of certain types of workers, should this be accounted for in our tax structure?
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> "In general, CIEP simply cannot see the purpose of such alterations in our tax code to compensate for a foreign tax structure that may be more efficient or optimal than our own (e.g., more reliance on consumption taxes and less reliance on taxes that may inhibit capital formation i.e., corporation income tax). From a pragmatic perspective, 'taxing away' the advantages of certain foreign locations may prevent a U.S. company from successfully competing in world markets would appear to be inequitable as well as foolish since no net gain would come to the U.S. at all from this firm's potential overseas activities.
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> "If there is a further domestic policy concern regarding the potential distortive labor effects of such runaway plants, the standard welfare economic solution of a 'side payment' or compensation is the appropriate solution. This is now statutorily provided for in the form of retraining grants, relocation subsidies and special unemployment compensation although these could be reviewed for improvements."

Others would argue that if before tax foreign rates of return are lower in foreign countries and foreign tax inducements cause investment abroad rather than in the U.S., there is a loss to the U.S. Similarly, the use of side payments is said to be acceptable where efficiency is gained, but in this case efficiency is lost.

(b) Prior tax haven approaches.

Tax havens include those countries that by tradition or design impose no taxes or minimal taxes on income received by or on behalf of foreign investors operating through such countries. Certain havens are identified as being entrepots for passive investment income, permitting concealment of such income. Others have designed their tax laws to attract manufacturing through tax holidays and are not engaged in aiding concealment of income.

In 1962, legislation was enacted providing for the current taxation to U.S. shareholders of the undistributed income of U.S. controlled foreign corporations earning tax haven income in the form of transshipment sales and service income and passive investment income (dividends, interest, royalties, capital gains). These provisions were significantly tightened in the Tax Reduction Act of 1975 by the elimination of several major exceptions to these rules. In 1973, the Administration proposed that the income of U.S. controlled foreign corporations taking advantage of foreign tax holidays or acting as "run-away" plants, should be taxed to the U.S. shareholders whether or not distributed.

(c) <u>How should the United States deal with tax haven countries?</u>

(i) <u>With countries acting as tax haven conduits or holding companies for investors?</u>

The United States should maintain a policy of encouraging other countries to cooperate in eliminating tax haven practices that distort investment and permit concealment of income. Financial tax havens are relatively few in number and can be easily identified by name. Many are mere island outposts with communications facilities. A few, such as Switzerland and Hong Kong, maintain substantial financial centers. Financial tax haven countries that do not cooperate in anti-tax evasion efforts should not be entitled to special benefits, such as reduced withholding taxes under tax treaties accorded other countries.

Where countries act as tax haven conduits for investment income we should (i) impose U.S. taxes on U.S. investors using such conduits (even where the income is not distributed) in order to maintain equity among U.S. taxpayers and (ii) impose higher U.S. taxes on payments to tax haven conduits that refuse to cooperate in revealing the identity of third country investors, in order to discourage international tax evasion.

Our present rules under Subpart F of the Internal Revenue Code tax the undistributed earnings of foreign holding companies as well as those of tax haven sales and service companies, to the controlling U.S. shareholders. Although this practice involves some considerable degree of complexity, it substantially limits the organization of companies for such tax haven purposes. As long as such operations are deterred, the actual practical complexity of administering these rules is reduced.

(ii) With countries providing tax holidays and tax incentives for local manufacturing and/or exports?

Developing countries and depressed regions within developed countries may claim the necessity for tax holidays and other non-tax incentives for local manufacturing. Our approach to such countries should be to encourage the adoption, in the MTN negotiations or elsewhere, of international rules for granting such incentives, to require consultation among interested countries, and to allow action by other countries through their import tariffs to offset trade distorting effects.

Unilateral efforts to prevent the use of manufacturing tax havens by U.S. investors through our tax laws leaves their exploitation to foreign competition. If such incentives have a significant distorting impact on products exported to the United States, we should be prepared to countervail as provided by existing U.S. legislation. Such an even-handed approach would affect the production of both U.S.-controlled and foreign-controlled companies manufacturing in tax havens. The rules should affect not only tax incentives but also the other forms of aid, some of which, like grants, may be interchangeable with tax concessions. Countervailing or other trade action would not be taken as an end in itself but as a correction for an artificial distortion elsewhere and as pressure to obtain more uniform international rules and conduct.

6. Should the application of our tax laws to foreign countries be on a general basis or a case-by-case basis through negotiated tax treaties?

Most members of the Task Force replied that the tax laws should be as general as possible and that treaties should be used to resolve particular bilateral problems, such as elimination of double taxation of particular types of income.

7. Should our tax code or treaty policy distinguish between developed and developing countries, e.g., to favor investments in developing countries?

With the exception of one member, the Task Force members advised against such distinctions in the tax laws.

The utilization of tax policy generally for balance of payments or other specific objectives may discourage the flow of resources into most productive uses. Although arguments may be advanced in favor of such policies, there should be an awareness of possible political or institutional, as opposed to purely economic, goals. If the goal is to stimulate investment in developing countries at the expense of more productive investment elsewhere, then goals of economic efficiency suffer and total world welfare is diminished. As is usually the case in economic analysis, considerations of redistribution of income should be separated from those of efficiency; if the most productive alternative for investment lies in developing countries, then investment will be attracted there without special incentives. Direct grants are recommended as opposed to indirect aid through the tax system.

There are a number of practical difficulties in writing statutory rules to identify "developing countries" to favor over "developed countries." The question of what countries qualify becomes politically difficult and once designations are made it is extremely difficult to change them. In 1962, a statutory list of developed countries was set forth by Congress in the Internal Revenue Code with the right of the President to designate other countries as developed by Executive Order. Relatively modest tax benefits turned on these distinctions. There have been no developed countries added to the statutory list. Thus, Israel, Saudi Arabia, Kuwait and the various oil emirates are all "less developed" as are Bermuda and the Bahamas, while "developed" countries include Spain. Furthermore, it is technically difficult to draft both workable incentives and rules to eliminate the use of investment in developing countries as a conduit for investment or business activities actually carried on elsewhere.

Finally, there is no fundamental reason to use the tax system for the purpose of granting special preferences to investments in developing countries even where those countries make tax concessions which they fear will be frustrated by U.S. rules. The present system of tax deferral permits U.S. companies to establish a foreign subsidiary which may take advantage of limited local incentives. When profits are repatriated they are fully taxed by the United States, subject to claiming tax credits from foreign income taxes imposed on that income. Thus, to realize the benefit of lower foreign tax rates or exemption, the profits must be reinvested in the foreign country, which works to its advantage. This is a reasonable approach and helps offset provisions in the Code, such as the investment credit, which are benefits solely for domestic investment and which would be complex and unsuitable to extend to foreign investment. Treaty grants of deferral might, therefore, be sought if legislative action otherwise eliminates deferral. The Senate in the 1960's rejected specific efforts to give tax sparing or extend the domestic investment credit to developing countries.

The Department of Commerce recommended incentives for investment in developing countries, pointing out that these are the markets of the future and U.S. participation in the development stages will pay dividends later. European countries recognize this and therefore provide for tax sparing in order to facilitate investment in these markets by their nationals. The Department of Commerce believes that the possibility should be restudied of employing bilateral agreements with selected countries.

8. <u>Should domestic entities owned by foreign investors always receive national (non-discriminatory) treatment under our tax laws and those of foreign countries?</u>

U.S. policy has been to eliminate all discrimination in our tax laws against foreign investment in the United States, whether in the form of U.S. branches of foreign corporations or U.S. subsidiaries organized by foreign owners. Our recent income tax treaties provide for reciprocal non-discrimination treatment. We have not entered into new or revised treaties with countries (such as Australia), which refuse to accept such non-discrimination provisions in a treaty.

In support of the United States policy of freedom of capital movements and trade, we should continue to extend non-discriminatory treatment under U.S. income tax laws and seek to obtain such treatment from others. This is as relevant to the tax area as efforts to liberalize world trade and implement flexible exchange rates for international monetary adjustment. It was generally suggested that the U.S. should influence others by its own example of non-discriminatory tax treatment. There is great potential for tax rules to be adjusted to discriminate against foreigners and application of national treatment is a powerful check on local policies.

However, our firm position on non-discrimination in the tax area should be examined in the light of the practical effect of over-all U.S. policy toward discrimination by other countries against U.S. investment in other areas. If we believe that non-discrimination by others in taxation and in other areas under treaties of friendship and commerce is a major policy goal, one option would be to take stronger action to coordinate tax treaty negotiations with the withholding of benefits in other areas in order to strengthen our negotiating position. If obtaining such non-discrimination is not a major policy goal, we should reconsider whether we should refuse to sign otherwise satisfactory treaties with countries such as Australia and Canada because they do not agree to non-discrimination in their tax laws. We should also reconsider whether we should object when countries that have integrated corporate and shareholder tax systems grant refunds of corporate tax only to shareholders who are citizens or residents.

With respect to dealing with discrimination against U.S. investment abroad, CIEP suggested a strong multilateral international code on national treatment. Others stressed that U.S. retaliatory discrimination against foreign investment in the U.S. may be either ineffective where there is little U.S. investment by the offending country or self-defeating to the extent that it would deter foreign investment in the U.S. that we would otherwise desire.

In appropriate cases, there could be greater coordination of tax treaty negotiations with other bilateral negotiations in order to strengthen the tax treaty negotiation position.

9. Should we give tax preferences as to the particular types of investment abroad, e.g., resource development vs. manufacturing?

In general, we should not give preference as to particular types of investment abroad over such investment in the U.S. or as between one form of foreign investment and another. Discrimination among particular types of investment abroad similarly runs counter to arguments which emphasize the optimal allocation of resources. Allowing investment to flow into the most productive sectors--be they primary resources, manufacturing, or whatever--results in the optimal use of capital. Basically, if there is a demand for a product or commodity, the investment will occur without the tax stimulus.

The Department of Labor commented:

> "An argument sometimes presented in favor of such a policy is that it would allow discrimination against some types of foreign investment believed to be harmful to U.S. national welfare without harming those types of foreign investment that are beneficial to this welfare. For example, such a policy could be used to reduce U.S. foreign investment in manufacturing, which is often believed to displace U.S. exports and hence, reduce U.S. employment, without discouraging foreign investment in such areas as natural resource development, which are generally believed beneficial to U.S. welfare. But measuring the effects of U.S. foreign investment on trade is very difficult, and recent research indicates that foreign investment in manufacturing may actually encourage U.S. exports. The best policy would, therefore, seem to be to avoid distorting capital flows from their most productive alternatives as determined by market forces."

The Commerce Department suggested that discriminatory taxation might be justified. For example, foreign investment in raw material production which reduces import costs might merit more favorable tax treatment than investment for the production of goods.

10. Should foreign income be a source of U.S. revenue, i.e., should United States multinational corporations make some minimum tax payment to the United States that cannot be offset by credits for income taxes paid to foreign governments?

If U.S. enterprises are earning income from abroad, the foreign jurisdiction has the right to impose a basic business income tax equal to our tax. To date we have accepted and should continue to accept the principle that the United States gives relief at the Federal level for foreign income taxes up to the full United States corporate income tax. Departure from this principle introduces an element of double taxation. To the extent that "tax avoidance" problems arise there should be a direct response through change in the relevant Code sections.

The arguments in favor of imposing some minimum U.S. tax (e.g., by allowing a credit for only 90 percent of the U.S. tax) are generally (a) the fact that state income taxes are not creditable against Federal tax; (b) that this limitation would encourage U.S. companies to resist paying foreign taxes rather than being indifferent to them (particularly in light of the over-all tax credit computation) and (c) as United States enterprises they are entitled to benefits conferred by the United States and should make some payment to the common support of the government. These arguments are insufficient to override the double tax problem which a minimum U.S. tax would create.

B Specific Application of Policy

1. Should there continue to be tax free transfers of technology to foreign operating subsidiaries?

There was a considerable variation in views among Task Force members as to the impact of present tax rules and company practices.*

There was a consensus that we should undertake a review of the tax aspects (as well as other aspects) of technology transfers to determine the effect upon the United States of our practices on technology transfers and appropriate tax policy.

2. Should royalty licenses and other transfers of technology to foreign companies by U.S. multinationals with U.S. based research be considered marginal so that little, if any, expense for research and development is allocated to their foreign source royalty and dividend income?

In April 1973, the Treasury Department issued what have become very controversial proposed regulations dealing with the statutory requirement that expenses be allocated by U.S. companies between U.S. and foreign source income. Public hearings have been held and review of the proposed regulations by Treasury and Internal Revenue Service Staffs is continuing.

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*Under present law, U.S. companies may transfer tax free, as a contribution to capital, any know-how or patents developed or obtained by the U.S. parent to a foreign affiliate for use in manufacturing abroad. No royalties or fees need be charged if the transaction represents a transfer of "property", i.e., a protected property right.

Failure to allocate deductions permitted under U.S. tax law to foreign source income in appropriate circumstances results in the deductions reducing only United States source income and consequently U.S. tax on such income. The extent to which deductions are allocated to foreign source income affects the computation of the foreign tax credit, since the credit for foreign taxes imposed on foreign source income is limited to the amount of United States tax imposed on foreign source income. Thus,. if deductions are allocated to foreign source income by the United States, but not permitted by the foreign country imposing its tax, the result is a higher effective foreign tax rate and the possible creation of excess foreign tax credits. The question of allocation of deductions is currently the subject of major dispute, particularly with respect to allocation of research and development expenditures, which are a current deduction under U.S. tax law.

There are two aspects of the issue. One is the application of current United States law which provides that all deductions or expenses must be allocated between U.S. and foreign source income of U.S. taxpayers. Where a deduction is not clearly allocable to one source or the other, it must be apportioned on some basis; at a minimum the allocation must be in proportion to gross income from each source.

The second question is, regardless of how the present law is to be applied, what should be the U.S. policy with respect to research and development allocations?

A few companies, e.g., the automobile industry, have instituted cost sharing agreements with their foreign affiliates and are reimbursed for portions of domestic research and development expense. These industries have little problem with proposed regulations to allocate research expenses to foreign source income. Inconsistent with the present statutory requirement, a number of other companies have failed to allocate any research and development expense to foreign source income. Others have allocated varying amounts without uniform guidance.

The problem can be described in a typical case. A pharmaceutical company has 55 percent of the consolidated earnings of the parent and its foreign affiliates from foreign sources. More than 90 percent of the research and development of the consolidated group is carried out in the United States. While research is devoted in some cases to drug products suitable solely for domestic or foreign sales, most of the research is in an area that would produce results commercially applicable throughout the world. Some know-how and patents are transferred as tax free contributions of capital to foreign affiliates. In other instances, royalties are charged to the related companies and to some unrelated affiliates for specific patents or know-how on successful research. Annual royalties are only a fraction of the large annual research expenditures. Except for the royalty charges, there is no reimbursement from any of the affiliates for the research undertaken in the United States. Virtually all of the research and development expense is, therefore, deducted against United States source income received on the parent's sale of pharmaceutical products in the United States, and U.S. taxes on that income are correspondingly reduced. To what extent should any of this expense be allocated to foreign source income of the consolidated group? Why, for example, should the cost of unsuccessful research be more clearly applicable to domestic income than foreign income on these facts? If allocations are made how can complexity be avoided in allocating to undistributed income? The mechanics become very complex.

The foreign affiliates of the drug company have substantial profits in foreign countries on which they pay foreign taxes comparable to the U.S. tax rate. Dividends paid to the parent company incur no additional U.S. tax because of the foreign tax credit. If significant allocations of research expense are made, the dividend income from the foreign subsidiaries would be substantially reduced and excess foreign tax credits would be generated. The same would be true on allocations of this expense to royalties (basing the allocation on the total sales of the U.S. company and those of the licensees). Indeed, a full allocation of research costs on the basis of world-wide sales would mean that the subsidiaries are not earning the profits claimed by them and foreign taxes would be reduced or even eliminated. Foreign governments would thus resist claims to reimburse the parent. High taxes are paid on apparent profits abroad and foreign tax credits are disallowed in the U.S.

The fact that this is not an isolated case and illustrates a general tendency indicates that we are subsidizing the profitability of a substantial number of foreign affiliates of U.S. companies. The apparent profits of these subsidiaries are taxed abroad by foreign governments and tax credits are claimed against U.S. income tax on the distributions. Ideally, the affiliates should be reimbursing the parent companies on a cost sharing basis. There was a diversity of opinions expressed by task force members as to the allocation, if any, that should be required, and no consensus was apparent.

The Commerce Department stated that corporate patent and know-how licensing abroad is always a marginal activity. At the time research is undertaken, the extent of any foreign licensing is unknown and irrelevant. Others warned that the proposed rules might discriminate in favor of foreign based multinationals and lead to a transfer of research to overseas facilities.

The Labor Department and OMB suggested that the view that technology transfers are marginal is inconsistent with assertions that if the ability of U.S. multinationals were restricted (presumably including reduced foreign tax credits) they would either reduce their R & D efforts or move their R & D overseas. Similarly, if the activity is marginal, over-all taxes could be imposed at higher rates without affecting transfers that would take place anyway and the level of domestic R & D would not be affected.

3. <u>What should be the United States policy toward international coordination of tax policies for combating tax avoidance; the formulation of rules on export and investment incentives; codes of conduct for multinational corporations; allocation of income and expenses among affiliated enterprises</u>?

We should work through the present MTN negotiations and the OECD on developing rules on tax incentives and for combating tax avoidance, as well as on allocation of income and expenses and greater uniformity in tax accounting concepts. Codes of conduct may be of use, but should be approached cautiously and apply not only to multinational corporations but also to host country behavior.

4. <u>What should be U.S. policy with respect to "tax deferral" whereby neither income nor losses of foreign subsidiaries are recognized by controlling United States shareholders while income and losses of foreign branches are taken into account currently</u>?

Tax deferral, accompanied by specific provisions to prevent accumulations of tax haven income abroad, works reasonably well. We should retain our present basic tax deferral system. The problem of tax equity among U.S. taxpayers is addressed by the tax haven rules discussed above. The case that our tax rules create a serious distortion in investment decisions and "export jobs" has not been made even though deferral is said to be at odds with the normative concept of capital export neutrality.

The revenue from an attempt to tax all net undistributed earnings of U.S. controlled foreign corporations would be approximately $365 million for 1976. This is less than 8/10ths of one percent of estimated total corporate tax revenues for the 1976 budget. On the other hand, such a substantial change in our tax laws as the elimination of deferral would (a) have a disruptive effect upon specific investments in foreign countries, since a U.S. owned enterprise would be taxed on a different basis than its competitors, (b) represent a major administrative and audit problem for taxpayers and the Internal Revenue Service, (c) create problems for shareholders in joint ventures and other arrangements where minority foreign shareholders would object to dividend payment policies required by the U.S. shareholders to make U.S. tax payments, (d) have in many instances an adverse impact on investments in developing countries, such as Israel, Egypt, Ireland, Brazil, Indonesia, (e) result in increased distributions by U.S. companies to receive the income on which they are being taxed and claim full foreign tax credits, which would mean more withholding taxes being paid currently to foreign countries,* (f) create political problems with respect to foreign countries resenting U.S. taxation of the domestic income of subsidiaries incorporated in those countries, and (g) to the extent anyone is motivated by lower foreign taxes, lead over time to increased joint venture operations by U.S. companies abroad to avoid current attribution of income and take advantage of those cases where there are more favorable tax rates.

5. <u>What should be U.S. policy with respect to the foreign tax credit?</u>

The U.S. should continue to maintain a foreign tax credit to prevent double taxation. The use, however, of an over-all method of computing the credit permits averaging of high and low taxes and to some extent encourages foreign activities to produce low tax income to absorb high foreign taxes from other jurisdictions. Although it would be desirable to eliminate such a tax-induced distortion of business activities, alternatives to restrict the foreign tax credit would require considerably more complicated allocations of income and deductions in order to trace taxable income either to individual countries or items of income.

The concept of the per country limitation is sound in that it relates foreign taxes to the same foreign income on which it is imposed. It does, however, involve difficult computation problems in allocating among countries and particularly in tracing dividends (and accompanying tax credits) from foreign subsidiaries to their ultimate origin. Under present law, we do not have a true per country limitation, since dividends are treated as having their source in the country of

---

*For example, where the foreign corporate tax rate is lower than the U.S. rate, the U.S. shareholders who must pay tax to the U.S. on the foreign income would cause a distribution of the income to be sure that they will receive a current full foreign tax credit (including foreign withholding taxes on the dividend) against the U.S. tax on the income deemed to have been received under U.S. law. Unless they distribute actual dividends currently, tax rates and income and deductions in later years may vary so that they would not be certain of full credits on distributions in later years. Withholding taxes would be paid to the foreign government on the dividend, which would be received in the U.S. with an accompanying foreign tax credit and the remainder of the dividend then being returned to the foreign subsidiary as a contribution to capital. The effective tax rate would be raised, but the revenue would tend to go to a foreign government.

incorporation of the subsidiary paying the dividend, regardless of the source of the income out of which the dividend was paid and all income taxes paid to any country on that income are considered to have been paid to the country of incorporation of the subsidiary. The 1975 Tax Reduction Act restricted the total foreign tax credits that could be claimed by one country on oil production income but permitted the averaging of some excess credits with low taxed income in other countries. The basic effort was to deal with excessive "taxes" that could have been imposed as non-creditable royalties.

We should pursue proposed Treasury legislation that would prevent the use of foreign losses to reduce U.S. source income and U.S. tax on that income, while subsequent profits remain untaxed by the U.S. because of credits for foreign taxes imposed when the foreign investment becomes profitable.

The Department of Labor suggested that the U.S. should seek to obtain a fairer share of the benefits of world-wide efficiency now lost through the granting of foreign tax credits on foreign source income.

6. <u>What should be U.S. policy with respect to the possible exemption of foreign source income from U.S. tax combined with the disallowance of foreign source losses?</u>

It is possible that exempting foreign source branch and dividend income from U.S. corporate tax and excluding all foreign losses would not result in a substantial revenue loss. However, preliminary estimates suggest that the loss from exempting all foreign source income, including dividends, interest, etc., would be above $1 billion.

The principal argument against such a rule is that it would permit substantial amounts of income to be earned by some taxpayers through tax havens, which many consider inequitable, and would place a substantial burden on inter-company pricing and income source rules.

7. <u>What should be U.S. policy toward the taxation of international shipping?</u>

A number of Task Force members reserved comment on this issue and suggested that specific proposals not be adopted until there was an interagency review of U.S. policy toward the taxation of international shipping. Others suggested that the United States should consider using only reciprocal treaties as a basis for exempting income of foreign flag vessels calling at United States ports, rather than employing present statutory reciprocal exemption, and should tax on a more reasonable basis of allocation the income of foreign flag tax haven ships calling at U.S. ports.

With respect to taxation of tax haven shipping controlled by U.S. owners, it was the consensus that tax rules should not encourage the allocation of capital to foreign investment.

The most specific declaration of U.S. policy on shipping is contained in section 101 of the Merchant Marine Act of 1936:

> "It is necessary for the national defense and development of its foreign and domestic commerce that the United States shall have a merchant marine (a) sufficient to carry its domestic water-borne commerce and a substantial portion of the water-borne export and import foreign commerce of the United States and to provide shipping service essential for maintaining the flow of such domestic and foreign water-borne commerce at all times, (b) capable of serving as a naval and military auxiliary in times of war or national emergency, (c) owned and operated under the United States flag by citizens of the United States insofar as may be practicable, (d) composed of the best-equipped, safest, and most suitable types of vessels, constructed in the United States and manned with a trained and efficient citizen personnel, and (e) supplemented by efficient facilities for shipbuilding and ship repair. It is hereby declared to be the policy of the United States to foster the development and encourage the maintenance of such a merchant marine."

This policy was reviewed by the Administration and Congress and reiterated by the Merchant Marine Act of 1970. The Commerce Department submitted the following statement on behalf of the Maritime Administration:

> "The Maritime Administration believes that U.S. tax policy toward international shipping should be designed to accomplish the goals set forth in Section 101 of the Merchant Marine Act of 1936. One provision of U.S. tax policy resulting from the Merchant Marine Act which does work in this direction enables qualified U.S. flag citizens to establish capital construction funds into which certain federal tax deferred deposits can be made. Federal income taxes are deferred on these funds as long as they are used for qualified purposes such as construction of new or replacement vessels or reconstruction of existing vessels.
>
> "However, not all U.S. tax policy is consistent with the goals outlined in the basic policy statement. An example of this U.S. tax policy is the exclusion of certain foreign-flag shipping income from the operation of Subpart F of the Internal Revenue Code. This exclusion permits deferral of income taxes on earnings from foreign shipping operations owned-by U.S. citizens until such earnings are actually repatriated to the U.S. shareholder as dividends, to the extent such earnings are invested in shipping assets.
>
> "This exclusion is particularly important for it provides significant financial advantages for U.S. owners of foreign

registered ships. It has been estimated that this exclusion constitutes a subsidy of $125 to $175 million per year for U.S. owners of foreign flag shipping. This tax subsidy encourages U.S. citizens to own and operate foreign fleets instead of U.S. built, registered, and manned ships. This subsidy in effect creates U.S. supported foreign competition for the programs intended to support U.S.-flag shipping which have been developed as a result of the provisions of the Merchant Marine Act of 1936."

8. Should we alter the tax treatment of expropriation losses?

Present rules generally permit taxpayers to arrange their foreign investments or the terms of an expropriation so as to obtain favorable tax treatment, i.e., ordinary losses rather than capital losses on expropriation. The over-all United States policy toward expropriation and the degree of pressure to be placed on U.S. investors during negotiations should determine whether we wish to maintain the present ease of obtaining such tax treatment. It was suggested that tax treatment of expropriation losses should encourage firms to resist under-compensation for expropriation property.

9. What should be United States policy with respect to the taxation of foreign investors (including governments) in U.S. securities, real estate, and branch operations?

The United States should tax at full U.S. rates the operating income of foreign investors (including governments) competing with U.S. business in the United States. We should not, however, impose withholding taxes on dividends and interest emanating from investments in the United States which have borne tax at the operating level and which are not connected with the active conduct of a business in the United States. In dealing with tax evasion problems, we should rely upon use of information returns rather than adopting burdensome and unworkable withholding taxes and refund systems.

If an integrated system for corporate and shareholder taxes were adopted in the United States, we should extract a reasonable over-all tax from the foreign investor.

If we retain our present corporate tax (48%) plus a withholding tax for dividends paid to foreign investors (30%), it would be appropriate to have a tax on deemed remittances of branch profits to have comparable over-all tax rates (corporate tax plus withholding) applicable to both branch and subsidiary operations.

ANNEX A

1974 CIEP STATEMENT

U.S. POLICY AND OBJECTIVES ON INTERNATIONAL INVESTMENT

General Premises

U.S. policy with respect to international investment should aim at the following objectives:

A. Promotion of economic growth and development in the United States,

B. Promotion of political-economic relations with other nations.

We believe these objectives can best be accomplished within an international economic system providing an environment which:

i. facilitates international trade and capital flows among nations:

ii. involves a minimum of governmental interference with international economic transactions while placing maximum reliance on market forces to direct world trade and investment;

iii. evolves within a framework of international cooperation.

General Investment Objectives

In this framework, the basic U.S. policy objectives concerning investment are to achieve--to the extent possible and consistent with the nature of progress in other areas of international economic cooperation--an international investment environment in which government policies would play a neutral role, neither encouraging nor discouraging investment flows. It is recognized that the ideal of neutrality cannot be achieved short of a complete international harmonization of policies, which for the time being is an unrealistic goal. Furthermore, every nation, including the U.S. needs to preserve flexibility to act to protect its security and other vital national interests. Nevertheless, it is desirable to work toward an international system of investment behavior which will maximize the achievement of the following:

I. Investment capital should be free to move to its most productive use in response to market forces and motivations, with the minimum possible distortion resulting from national policies or practices governing or affecting investment. There should be a presumption against the use of controls on capital flows. In cases where controls are resorted to they should be subject to international consultation and surveillance. This includes controls for balance of payments or cyclical policy reasons as well as controls on entry and establishment of foreign investors for structural or for non-economic reasons. Moreover, national incentives and disincentives affecting investment of a kind which can be expected to have substantial international effects should be avoided. When considered necessary for the achievement of legitimate national objectives such policies should be amenable to international examination and discussion.

II. Foreign investors should be given national treatment, which means they should be treated no less favorably than other host-country nationals, subject to the same rights and obligations conferred or imposed by that country's laws and guaranteed full legal protection under them.

III. Foreign investors are not subjected to special, politically-motivated inducements, constraints or arbitrary treatment, and actions by governments regarding particular foreign investments are taken subject to defined rules and procedures.

IV. Adequate mechanisms are developed to facilitate international consultations on investment issues, and disputes which arise among governments are settled in accordance with international law pursuant to agreed and fair procedures.

Exceptions to these principles (including the neutrality of government policies, national security limitations, etc.), should be specifically defined, applied on an MFN basis, and recognized as subjects for intergovernmental consultation (as outlined in the following sections).

FOR OFFICIAL USE ONLY

Business Conditions Report

November 14, 1975

U.S. Department of Commerce
DOMESTIC AND INTERNATIONAL BUSINESS ADMINISTRATION
Bureau of Domestic Commerce

FOR OFFICIAL USE ONLY

FOREGOING RESTRICTIONS MAY BE REMOVED
90 DAYS AFTER PUBLICATION

CONTENTS

INDUSTRY HIGHLIGHTS

BUSINESS INDICATORS

DEVELOPING ISSUES

For further information contact:

Mr. Samuel B. Sherwin 967-5491
Mr. Charley M. Denton 967-5223

Enquiries and Suggestions Welcomed.

Industry Highlights

INDUSTRY HIGHLIGHTS

AUTOMOBILES: OCTOBER SALES INCREASE

CURRENT

° October sales of domestic built cars totaled 773,623, an increase of 23 percent over 627,521 sold in October 1974. However, October 1974 was initial month of deepest slide in domestic auto sales in decades.

° October sales volume is 9 percent below October 1973, and 20 percent below October 1972.

° Due to depletion of 1974 and 1975 foreign model inventories, plus interest in 1976 domestic models, October foreign car sales dropped 11 percent to an estimated 114,500 compared to sales a year earlier. Foreign share of domestic market was approximately 14.8 percent, about normal. Earlier in the year the import share had risen to 22 percent.

° Guarding against inventory build-up, manufacturers plan November production of 596,000 cars even though estimates of November sales range from 625,000 to 665,000. November inventories should be near 1.5 million units, an industry average of 53 days' supply.

MORTGAGE ACTIVITY AT HIGH LEVEL

CURRENT

° Home lending activities of mortgage companies continued at high level in August, according to survey of Mortgage Bankers Association of America.

° Closings of single-family loans were $1.23 billion in August, up from $1.21 billion in July, on seasonally adjusted basis. This was fifth time in eight months that industry closings were above $1.2 billion. Never before in the ten years of this survey has the industry exceeded that total more than twice in a year.

° Equally important, mortgage companies continued to issue a large volume of commitments to builders and borrowers to fund future single-family loans. This is despite a sharp increase in mortgage rates during August.

° These commitments totaled $13.6 billion during first eight months 1975, nearly 25 percent more than was issued in same 1974 months. This increase means mortgage companies will continue closing a large volume of home mortgages into first quarter 1976.

SOFTWOOD LOGS AND LUMBER: EXPORTS INCREASE IN THIRD QUARTER

CURRENT ° During first three quarters 1975, softwood log exports of 2,133 million board feet (valued at $557 million) represented a quantity increase of 17 percent over same period 1974.

° Japan, which has accounted for 87 percent of U.S. softwood log exports this year to date, increased its third quarter purchases by 21 percent over same period last year. Anticipated growth in Japan's housing market for second half 1975 primarily is principal factor in this increase.

° Softwood lumber exports for first three quarters 1975 of 1,026 million board feet (valued at $251 million) were down 17 percent from same 1974 period. This is an improvement over 34 percent decline of first half 1975, compared to same 1974 period.

° Third quarter statistics show a 41 percent increase in softwood lumber exports over that period 1974 due to marked improvement in sales to European countries.

MICROFILM EQUIPMENT SALES UP

CURRENT ° During 1974-75 recessionary period, unit shipments of photographic equipment declined, except for microfilm equipment. Reduced processing costs and efficiencies associated with microfilming paper records made this technique a necessity for effective maintenance and retrieval of information.

° Unit shipments of conventional microfilming equipment are expected to increase 10 percent, with prices rising 8 percent to a total of $235 million in 1975. Equipment will account for 30 percent of estimated $775 million total microfilm industry in 1975. Supplies and services account for bulk of industry total.

° Strongest gain will be made in computer-output-microfilm equipment (COM). COM eliminates the bulk of paper generated by computers, and operates at speeds twenty times faster than computer impact printers. An estimated 600 COM units, valued at $64 million will be installed in 1975 -- a gain of 30 percent over 1974.

° A similar surge in microfilming has occurred in Europe with 1975 sales exceeding the previous year by 25 percent, while other photo equipment unit sales are declining. (COM units installed in Europe are of American make.)

COMPUTERS: HONEYWELL TO ACQUIRE XEROX COMPUTER BASE

° In 1970, Honeywell, Inc. acquired General Electric's computer business as latter firm left market, and was able to convert many of G.E.'s former customers to its own equipment. Honeywell announced in April, 1974, a complete line of computers which molds its products and those of General Electric into one compatible family.

° Since July 1975, when Xerox announced its withdrawal from computer mainframe business, (August 8 Business Conditions Report) it has sought a company which would agree to take over its customer base.

CURRENT ° In mid-October, Honeywell signed a letter of intent with Xerox that set forth preliminary terms under which Honeywell would acquire Xerox's computer activities. If this agreement is completed, Honeywell could reap an additional income of $30 million annually from rentals and maintenance revenues.

° If firm can convert a high percentage of Xerox's estimated 900 customers to its equipment, Honeywell will raise its share of the world's computer base, presently estimated near 13 percent. Honeywell will also reach higher economies of scale in production and marketing.

METRIC FASTENERS: AUTOMOTIVE INDUSTRY PLANS USED

° Early this year an international system of screw thread standards was agreed to by the International Standards Organization (ISO). American National Standards Institute (ANSI) is developing U.S. standards compatible with ISO metric standards.

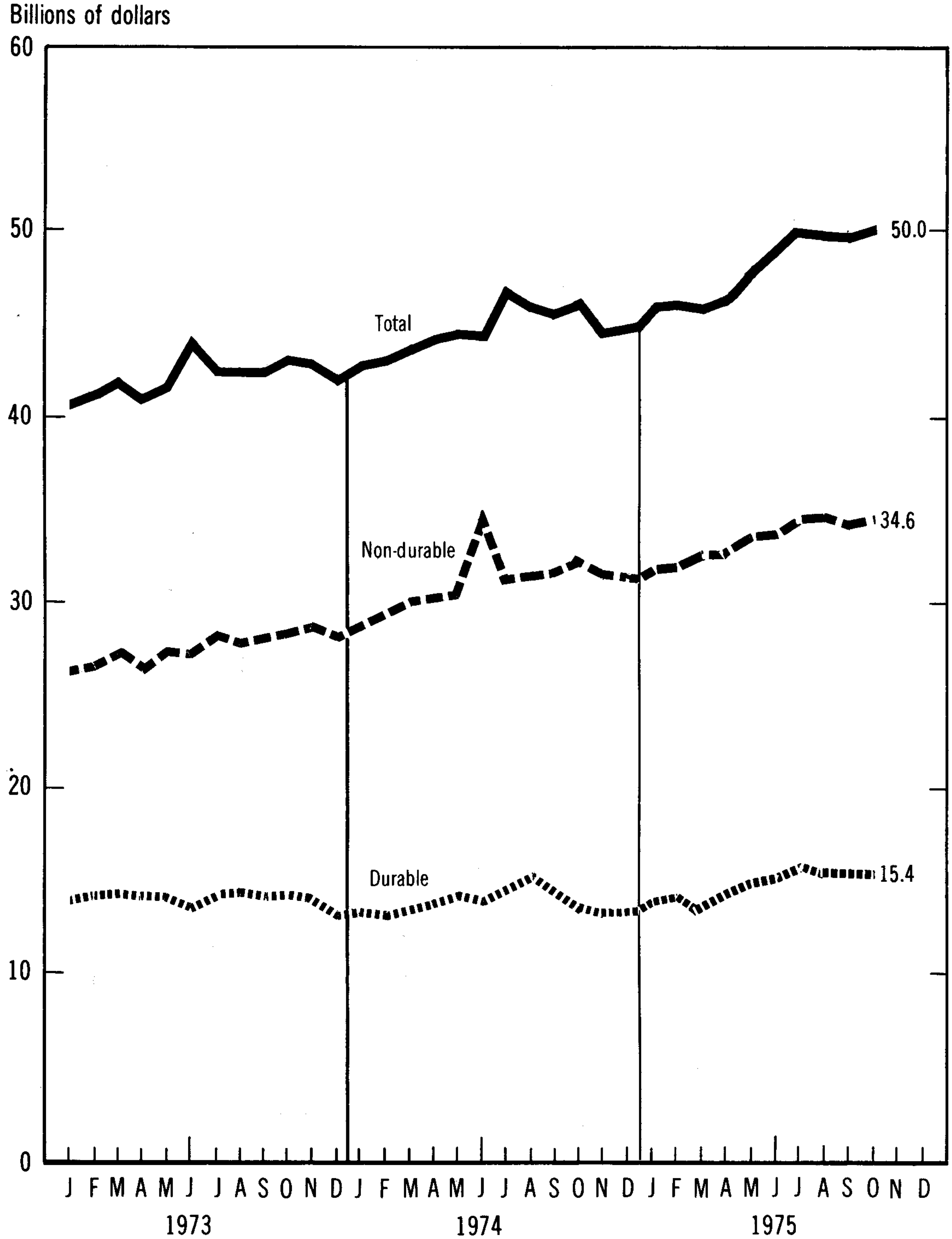
° Conversion to international metric screw thread system was considered a milestone for this group of products that has one of most difficult and complex standards systems.

° Three major automotive producers reportedly have started using metric dimension fasteners in place of inch dimension fasteners for some applications. One producer is using metric fasteners extensively in a new small car.

- Use of metric fasteners in automobiles is particularly significant because approximately 4,000 fasteners are used on an average auto, and the automotive market accounts for annual fastener sales of about $500 million, or 20 percent of total fastener industry sales.

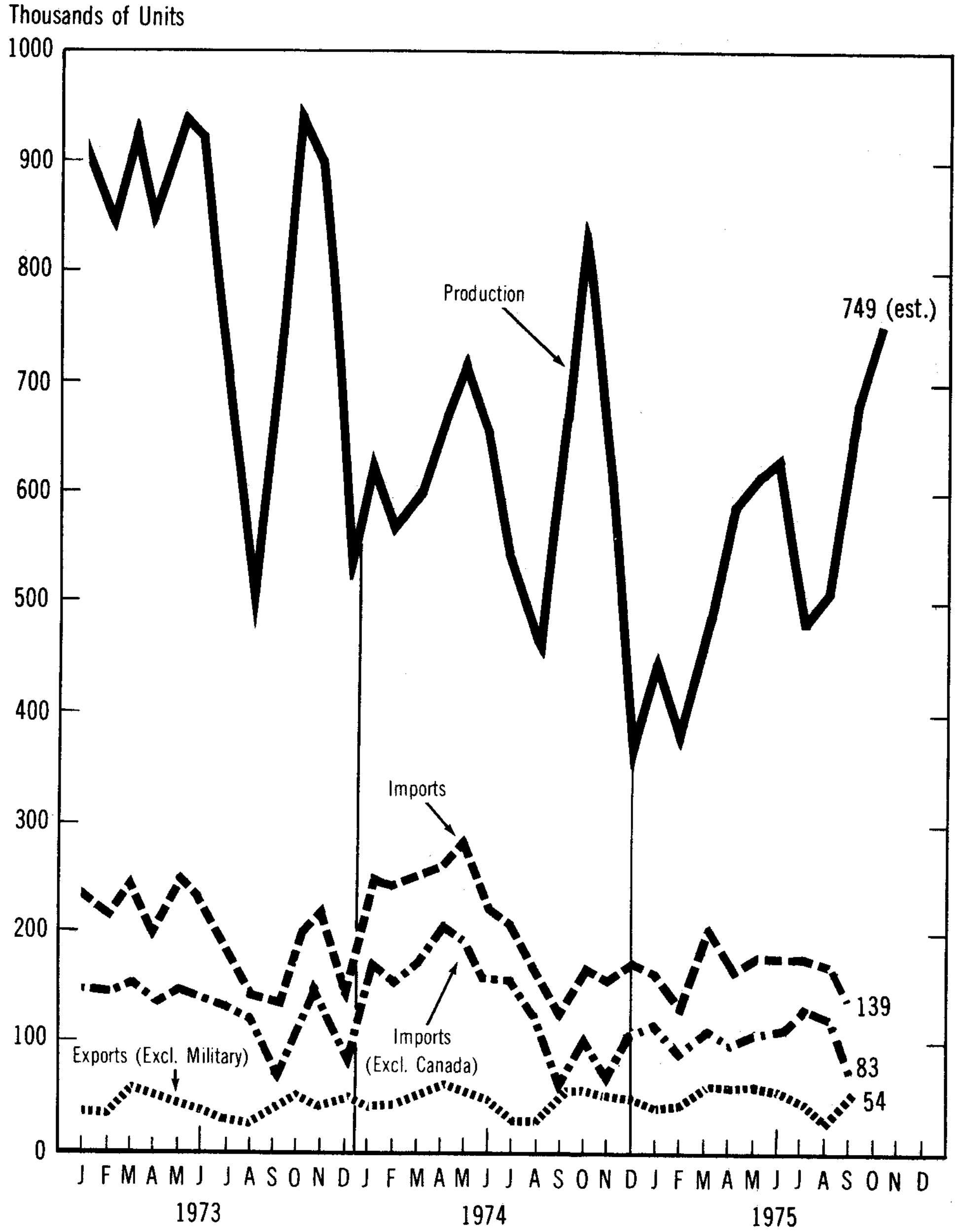
- This rapid acceptance of metric fasteners by such a large and important consuming industry is an indication that, in the near future, there may be widespread conversion to metric fasteners in the U.S.

BUSINESS INDICATORS
RETAIL SALES
(Seasonally Adjusted)



Source: Bureau of the Census

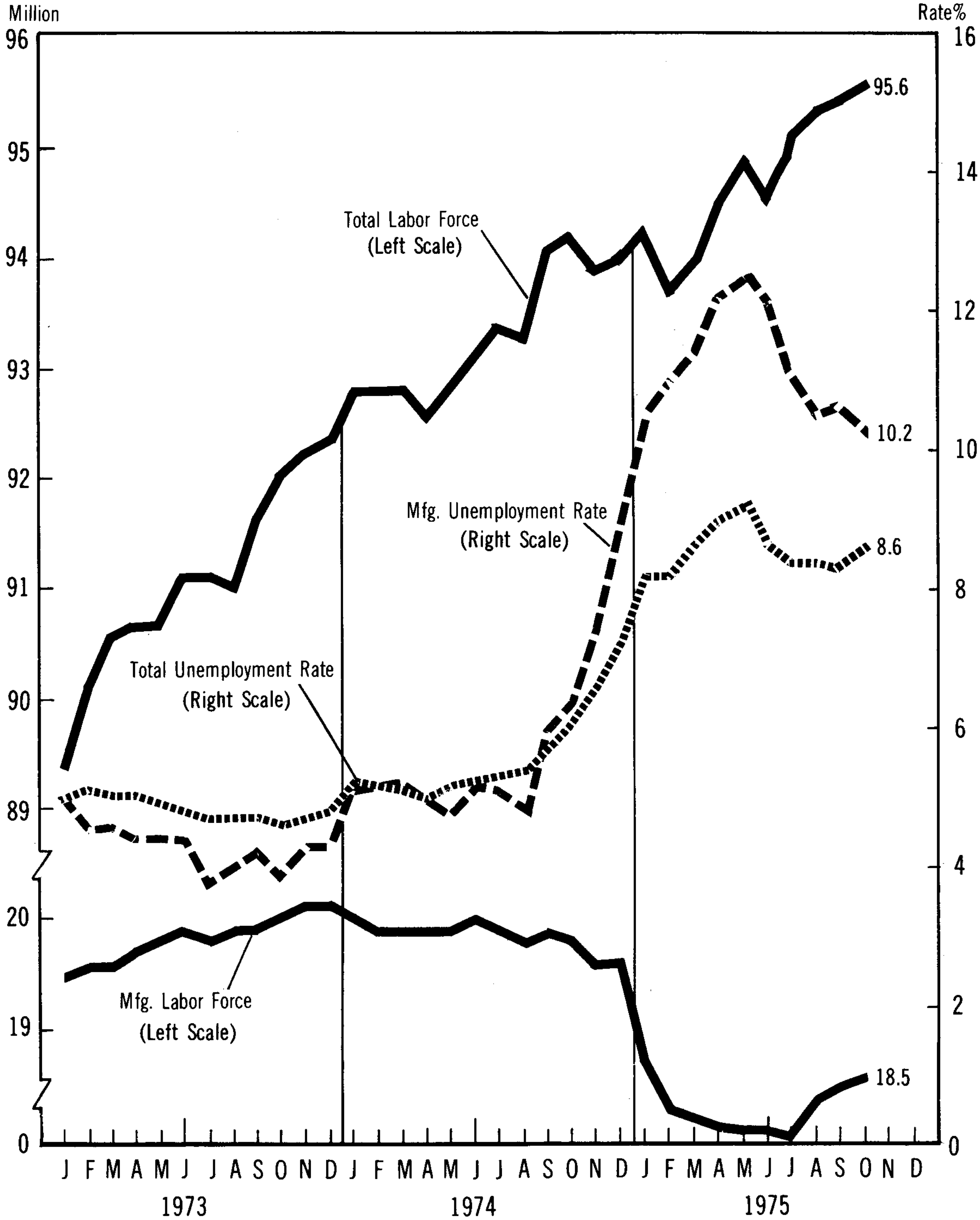
PASSENGER CARS, NEW
(Not Seasonally Adjusted)



Source: Motor Vehicle Manufacturers Association, Bureau of the Census

LABOR FORCE AND UNEMPLOYMENT RATES

(Seasonally Adjusted)

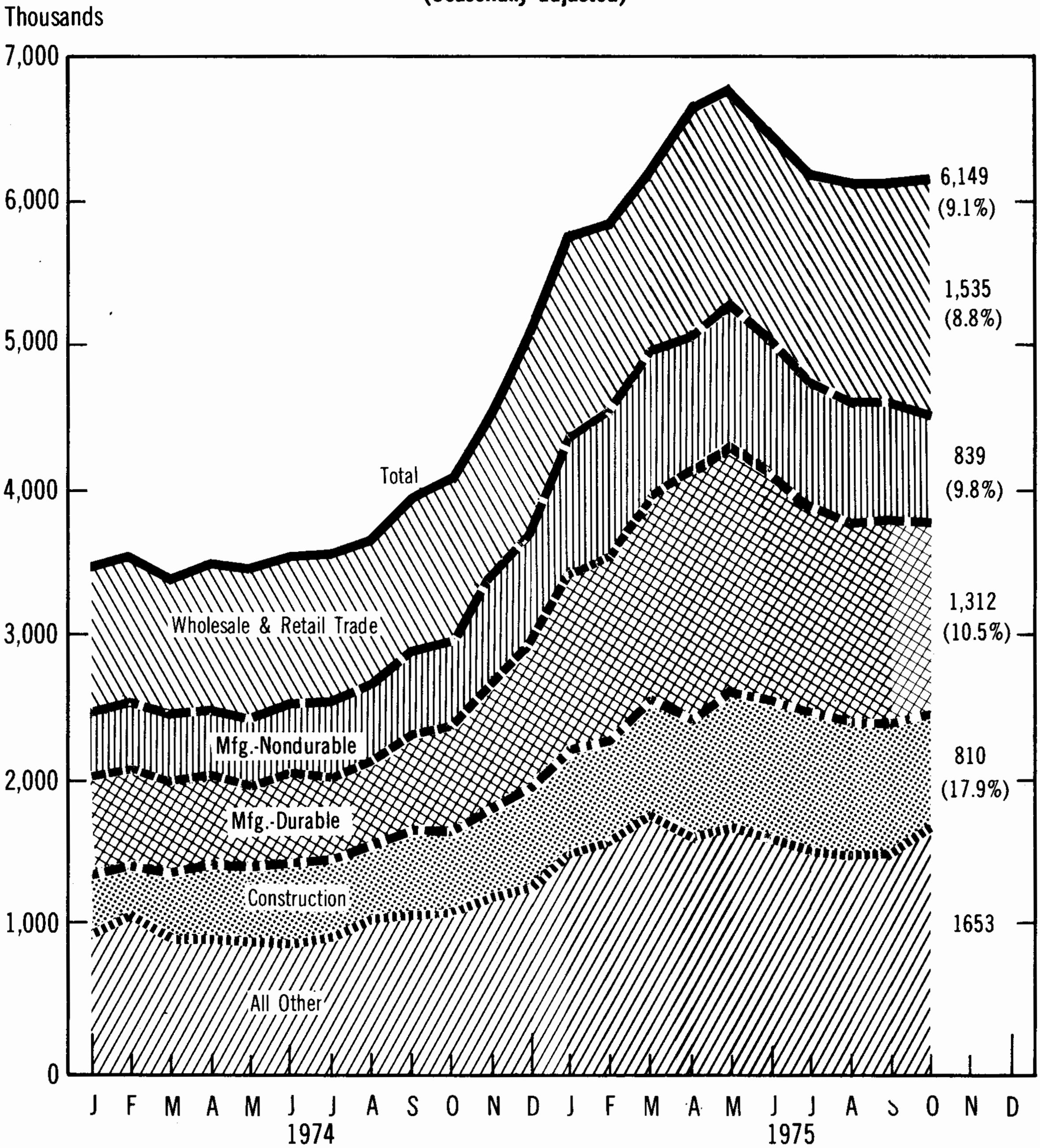


Source: Bureau of Labor Statistics

UNEMPLOYMENT - SELECTED INDUSTRIES

Household Data

(Seasonally adjusted)



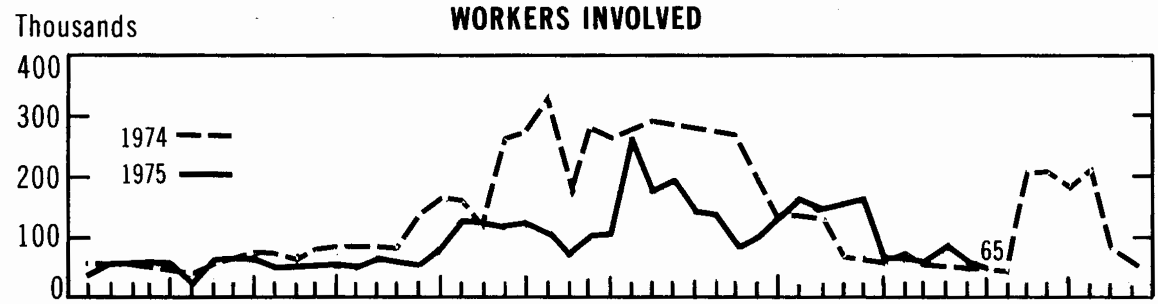
* Unemployment rate 1/Nonagricultural private wage and salary workers.

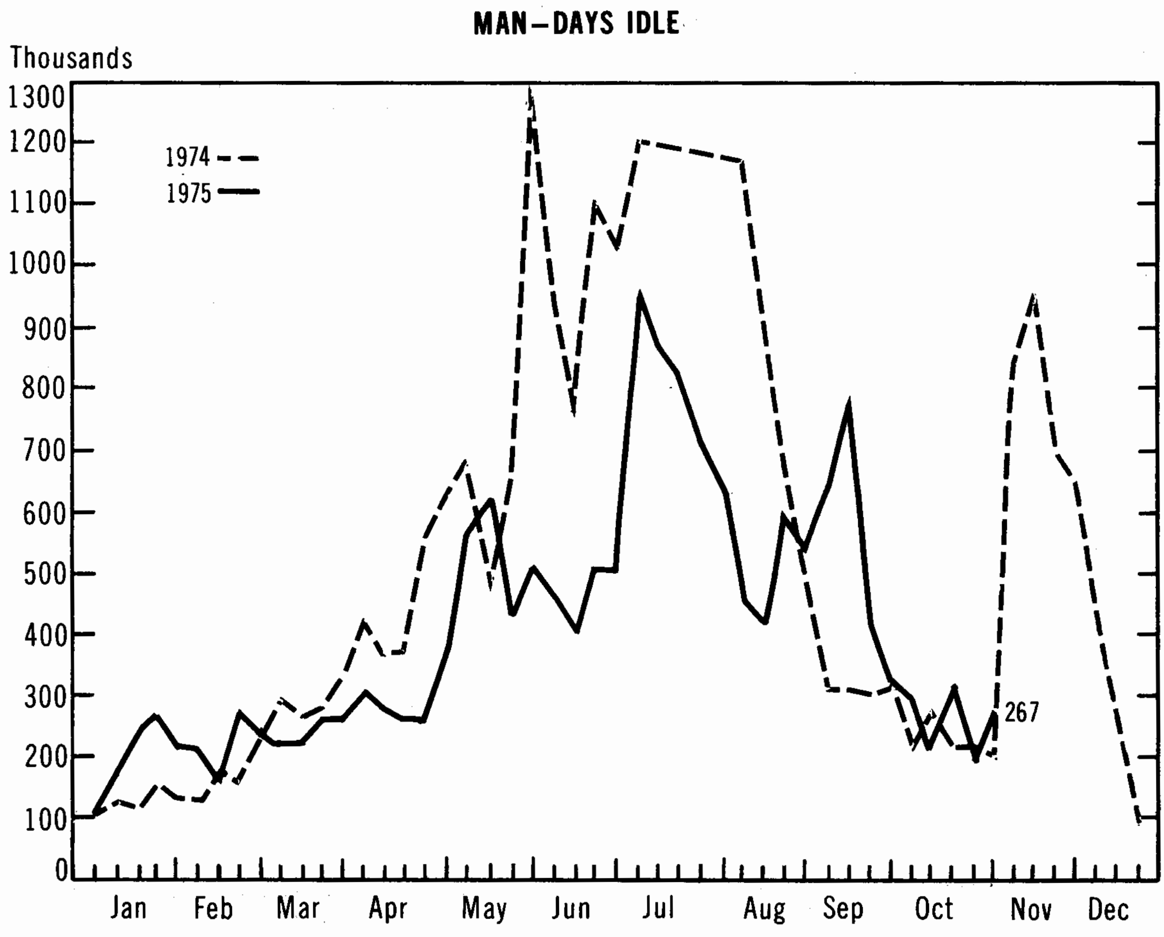
Source: Bureau of Labor Statistics

WEEKLY HOURS AND EARNINGS
(Seasonally Adjusted)

Source: Bureau of Labor Statistics

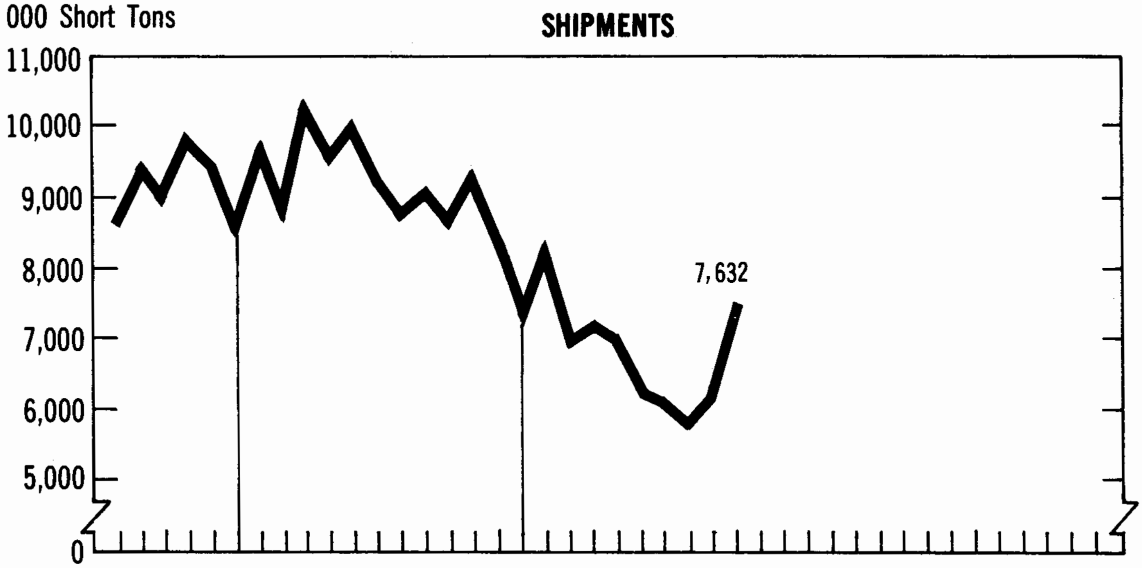
WORK STOPPAGES DURING WEEK



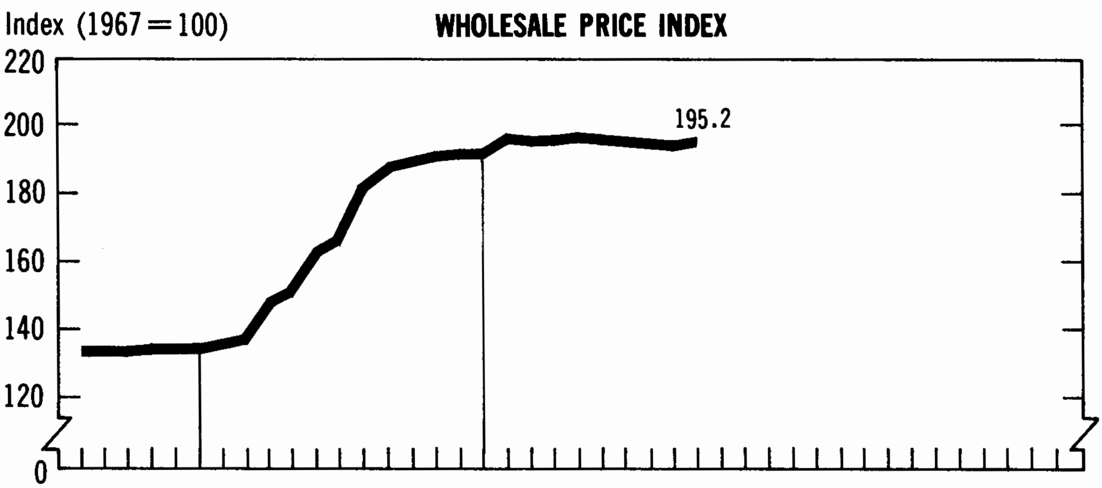


Source: Department of Labor

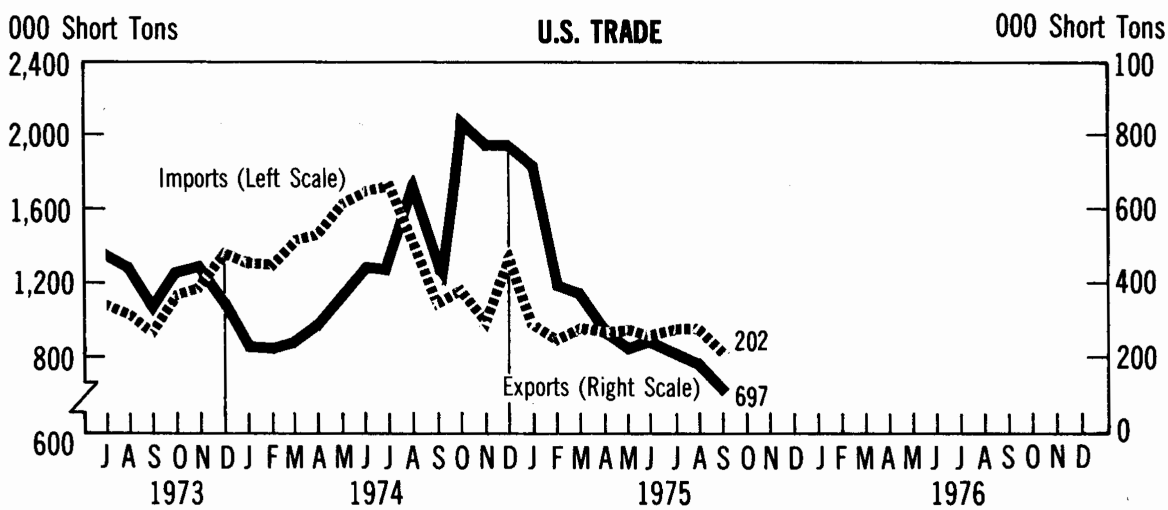
STEEL MILL PRODUCTS



Source: American Iron and Steel Institute.



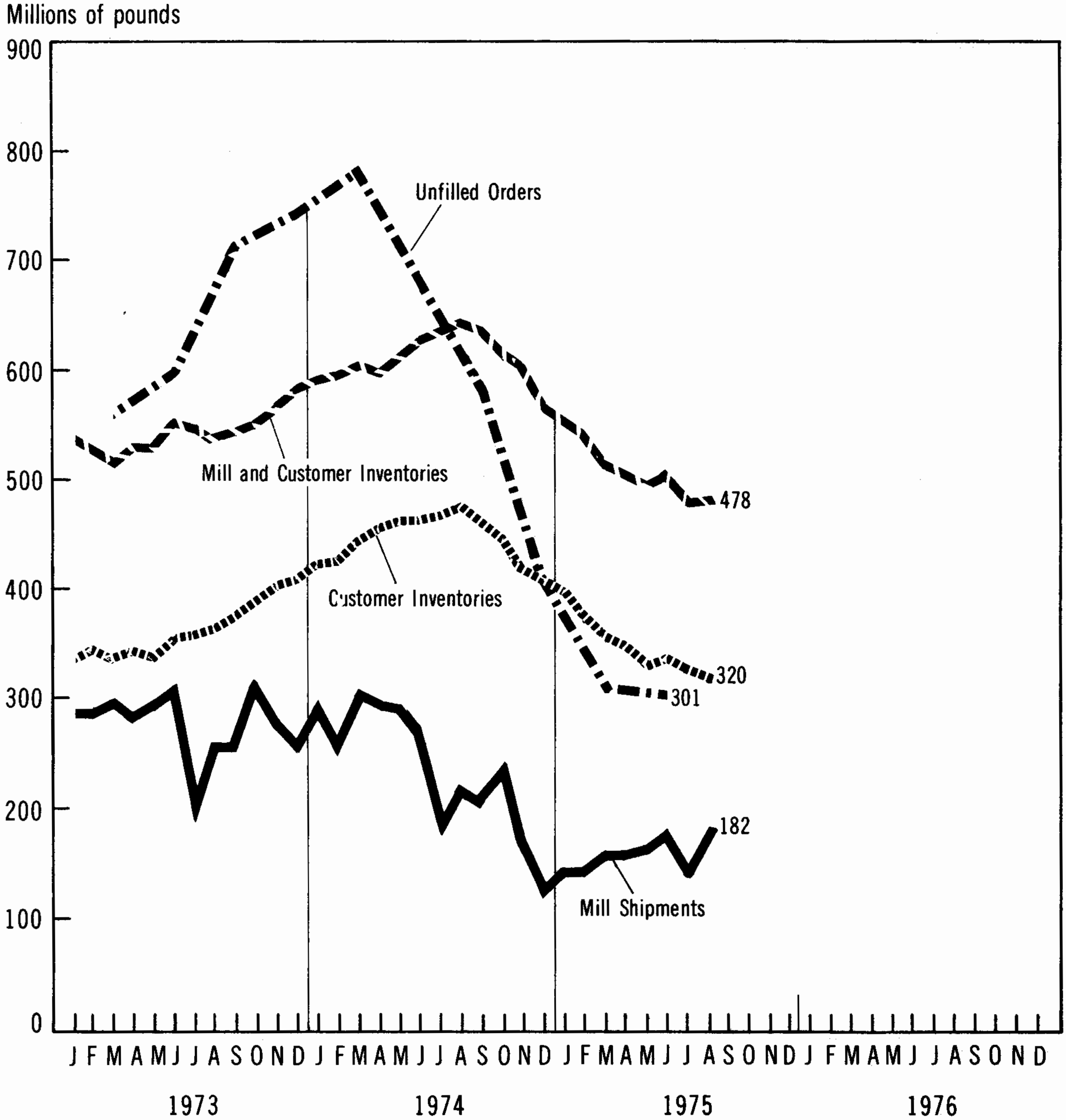
Source: Bureau of Labor Statistics.



Source: Bureau of the Census.

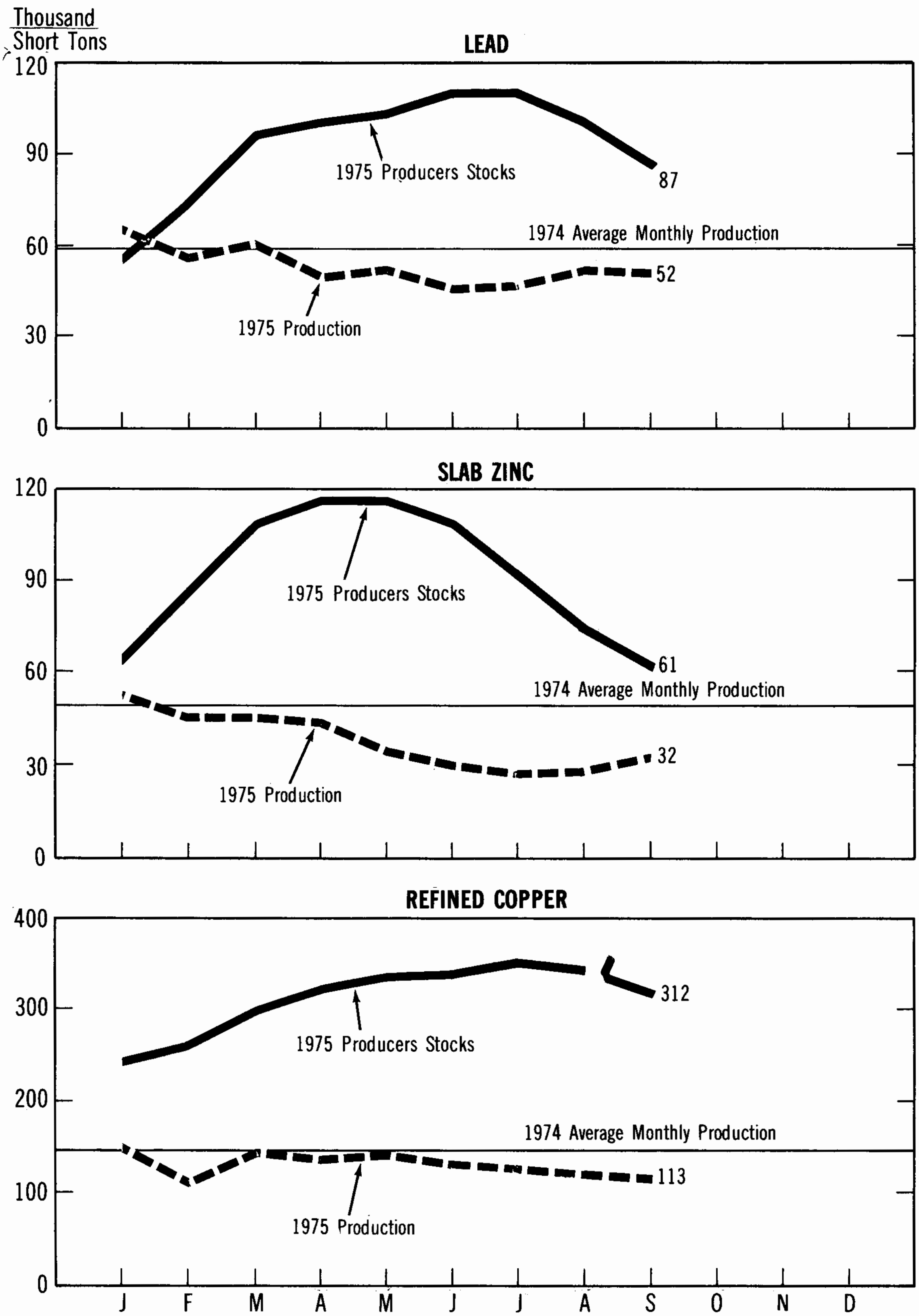
BRASS MILLS

(Not Seasonally Adjusted)



Source: BDC and Bureau of the Census.

NONFERROUS METALS



Source: American Bureau of Metal Statistics
Zinc Institute Inc.
Lead Industries Association Inc.

Energy Related

ENERGY RELATED

INDUSTRIAL HEATING EQUIPMENT INDUSTRY REMAINS STRONG

- New orders for industrial heating equipment totaled $425 million during first nine months 1975, equal to same period 1974, a record year for industry.
- Continued high level of activity is attributed to demand for new energy saving technology, as well as a strong export market.
- With expected upswing in overall industrial activity, new orders for industrial heating equipment during fourth quarter should enable industry to exceed 1974 record level.

GASOLINE PRICES IN 52 CITIES

CURRENT ° Weekly average price excluding taxes falls again; 1975 to-date average pump price continues rise. (See chart in Price Indicators.)

ENERGY RELATED WHOLESALE PRICE INDEXES

- Coal, Crude Petroleum, and Petroleum Products, Refined. (See charts in Price Indicators.)

Supply Situations

SUPPLY SITUATIONS

STEEL MILL PRODUCTS: SHIPMENTS EXPECTED TO DECLINE IN FOURTH QUARTER AFTER SEPTEMBER PRICE-HEDGE BUYING

CURRENT ° Domestic

° Shipments of domestic steel mill products, continuing a trend of price-hedge buying which developed in August, plus increased orders from the auto industry, jumped 20.6 percent from 6,327,000 tons in August to 7,632,000 tons in September.

° Increase was above normal rate due to accelerated shipments in anticipation of price hikes that became effective October 1. September shipments of steel products, however, remain 11 percent below the 8,601,000 tons shipped in September 1974. (See chart in Business Indicators.)

° Shipments in October and November 1975 are expected to drop back from September level to depressed level of mid-summer. Weekly raw steel production in October averaged 2,090,000 tons, or 7 percent below the 2,245,000 tons produced in peak week ending September 20.

° For 1975 thorugh November 1, raw steel production was 99,730,000 tons, 19 percent below the 123,185,000 tons produced in the comparable 1974 period.

° Due largely to pick-up in shipments in September, producing mills inventories dropped to 15,400,000 tons on hand as of September 30, compared to 16,900,000 tons as of August 31.

Foreign

° September imports of steel mill products declined to another three-year low of 697,000 tons, down 7 percent from 748,000 tons imported in August. (See chart in Business Indicators.) This is 45 percent below the 1,279,000 tons imported in September 1974.

° Steel mill product exports also dropped to a three-year low of 202,000 tons in September, or 25 percent below the 271,000 tons exported in August. This represents a decline of 42 percent from the 346,000 tons exported in September 1974.

ALUMINUM: AUGUST DEMAND INCREASES SLIGHTLY

° Due to increase in demand, net shipments of aluminum ingot and mill products in August were highest monthly for any of first eight months in 1975, and amounted to 880 million pounds. This was an increase of 8.4 percent over shipments of 812 million pounds for July 1975. August shipments were 20 percent less than August 1974 shipments of 1,099 million pounds.

° 1975 eight month cumulative shipment total of 6,059 million pounds was 38 percent less than comparable 1974 period total of 9,779 million pounds.

° Total month-end inventories, including ingot, mill products and scrap, continued high as August inventories of 6,038 million pounds were only 0.5 percent less than revised July inventory quantity of 6,070 million pounds.

° Inventories for August 1975 were 33 percent greater compared to August 1974 inventories of 4,533 million pounds. With inventories remaining high, U.S. primary aluminum industry continued to operate at 75 percent of capacity. Low operating conditions exist in all free world countries.

° In U.S., primary aluminum production for January - August 1975 period amounted to 5,279 million pounds, down 19 percent from the 6,527 million pounds for comparable 1974 period.

° Both total imports and exports for August (including scrap, unwrought aluminum and semifabricated products) increased over July; imports increased by 39 percent and exports by 61.5 percent. (Exports and imports remained generally strong in September).

° Compared to January-August 1974 period, U.S. trade for comparable 1975 period was down 23 percent in total imports and 35 percent in total exports.

° Industry anticipates continuing market improvement this year and in 1976, with a slightly slower pace for 1976 than earlier predicted.

SELECTED PETROCHEMICALS PRODUCTION UP

CURRENT

- September 1975 production of most of selected petrochemical products again increased, and was over August 1975 levels, continuing recovery which began in May.

- U.S. International Trade Commission production data for third quarter 1975 show significant increases for petrochemicals over second quarter 1975.

- Production increases ranged from 6 percent for ethylene dichloride to 39 percent for cyclohexane. Plastic material production increases ranged from 10 percent for polystyrene to 29 percent for low density polyethylene. Butadiene was 35 percent higher; toluene, 30 percent; synthetic fibers (nylon), 28 percent; and ethylene was up by 20 percent.

- Production figures for third quarter 1975 remained below third quarter 1974:

  -- polystyrene and polyvinyl chloride 20 percent under third quarter 1974 production levels;

  -- ethylene dichloride and cyclohexane each 16 percent lower;

  -- low density polyethylene and ethylene were lower by 17 percent and 15 percent, respectively;

  -- nylon fibers were 8 percent below; and

  -- benzene production was 42 percent below;

  -- exceptions were ethylene glycol, up 17 percent, and synthetic fibers (polyester) up 4 percent over third quarter 1974.

- While present production for these selected petrochemicals is on rise, with exception of ethylene glycol and synthetic fibers (polyesters), production remains well below comparable 1974 levels.

CHLORINE: OUTPUT RISES 16 PERCENT SINCE JULY 1975

- Chlorine is used largely to produce organic chemicals for solvents (47 percent); vinyl chloride (19 percent); pulp and paper (15 percent); and inorganic chemicals (10 percent).

- Production of chlorine reached an all-time high of 31,274 tons per day in November 1974, when the industry operated at 97.8 percent of capacity.

° In July 1975, production of chlorine fell 27 percent to low of 22,958 tons per day, reflecting slump in production of vinyl chloride, other chlorinated hydrocarbons, and pulp and paper.

CURRENT ° Production of chlorine rose in August and September, reaching 26,661 tons per day in September or 16 percent higher than in July.

° The industry operated at 78.8 percent of capacity in September compared with 67.9 percent of capacity in July. Increase in output paralleled increased production of ethylene dichloride (intermediate for vinyl chloride), pulp and paper, and the three principal chlorinated solvents, trichloroethane, trichloroethylene, and perchloroethylene.

° Although change from July to September 1975 is significant, daily production rate is still 15 percent below November 1974 level.

° Output for January-September 1975 totalled 6,763,281 tons or 16.1 percent below output for first nine months 1974.

° Chlorine list prices ranged from $140 to $178 per ton in early 1975 when demand was strong and supply tight. List prices then fell to range of $115 to $140 per ton in April 1975 and have remained at that level despite increased production costs.

Labor Developments

LABOR DEVELOPMENTS

RAILROADS: STRIKE DEADLINE DEFERRED

CURRENT

- The four members of Railway Employees' Department of AFL-CIO (Boilermakers, Electrical Workers, Firemen and Oilers and Railway Carmen) and nation's railroads agreed to postpone strike deadline scheduled for November 11 until November 18. Parties will continue to meet this week in effort to reach agreement.

PRINTING INDUSTRY: NEW YORK CITY PRINTERS AND UNIONS SIGN HISTORICAL AGREEMENT

CURRENT

- Tentative agreement was reached on 10-year contract by New York City's commercial printing industry, and New York Typographical Union No. 6, to allow unlimited technological improvements in printing plants while guaranteeing printers' job security.
- Agreement, covering 4,400 New York printers, is similar in major respects to 11-year pact signed during summer by same Union and City's three newspapers.
- Employers will be permitted to utilize automation for printing production at wage scale lower than present journeyman's pay ($10 per hour), to have greater flexibility in work scheduling, and to have mandatory retirement for printers over age 68, as of January 2, 1977.
- After initial contract year, union members will receive an annual 3 percent salary increase plus quarterly cost of living adjustments, substantial bonuses for retirees, and a company-paid subsidy fund to defray a portion of payroll costs of print shops that hire otherwise unemployed printers.
- Subsidy fund is expected to make New York City printers competitive in bidding on print jobs that had previously left the City for areas with lower labor costs.
- Labor and management consider agreement a breakthrough in commercial printing industry labor negotiations, and predict its provisions will spread to cities beyond New York.

UNITED MINE WORKERS PENSION PLAN

- United Mine Workers Union represents 120,000 of total (140,000) bituminous coal miners.
- Under present union pension plan, a miner with minimum of 20 years service can retire at age 55 or greater with fixed pension of $200 per month. Pension does not change with increased years of service and/or retirement age. Retirement rate under this plan is 5,000 to 7,000 miners per year.

CURRENT

- Pensions under new retirement plan, effective January 1, 1976, will be determined by sliding scale based on total years of service and retirement age.
- Miners with 10 years of service can retire at age 55 with pension of $94.80 per month. Maximum of $510 per month can be received under this plan with 40 years service and a retirement age of 62 years or greater.
- On January 1, 1977, pension will be increased to $98.75 per month for 10 years service at age 55, and $530 per month with 40 years service at age 62 or greater.
- At present, 80,000 miners draw retirement pay. These retired miners will not be affected by new plan and will continue to receive $200 per month.
- New plan is expected to increase retirement rate to 15,000 per year. Result will be loss of older, more experienced miners with greatest impact in old, established coal fields (e.g., in West Virginia, Pennsylvania, Kentucky, and Illinois).
- In general, employers are not worried about filling anticipated vacancies, because there is a surplus of applications for most mine jobs.

NINE-MONTH MEDIAN WAGE GAIN UP

- Median first-year wage gain in contracts negotiated during first nine months 1975 was 55.2 cents per hour, 20.3 cents an hour above median in the same 1974 period, according to Bureau of National Affairs, Inc.
- Excluding construction, the all-industries median gain was 43.4 cents. In construction industry, median gain for nine month period was 75.1 cents.

AIRLINES: PILOTS FOR EASTERN AGREE TO FOREGO PAY RAISE

- 3,600 pilots of Eastern Airlines, members of Air Line Pilots Association, have agreed to forego pay raises next year and to fly ten more hours monthly in exchange for a share of future Eastern profits.

STRIKES

(Source: Federal Mediation and Conciliation Service)

- During week ending November 5, approximately 99,300 employees were involved in 325 strikes throughout the United States.
- Seventeen of the work stoppages were in the major and/or significant category where 1,000 or more employees were in the bargaining unit.
- During approximately same year-ago period (November 6, 1974), there were 321 work stoppages involving 90,100 employees. Nineteen of these work stoppages were in the major and/or significant category.

NEW AND SETTLED MAJOR STRIKES

(Source: Federal Mediation and Conciliation Service)

- New:
  Singer Company and the IUE
  Elizabeth, New Jersey
  1,620 employees; began 11/10/75

  General Telephone Company of Kentucky and the CWA
  Lexington, Kentucky
  1,150 employees; began 11/10/75

  Westinghouse Air Brake and DALU (Directly Affiliated Local Union)
  Wilmerding, Pennsylvania
  4,000 employees; began 11/1/75

- Settled:
  ARA Services, Inc. and HREU
  Dubuque, Iowa
  4,500 employees; 9/22/75 through 10/31/75

COST-OF-LIVING ADJUSTMENTS

° Basic Steel and Can Industries: on November 1, 400,000 members of United Steelworkers employed in basic steel industry received cost-of-living adjustment of ten cents an hour. 36,300 Steelworker members employed in can industry will receive similar adjustment on November 15.

° Coal Miners and Mine Construction Workers: workers represented by United Mine Workers will receive seven cent an hour cost-of-living increase for work performed after November 1.

CANADIAN PAPER INDUSTRY STRIKES: NEGOTIATIONS COLLAPSE; U.S. NEWSPRINT STOCKS REMAIN HIGH

° 65 to 70 percent of annual U.S. supply of newsprint is provided by Canada.

° Contract talks between Abitibi Paper Company and striking Canadian Paperworkers Union broke off on November 7 with no settlement imminent. Abitibi is Canada's leading newsprint producer with 20 percent of that country's total newsprint capacity.

CURRENT ° More than half of Canada's total newsprint capacity is idled by strike action, and Canadian newsprint shipments to the U.S. are down 12 percent for January-September 1975, compared to same 1974 period.

° U.S. newsprint stocks remain high, assuring adequate supply through remainder of 1975.

° U.S. newsprint inventories exceeded 2-month supply at end of September 1975, increase of 56 percent over September 1974 level, according to American Newspaper Publishers Association.

° U.S. newsprint stocks have remained high as result of reduced domestic newsprint consumption, down 11 percent in 1975, compared to 1974, and increased U.S. newsprint production, up 14 percent in September 1975, compared to 1974 level.

Price Developments

PRICE DEVELOPMENTS

CEMENT: PRICES RISE WHILE SHIPMENTS DECLINE

• In 1974, cement shipments dropped 9 percent to 81 million short tons. 1975 data point to further decline.

CURRENT ° Shipments in third quarter 1975 were 10 percent less than third quarter 1974. This represents improvement over first two quarters 1975 when U.S. cement shipments were down 25 percent and 21 percent, respectively, from same 1974 periods. However, cumulative 1975 shipments through September were 18 percent below first 9 months 1974.

° October 1975 wholesale price index for cement was 196.3 (1967=100), a 15 percent rise over October 1974. Price increases of this size, in a year of very weak demand, are unusual for this industry. Higher energy and transportation costs were major contributors to cement price rises.

POLYSTYRENE: PRICE INCREASES POSTPONED

° Early in October, Dow announced that polystyrene (PS) prices would be increased by 3 cents per pound, effective October 15 for spot sales and November 1 for contract sales. (See Business Conditions Report October 10, 1975).

° Six of top eight polystyrene producers followed this move. General purpose grade polystyrene was increased from 27 cents to 30 cents per pound.

CURRENT ° Two major producers, Amoco and Foster Grant, declined to raise prices at present time. As a result, Dow and the other six manufacturers are delaying price increases by granting 3 cents per pound temporary discount until January 1, 1976.

° Although producers feel that price increases are justified by higher production costs, industry sources state increases were not well-timed. Normally, this time of year is not very active for fabricators and converters.

° PS production for September 1975 was 267 million pounds, 8 percent higher than for August 1975, but still 16 percent below September 1974.

PROCESS CONTROL AND MEASUREMENT SYSTEMS:
HEWLETT-PACKARD ANNOUNCES PRICE CUTS

CURRENT ° Hewlett-Packard Company, a leading producer of industrial instruments, announced price cuts, averaging over 20 percent, on selected process control and measurement systems. Maintenance charges were reduced about five percent.

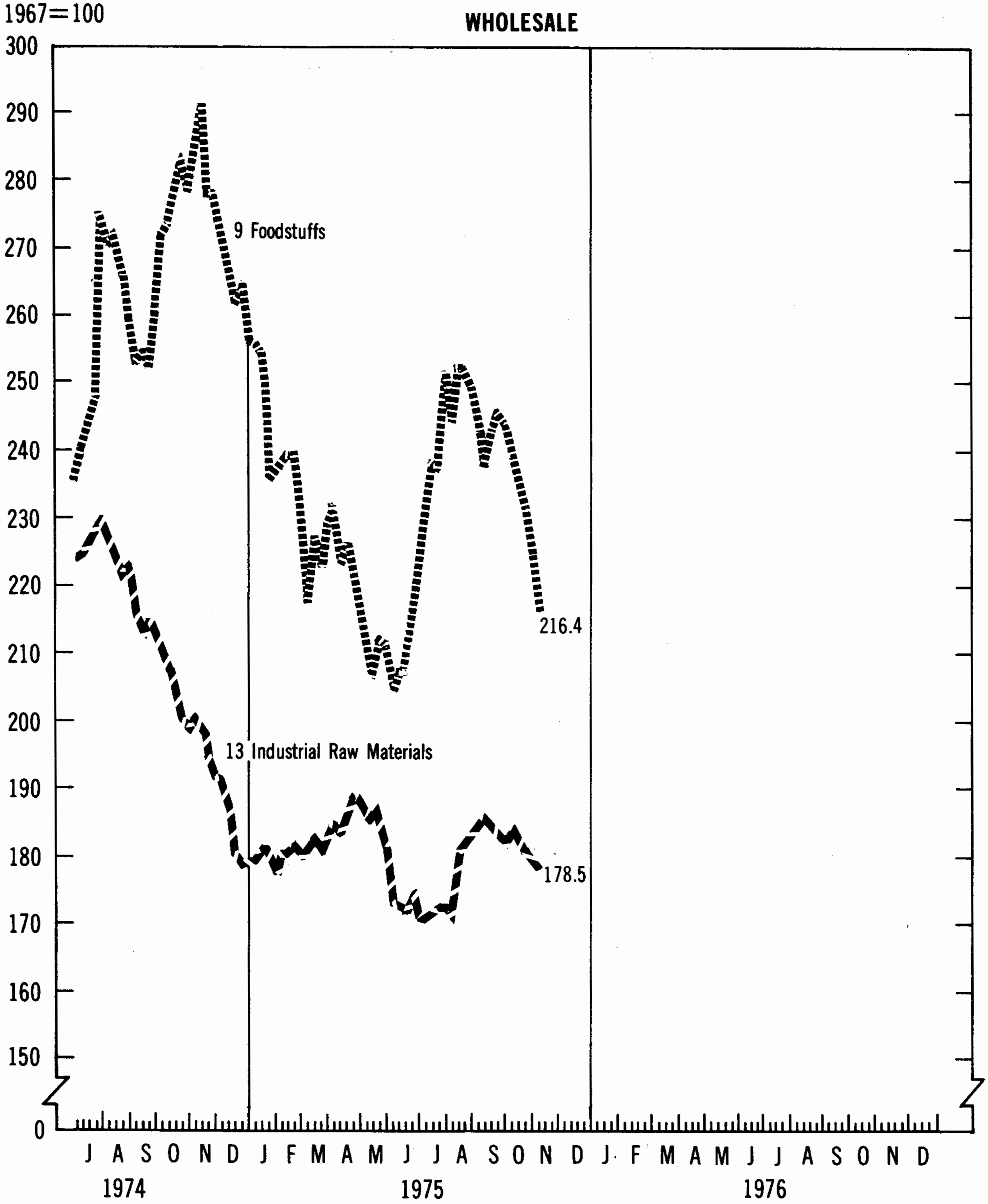
° Price cuts were made possible by lower overhead, improvements in labor costs, and lower prices for some components, according to the company.

FERROUS SCRAP

° Price continues to decline. See chart in Price Indicators.

PRICE INDICATORS

TUESDAY SPOT MARKET PRICES



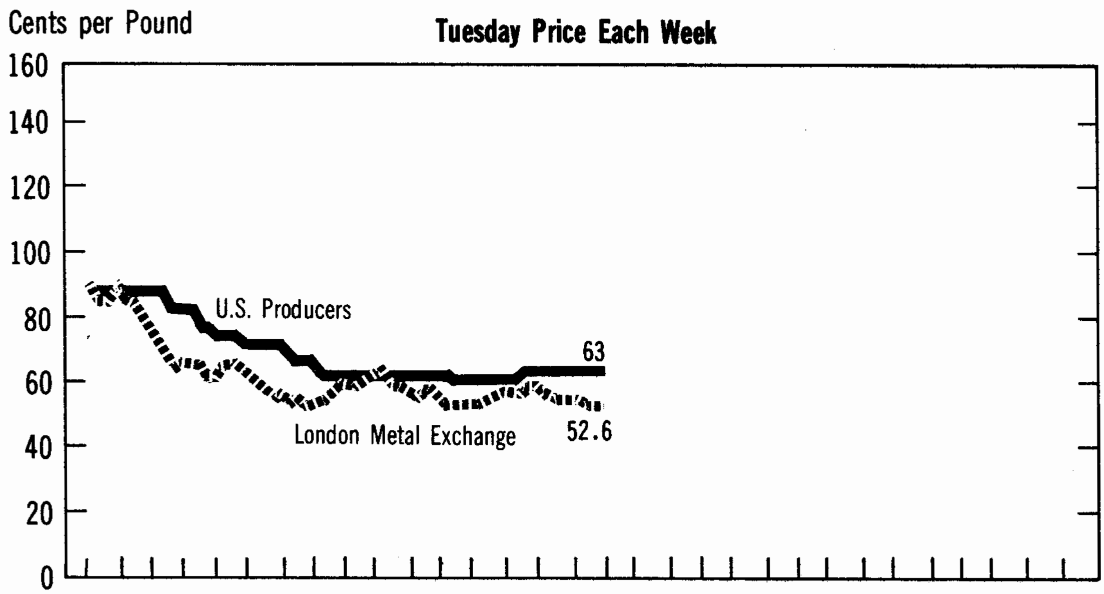
Source: Department of labor

KEY COMMODITY PRICES

COPPER PRICES

(Wirebar Basis)

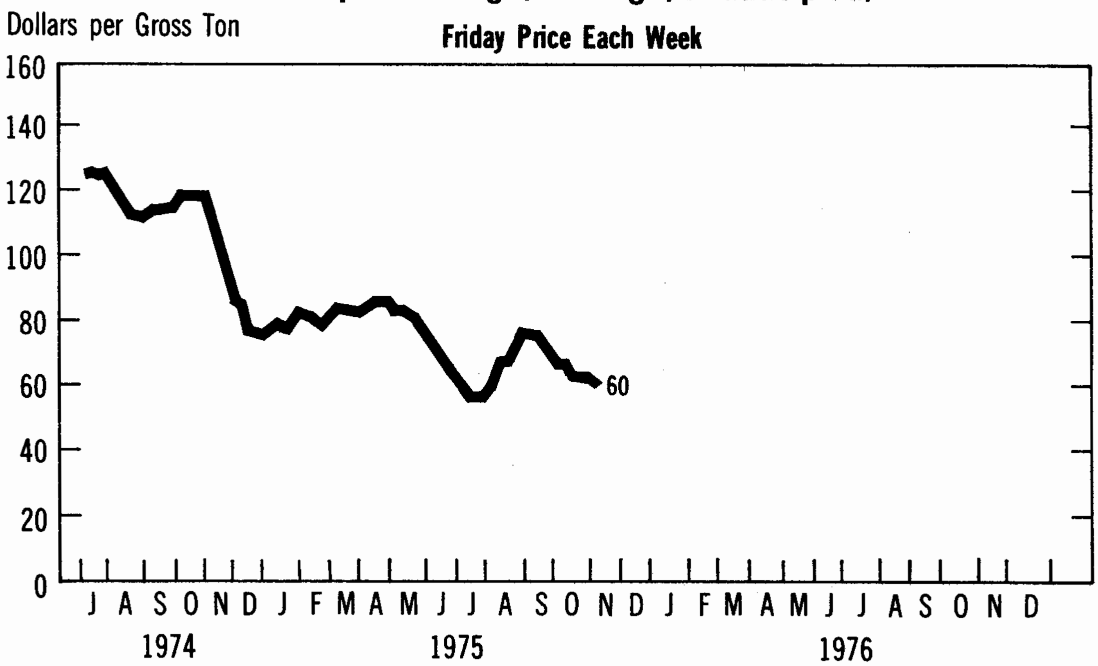
Tuesday Price Each Week



FERROUS SCRAP

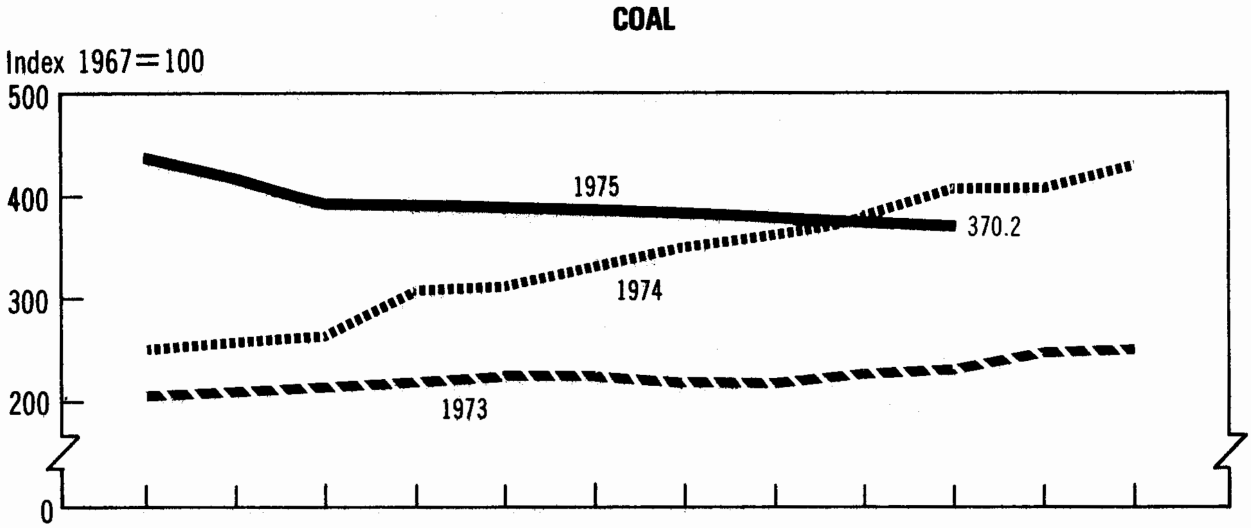
(Composite Price, No.1 Heavy Melting Steel Scrap Pittsburgh, Chicago, Philadelphia)

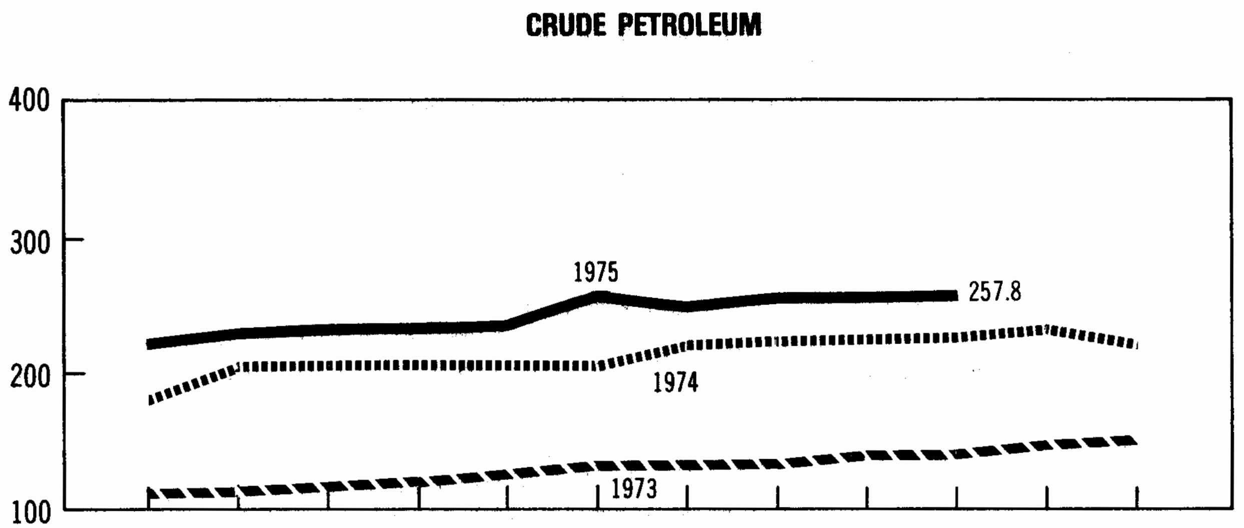
Friday Price Each Week

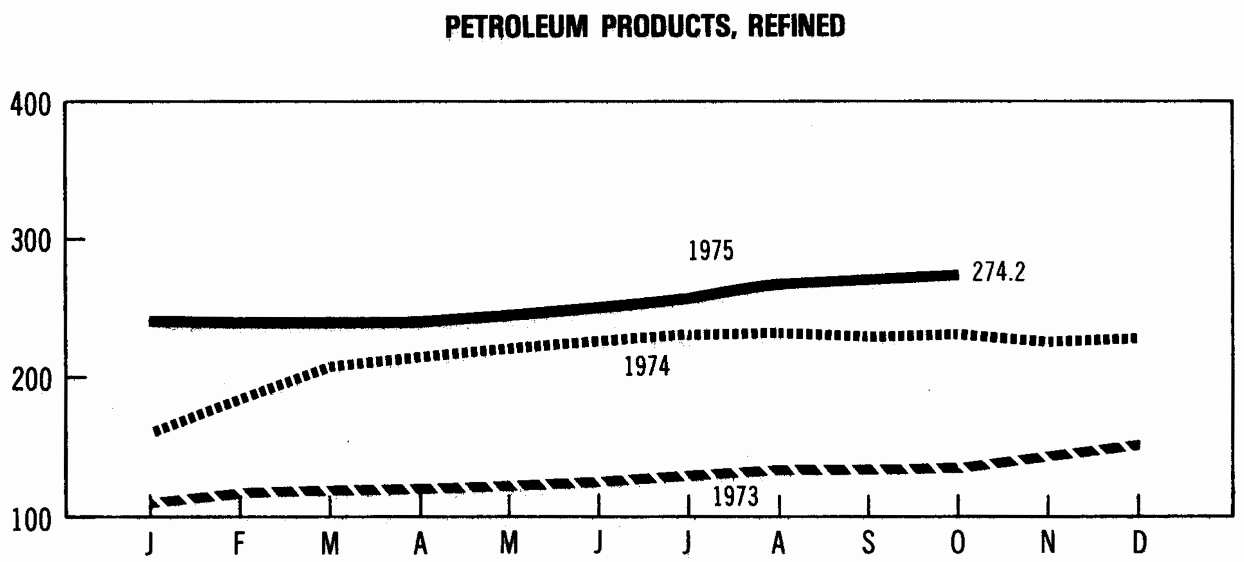


Source: American Metal Market

ENERGY RELATED — WHOLESALE PRICE INDEXES

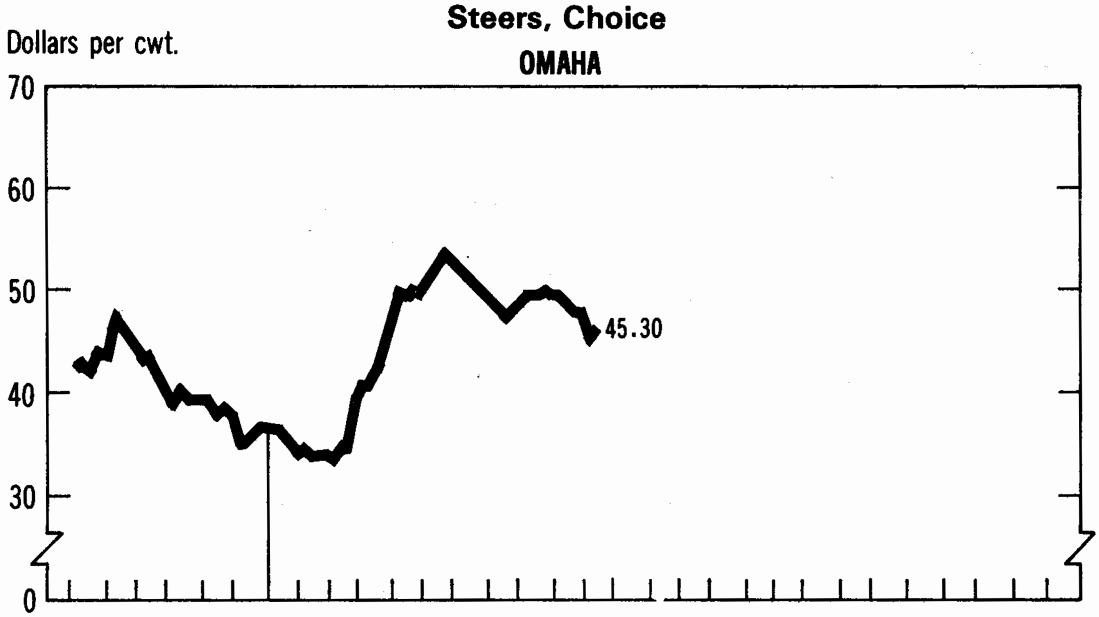


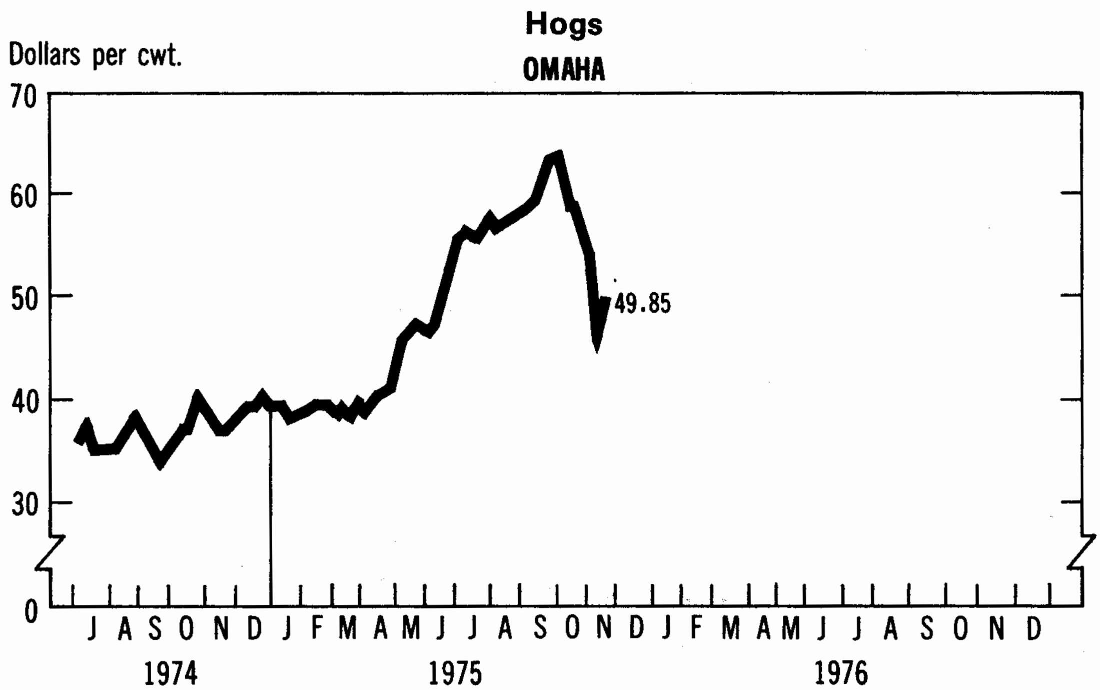




Source: Bureau of Labor Statistics

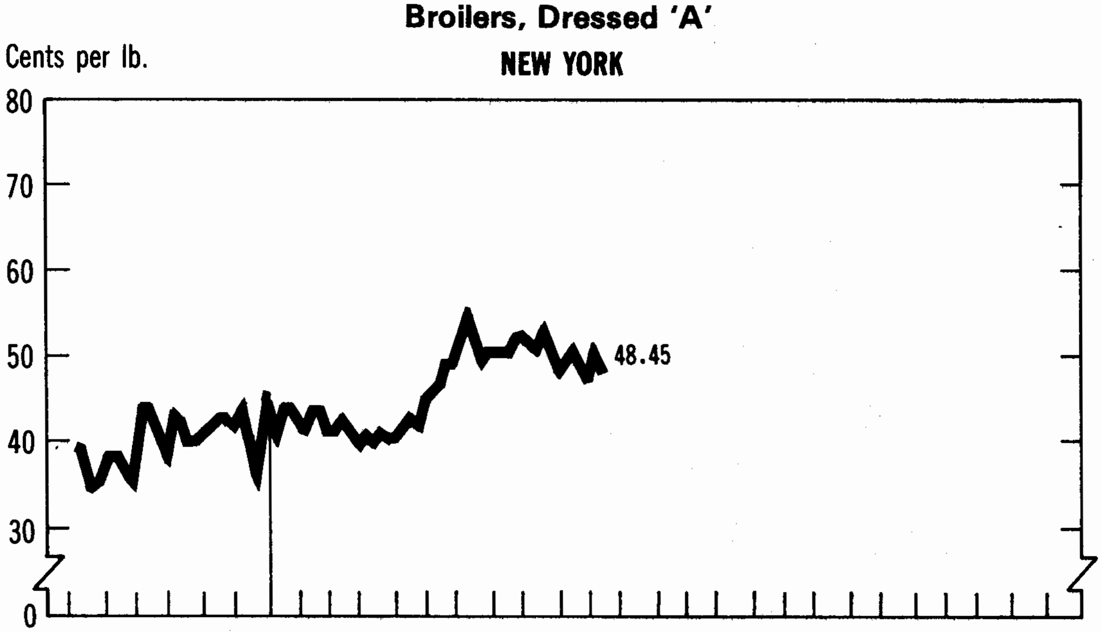
SPOT AGRICULTURAL PRICES

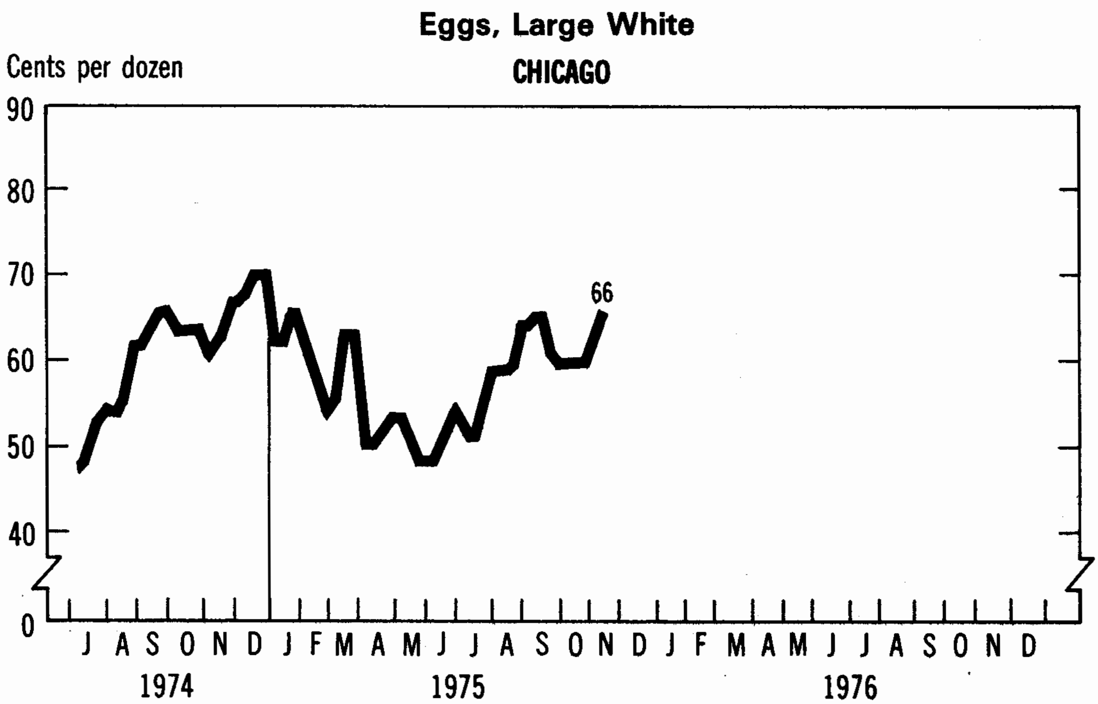




Source: Agricultural Marketing Service, Department of Agriculture.

SPOT AGRICULTURAL PRICES





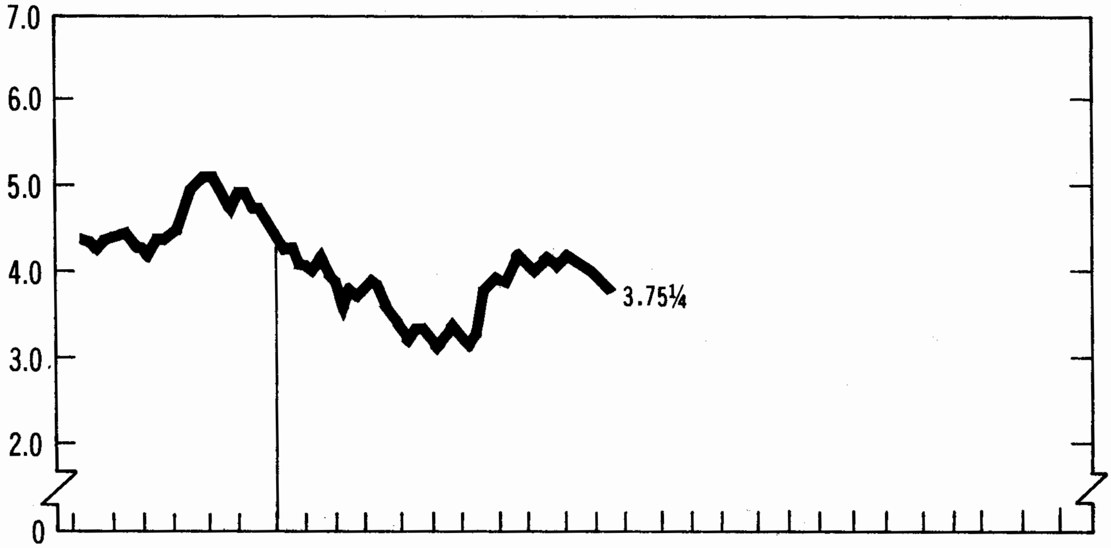
Source: Agricultural Marketing Service, Department of Agriculture.

SPOT AGRICULTURAL PRICES

Wheat No. 2 Ord. Hard

$ per bu.

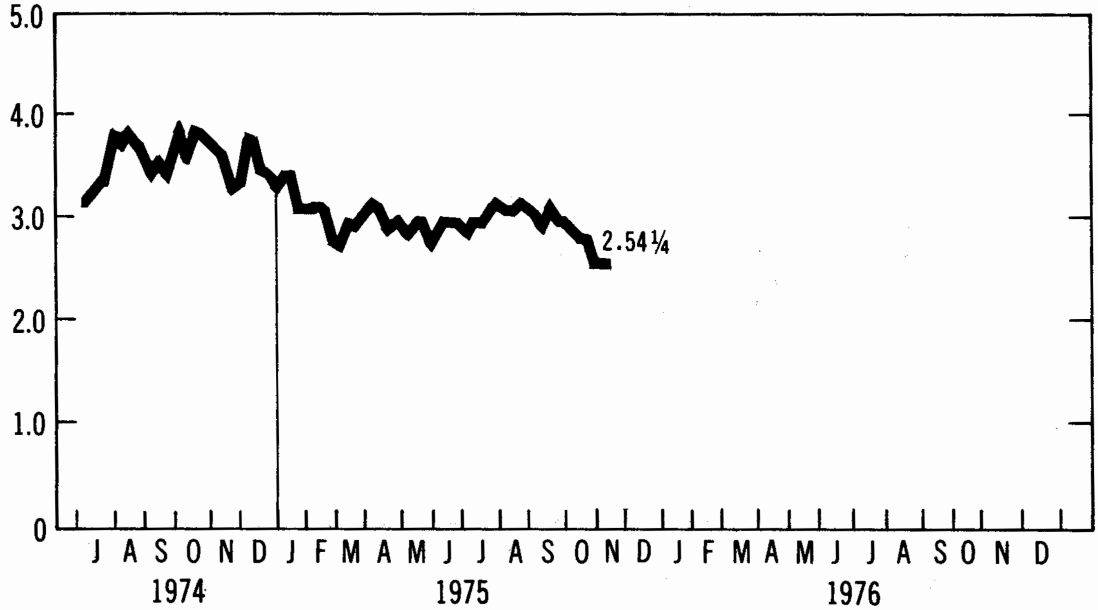
KANSAS CITY



CORN No. 2 Yellow

$ per bu.

CHICAGO

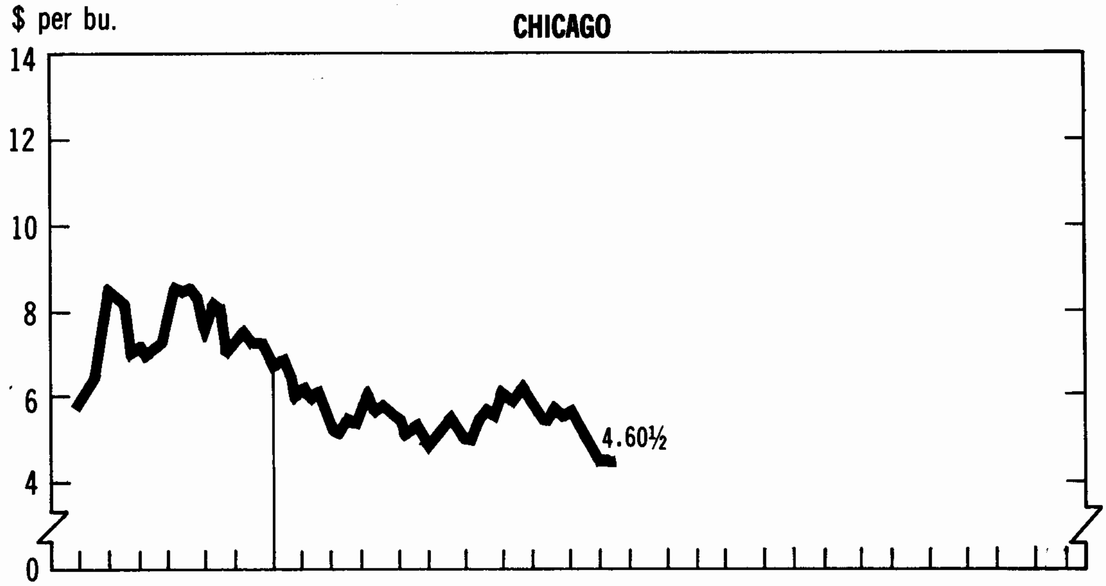


Source: Agricultural Marketing Service, Department of Agriculture.

SPOT AGRICULTURAL PRICES

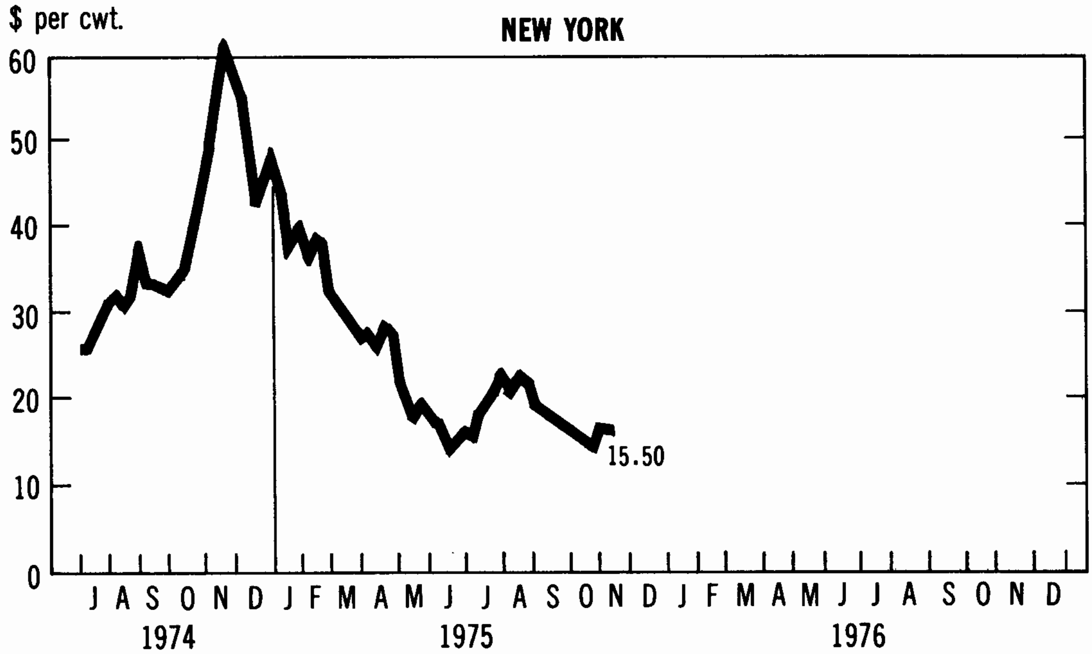
Soybeans No. 1 Yellow

CHICAGO



Raw Sugar

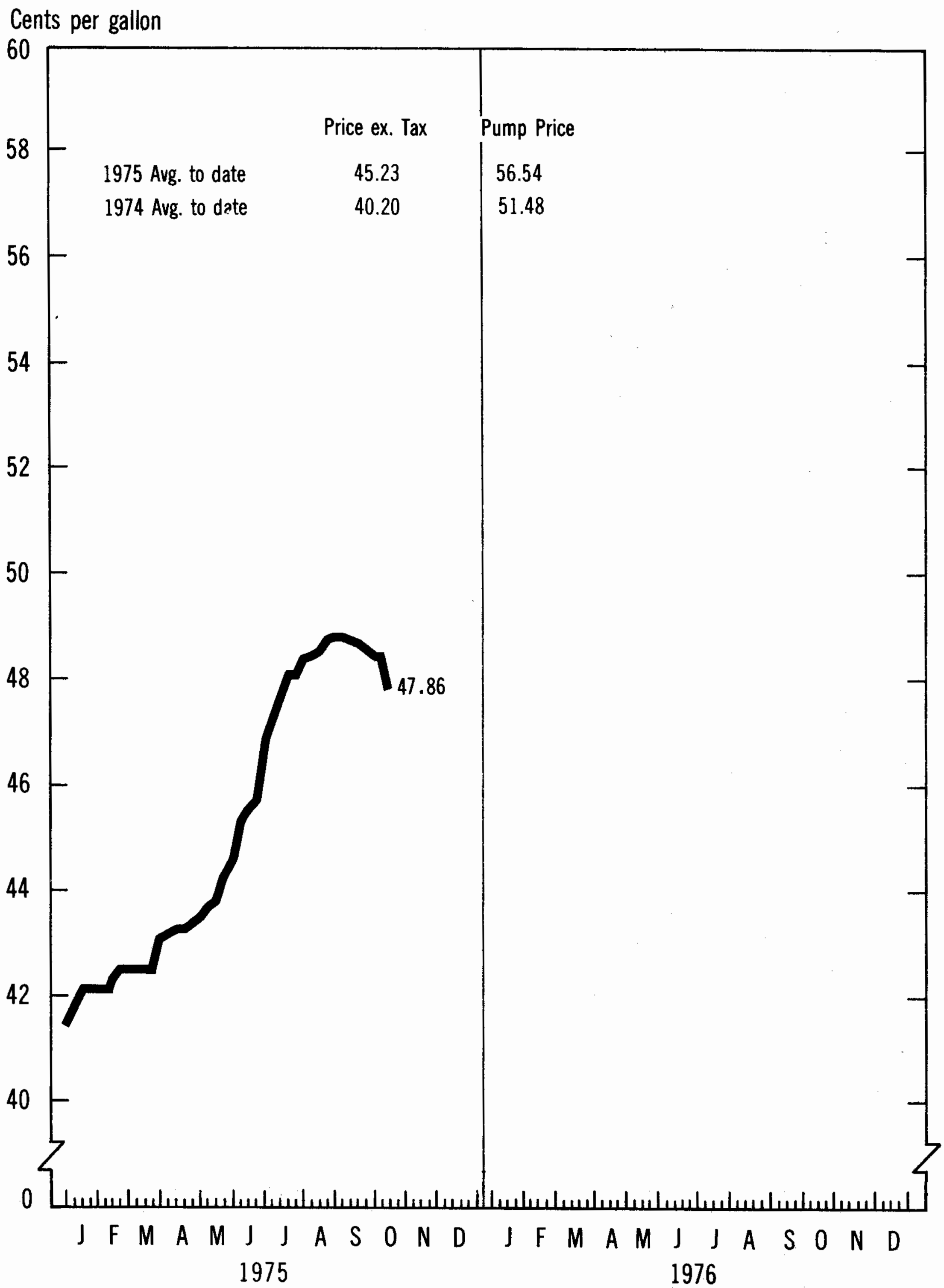
NEW YORK



Source: Agricultural Marketing Service, Department of Agriculture

GASOLINE PRICES IN 52 CITIES

WEEKLY AVERAGES[1]



1/ Prices exclude Federal, state and local taxes ranging from 9¢ to 13¢

Source: Oil and Gas Journal

Developing Issues

DEVELOPING ISSUES

OSHA PROPOSES NEW LEAD STANDARDS

- ° Present standard for airborne exposure to lead and lead compounds, adopted in 1971 under the Occupational Safety and Health Act, is 200 micrograms per cubic meter.
- ° Standard affects approximately 31 industries -- including primary and secondary lead smelting and refining, primary copper and zinc facilities with by-product lead operations, battery manufacturing, ceramic and glass working, printing, and plumbing.
- ° National Institute for Occupational Safety and Health (NIOSH) has recommended lowering lead standard to 150 micrograms.

CURRENT

- ° Occupational Safety and Health Administration (OSHA) has proposed cutting lead standard in half to 100 micrograms, with an "action level" at 50 micrograms, which requires additional medical monitoring in affected areas.
- ° Proposed regulations also require that compliance be made by engineering modifications and work process controls, rather than by means of respirators.
- ° Lead Industries Association has initiated an industry-wide study to examine technical and economic feasibility of proposed standard.
- ° Comments on the proposal are due OSHA on or before December 2. Standard will become effective 30 days after final publication in the Federal Register.

FOOD INDUSTRY BACKHAUL: FTC SEES NO ADMINISTRATIVE REMEDY

- ° In retail and wholesale food industry, backhaul is governed by Federal Trade Commission interpretation of Section 2(a) of Robinson-Patman Act. FTC holds that Act does not allow full f.o.b. pricing, which will limit extent to which backhaul will be utilized.

° It was previously implied (Business Conditions Report, October 31, 1975) that Administration's proposed Trucking Regulatory Reform Act would lead to increased backhaul in food industry. This is misleading as backhaul in this industry, which usually owns and operates its own trucks, is not controlled by Interstate Commerce Commission, the regulatory body to be most affected by proposed Act.

CURRENT ° A recent FTC letter to the Council on Wage and Price Stability reaffirming their interpretation of Robinson-Patman indicates that there is no administrative remedy for increasing backhaul.

° Thus, any improvement would probably require legislation, amending Section 2(a) of the Robinson-Patman Act.

TRADE REFORM ACT OF 1974, ADJUSTMENT ASSISTANCE TO WORKERS: UPDATE

° Under the Trade Reform Act of 1974, Title II provides for relief from injury caused by import penetration. One type of relief is "adjustment assistance to workers" (Chapter 2).

CURRENT ° As of October 31, according to Department of Labor:

-- 73 petitions for assistance affecting 38,500 workers have been certified, an increase of 14 petitions and 3,700 more workers since September 30;

-- 58 petitions affecting 44,200 have been denied, an increase of 12 petitions and 2,500 workers since September 30;

-- 142 petitions affecting 33,100 workers are in process of review; and

-- 2 petitions affecting 3,300 workers have been withdrawn.

° Industries with highest number of workers certified are transportation equipment, 15,700; electrical and electronic machinery equipment and supplies, 11,700; and leather and leather products, 5,700.

° States with most affected workers are Michigan with 10,100, Missouri with 7,400, and Virginia with 5,100.

FOREGOING RESTRICTIONS MAY BE REMOVED
90 DAYS AFTER PUBLICATION