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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 14, 1971

To Chairman Burns

Subject: Recent activity of foreigners

From John D. Stoffels *JDS*

in the U.S. stock market.

~~STRICTLY CONFIDENTIAL--HIGHLY SENSITIVE~~

After the Board meeting this morning, I made contact with Andrew J. Melton, Chairman of the Executive Committee of Smith, Barney (a colleague of Bill Grant). Mr. Melton put me in touch with the head of Smith, Barney's European operations who is based in Paris but was in New York for the day.

Smith, Barney deals with approximately 150 large institutional clients on an active basis; they are not a speculatively oriented house and have few individual foreign clients, but their institutional business is substantial by European capital market standards.

Total trading volume in Smith, Barney's foreign operations is up 73 per cent for the first quarter 1971 as compared with the first quarter of 1970. There has been a slight increase in trading volume by their foreign customers in the past two weeks, and this was attributed by them to investors' disenchantment with the liquidity (or lack thereof) in the Eurodollar market, a disenchantment that led them to the U.S. equity markets as the most liquid investment outlet for U.S. dollars. Throughout 1971 thus far, foreigners have been slight net buyers in the U.S. stock market.

An updated table of available Treasury data on foreign purchases of U.S. stocks is being prepared and will be sent to you on Monday.

cc: Messrs. Partee & R. Solomon



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 23, 1972.

To Governor Brimmer

Subject: _____

From Samuel Pizer *SP*

STRICTLY CONFIDENTIAL (FR)

This note relates to the question that you asked on Monday morning regarding the fund established by the German government to help finance German direct investments in the United States. I am attaching a copy of a statement giving the details of the establishment of that fund, which was part of the German-American offset agreement of August 1969. The assets in the fund are held at the New York Federal Reserve Bank, invested in Treasury bills and U.S. Government agency securities. The attached table shows the amounts held in that account. As you will see the account was built up to the full amount by June 30, 1971 (\$166 million). Since that time there has obviously been only a minor use of the fund, possibly because potential German investors did not find the terms on which they could obtain these funds sufficiently attractive.

Attachments

cc: Chairman Burns ✓
Governor Mitchell
Governor Daane
Governor Sheehan
Mr. R. Solomon
Mr. Bryant
Mr. Reynolds
Mr. Gemmill
Mr. Hersey
Mr. Katz
Mr. Norwood
Mr. Wood
Mr. Sammons
Mr. Irvine
Mr. Roxon
Mr. R. Smith
Mr. Promisel
Mrs. Junz



May 23, 1972

~~STRICTLY CONFIDENTIAL (FR)~~

KW Account at F.R. Bank of New York
(In millions of dollars)

Date	U.S. Treasury Bills	U.S. Govt. Agency securities	Total	Change
1970 - June 30-Nov. 30	56.0	--	56.0	
Dec. 31	111.6	--	111.6	55.6
1971 - Jan. 31	111.6	--	111.6	--
Feb. 28	111.0	--	111.0	-.6
Mar. 31	110.9	--	110.9	-.1
Apr. 30	110.5	--	110.5	-.4
May 31	110.4	--	110.4	-.1
June 30	166.0	--	166.0	55.6
July 31	166.1	--	166.1	.1
Aug. 31	166.2	--	166.2	.1
Sept. 30	136.5	29.0	165.5	-.7
Oct. 31	136.5	29.0	165.5	--
Nov. 30	135.5	29.0	164.5	-1.0
Dec. 31	135.5	29.0	164.5	--
1972 - Jan. 31	117.9	42.0	159.9	-4.6
Feb. 29	103.7	57.0	160.7	.8
Mar. 31	103.5	57.0	160.5	-.2
Apr. 30	103.5	57.0	160.5	--
May 18	103.6	57.0	160.6	.1



KREDITANSTALT FÜR WIEDERAUFBAU
6 Frankfurt am Main
April 2, 1970

Financing Contributions of Kreditanstalt für Wiederaufbau
for German Direct Investments in the U.S.A. under the
German-American Offset Agreement 1969/71

I. Introductory Remarks

Under the German-American Offset Agreement of August 19, 1969 an amount not exceeding the equivalent of DM 600 million will be made available by Kreditanstalt für Wiederaufbau (KfW) to assist in the financing of direct investments by German firms in the U.S.A. The relevant funds first raised by KfW on the capital market and invested for a limited period in U.S. Government or Government Agency securities can finally be converted into financing contributions to German direct investments in the U.S.A.

II. Object of Financing

Financing contributions may be made to direct investments by German firms in the U.S.A., in particular for investments of small and medium-sized firms that might not otherwise have ready access to the capital market.

Such direct investments may either be in the form of a new establishment of an enterprise in the U.S.A., which the German investor undertakes by itself or jointly with American partners, or the purchase of a stockholding in an already existing U.S. corporation. However, only new investments are eligible for financing under this program; refinancing of investments already made or under way will be excluded.

A further prerequisite for the granting of financing contributions is a well-scrutinized and profitable project, the proper execution of which is guaranteed.



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Enclosure # 1
of Frankfurt's A- 153

German Firms in the U.S.A.

Total: 176
of which Manufacturers: 46

Division by Branches:

Manufacturers of Machinery and Machine Tools

Plastics and Rubber Working Machinery	4	
Textile Machinery	10	
Mining and Oil Field Machinery	4	
Conveying Systems	3	
Wood Working Machinery	2	
Food Industry Machinery	3	
Wire Weaving and Fabricating Machines	2	
Paper and Packaging Machinery	4	
Cryogenic Machinery	2	
Construction Machinery	2	
Office Machinery, Cash Registers	4	
Graphic Machinery	2	
Metals and Metal Products		13
Steel and Iron	5	
Non-ferrous Metals	2	
Instruments and Fittings		9
Electrical and Electronic Industry		30
Components	4	
Consumer Goods, Household Appliances	14	
Electromedical Apparatus, Communications	4	
Motor Vehicles, Motors, Aircraft		8
Holdings		1
Chemical Industry		31
Plastics	7	
Pharmaceutics	5	
Essential Oils and Products	3	
Forwarding and Transportation		8
Chinaware, Glass, Ceramics		4
Garment Industry, Sewing Machines		8
Insurance		4
Photography		5
Engineering Offices		4
Mail Order Houses		1
Jewelry, Costume Jewelry		1
Publishing Houses		2
Coal		1
Banking, Security Trading		5

Discrepancies in the sub-totals are explained by the fact that many companies are active in more than one branch.

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III. Methods of Financing

In the interest of a most flexible and versatile handling of this financing instrument, the following contributions may be made to assist in the financing to be arranged by the relevant German investor:

- a stockholding of KfW, for a limited period, in the American subsidiary of the German investor,
- the granting of convertible loans, in special cases also the granting of other than convertible loans, to the American subsidiary of the German investor.

These measures may also be combined with one another.

The Offset Agreement stipulates that the financing contributions may not exceed 50 percent of the total investment to be arranged by the German firm, i.e. the KfW-portion must not exceed the amount to be paid by the German investor out of its own resources. For projects of firms having already made investments in the U.S.A. or belonging to a group of corporations that has already invested in the U.S.A., the financing contribution per investment will not exceed DM 32 million.

The financing contributions will on principle be given on a long-term basis. In general, the maximum will be a term of 10 years, in exceptional cases of up to 15 years. The other conditions will depend on KfW's procurement costs for raising the funds.

Contracting partner of KfW will in the case of loans be the American corporation in which the German investor interested in obtaining a financing contribution undertakes a direct investment. Supplementary contracts with the German investor will be required if the American firm cannot furnish adequate security for the loan; in the case of stockholdings for a limited period, these contracts will, inter alia, determine the time and the conditions of the subsequent purchase of such stockholding by the investor.

The scope of KfW's influence within the framework of such financing contributions will mainly depend on the risk involved and on the form of its engagement; KfW will not exercise any management functions.



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Enclosure # 2
of Frankfurt's A-153

3

IV. Procedure

Inquiries regarding the granting of financing contributions are to be addressed to KfW (6000 Frankfurt am Main, Palmengartenstrasse 5 - 9). Although it will on principle be the American subsidiary of the German investor that will become the borrower, resp. the firm in which KfW's stockholding will be held, it is nevertheless advisable for the German investor to establish contact with KfW already at an early stage of the investment project. The application may also be submitted via the investor's German bankers and should include details of the intended investment.

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February 19, 1973

To: Mr. Ralph Bryant

From: R. F. Gemmill

Subj: Mills' proposal to suspend U.S. taxes on interest and dividends of foreigners

As reported in the Washington Post (Feb. 17, 1972, page A-3), Rep. Mills proposed "an immediate temporary suspension of U.S. taxes on interest and dividend payments earned by foreigners on investments in this country." The purpose of this action would be to encourage an inflow of foreign capital. The following comments might be made on this proposal:

1) A temporary suspension of U.S. taxes on foreign investment income would not attract foreign long-term capital, since the benefits would only be temporary. Although such a measure could, in theory, stimulate inflows of short-term capital, it should be noted that interest paid to foreigners on bank deposits is already exempt from U.S. taxes (and will be until the Foreign Investors Tax Act comes into force at the end of 1975). Moreover it is not clear that it is in the U.S. interest to seek to stimulate short-term inflows (which might well have the effect of preventing needed exchange rate adjustment.)

2) A "permanent" removal of U.S. taxes from foreign investment income could attract some additional foreign long-term capital inflow. Although no quantitative estimate of the added inflow can be provided, it should be noted that: (a) most of the



foreign long-term investment in the United States at present comes from industrialized countries with which we have tax treaties;

(b) the treaties provide for relatively low rates of U.S. withholding tax on foreign income; (c) foreign taxpayers can generally claim credit against their foreign tax liabilities for any U.S. taxes withheld. Elimination of U.S. taxes on foreign investment income would benefit principally foreign investors from countries that do not have tax treaties with the United States and/or investors who pay no foreign taxes (and hence cannot claim credit for U.S. taxes paid.)

3) The Fowler-McKinney Task Force, established by President Kennedy in 1963 to recommend measures that might encourage foreign investment in the United States, considered the advisability of eliminating U.S. taxes on foreign investment income. The report makes no formal mention of this issue, but in my judgment discussions by the Task Force clearly indicated that the reason for not making a favorable recommendation on the issue was the desire not to establish the United States as a major tax haven.

4) A general tax exemption for foreign investors might increase the ease of tax evasion by U.S. residents who could acquire foreign addresses.

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OF THE
DEPARTMENT OF JUSTICE



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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date August 7, 1973

To Governor Robert C. Holland

Subject: _____

From Charles J. Siegman *CJS*

Ralph Bryant requested that I send you the attached note by Robert Gemmill responding to your July 17 memo to Chairman Burns.

Your memo has been circulated to others in the Division, and further thought is being given to the issues raised in the memo. In addition to assessing means of a shorter-term nature along the lines suggested in your memo that attempt to increase the attractiveness to foreigners of dollar holdings, several economists are evaluating longer-term proposals that aim to reduce the potential of undesirable shifts of foreign dollar holdings. As part of the Division's work dealing with international monetary reform, we are appraising the merits and limitations of proposals to consolidate outstanding dollar balances and proposals that would establish rules for the management of countries' currency reserves.

Attachment.

cc: ✓ Chairman Burns
Governor Daane



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date July 20, 1973

To Mr. Ralph C. Bryant

Subject: Initial reactions to

From Robert F. Gemmill

Gov. Holland's memo of July 17

(1) Tax deductions on returns paid to foreign owners of U.S. securities

a. Interest earned by foreigners on bank deposits (and, I believe, also on acceptances) is presently exempt from U.S. taxes, and will be until the Foreign Investors Tax Act comes into effect at the end of 1975. The effective date of the Act might be further postponed, but that would hardly appear necessary now if the policy objectives are short-term.

b. We could seek an amendment of U.S. tax laws to exempt other short-term instruments (Government securities), but I doubt that this would have any practical significance, given current interest rates.

c. Some problems involved in suspension of U.S. taxes on interest and dividend payments to foreigners are set forth in the attached memo (February 19, 1973) -- especially points #2-4.

(2) Possible reduction of reserve requirement on Eurodollar borrowings

a. Our view may depend in good part on our assessment at any particular time of the marginal source of funds to the Eurodollar market. Increased Eurodollar borrowings by U.S. banks might lead to an increased U.S. payments surplus on official settlements -- if, for example, Japanese were supplying funds to the Eurodollar market, and in the process reducing Japan's official reserves. Alternatively, if increased Eurodollar borrowing by U.S. banks raises Eurodollar deposit rates the main impact could be on the demand for EEC currencies, with a consequent improvement in the dollar exchange rates of these currencies.



(b) If we find that we do want to promote a firming of deposit rates in the Eurodollar market, I would prefer to seek it through a transfer of official balances from the market to the U.S., rather than through short-term borrowing by U.S. banks. Reduction in outstanding official placements in the market is more consistent with our long-term objectives than is an increase in interest-sensitive borrowings.

(3) Treasury borrowing in the Eurodollar market

(a) The Treasury and Ex-Im notes issued in 1971 had two purposes -- to mop up Eurodollars and to reinforce the incentives banks had to retain Eurodollar bases. Any Treasury borrowing at the present time would only serve to mop up Eurodollars. It might be regarded as a first bite of funding.

(b) If the Treasury is to issue special, high-interest dollar obligations to foreigners, in order to firm Eurodollar rates, as under #2 above, it would appear most appropriate for the Treasury to issue the securities selectively to foreign central banks -- facilitating the shifting of official funds from Eurodollar placements to U.S. securities.

With any special Treasury issue, it will be necessary to avoid having foreign private investors substitute that issue for existing dollar assets held in the United States -- and also to prevent similar shifting by U.S. investors. Limiting sale of the special Treasury issue to foreign central banks would help avoid these types of substitution; techniques would have to be developed (if possible) to avoid similar shifting of official balances from other U.S. instruments.



(4) Treasury borrowing of Euro-DM

a. Assuming that the Treasury acquired DM in the process (and is not issuing a dollar obligation repayable in DM), it will have marks available for sale on foreign exchange markets or for direct sale to the Bundesbank. Would we want marks for either of these purposes, and if so, wouldn't it be more advantageous to obtain them through swap drawings?

b. Say's Law may operate here. If we are concerned about shifts of foreign reserves from dollars to marks won't we merely compound the problem by issuing U.S. Government obligations denominated in marks? Such an instrument might well be more attractive to foreign central banks than Euro-DM deposits, or even than deposits in the Bundesbank.

c. Since the Euro-DM rate is merely the Eurodollar rate plus the forward premium or discount, wouldn't we be better advised to operate directly on either the Eurodollar rate or the forward rate (or both) rather than to sell DM obligations?



HENRY S. REUSS, WIS.
WILLIAM S. MOORHEAD, PA.
THOMAS M. REES, CALIF.
RICHARD T. HANNA, CALIF.
WALTER E. FAUNTROY, D.C.
ANDREW YOUNG, GA.
FORTNEY H. (PETE) STARK, JR., CALIF.
ROBERT G. STEPHENS, JR.,

U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON INTERNATIONAL FINANCE

OF THE

COMMITTEE ON BANKING AND CURRENCY

NINETY-THIRD CONGRESS

WASHINGTON, D.C. 20515

BILL FRENZEL, MINN.
JOHN B. CONLAN, ARIZ.
CLAIR W. BURGNER, CALIF.

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December 19, 1973

B4a

Dr. Arthur F. Burns
Chairman
Board of Governors
Federal Reserve System
Washington, D.C. 20551

Dear Chairman Burns:

We were so very pleased to have you testify
before the Subcommittee on International Finance.
You are a most cordial and expert witness.

During the hearings, the matter of foreign investment in the United States came up, and you said that you would be interested in seeing our staff reports on the subject. Accordingly, I enclose a copy of the two reports on Foreign Direct Investment in the U.S. and on Foreign Investment in U.S. Stocks and Bonds. The copy of the former report does not include the appendices, as they run to several hundred pages and have not yet been reproduced. However, we will furnish any that are of interest to you and will send you the complete report as soon as it is printed. We would certainly welcome any comments you may have on these reports.

Thank you again for appearing before the Subcommittee and for joining me for lunch afterwards. With best wishes and warm regards, I remain

Sincerely yours,

Henry
Henry B. Gonzalez
Member of Congress
Chairman

Enclosures (2)



FOREIGN DIRECT INVESTMENT
IN THE UNITED STATES

STAFF REPORT

of the

SUBCOMMITTEE ON INTERNATIONAL FINANCE
COMMITTEE ON BANKING AND CURRENCY

House of Representatives
93rd Congress, First Session

October 1973



6

FOREIGN DIRECT INVESTMENT
IN THE UNITED STATES

STAFF REPORT
of the
SUBCOMMITTEE ON INTERNATIONAL FINANCE
COMMITTEE ON BANKING AND CURRENCY

House of Representatives
93rd Congress, First Session

October 1973



Preface

Twice during the last two years the Subcommittee on International Finance was called on to approve a devaluation of the dollar. In the hearings on this legislation and in other hearings held by the Subcommittee, it became clear that improvement in the U.S. balance of payments and rehabilitation of the dollar are multifaceted problems and that devaluation alone is not sufficient.

One of the most significant problems facing the dollar is the overhang - the enormous foreign holdings of U.S. dollars. The overhang is a major cause of the dollar's problems in the foreign exchange markets and a major hurdle to monetary reform.

The rapidly increasing amount of foreign direct investment in the U.S. may represent an important means of reducing the overhang and improving the U.S. balance of payments, according to witnesses appearing before the Subcommittee. The boom in foreign direct investment in the United States may be partly the result of the dollar devaluations.

In view of the Subcommittee's concern about the dollar overhang and its interest in the effects of the dollar devaluations, the Staff of the Subcommittee examined foreign direct investment in the United States and prepared this material on the subject.

In the context of this report foreign direct investment means substantial ownership and control of complete business entities - factories, commercial facilities, corporations. The term does not include portfolio investment in debt and equity securities, which does not involve control of management decisions or active operation of a business.



FOREIGN DIRECT INVESTMENT IN THE UNITED STATES

CONCLUSION:

Foreign direct investment in the United States is booming. In 1973 it resumed the upward trend that began in 1966 but which was interrupted by international monetary crises in 1971 and 1972. Among the principal factors behind the increase in foreign direct investment in the U.S. have been the devaluations, and subsequent decline, of the dollar.

In the short run the increase in foreign direct investment in the United States will be beneficial to the U.S. balance of payments and aid in reducing the dollar overhang. But over the long term, foreign direct investment will have a negative effect on the balance of payments and result in a dollar outflow. This negative effect is the exact opposite of the effect of U.S. foreign direct investment abroad, which is a major positive contributor to our balance of payments.

The increase in foreign direct investment in the U.S. must be viewed as a boost for our balance of payments that is almost unrelated to the dividend and other outflows to foreigners on their investments here. The outflow will occur whether or not there is any new inflow, for the outflow is income to foreigners on previous investments. (In fact 1973 may be only the third year since 1962 in which new capital inflows exceed the dividend and other outflows.)

Fears of foreign domination or control of the American economy or industry are not realistic. The amount of foreign direct investment in the U.S. is now, and will continue to be, miniscule compared with the total U.S. economy and the total assets of U.S. business.

* * * * *

Introduction

In all of the talk about U.S. investment abroad, it is sometimes



overlooked that many foreign companies produce in the U.S. market and make long term investments in a wide variety of business enterprises. Foreign investment in the U.S. is certainly not as large as U.S. investment abroad, but it is growing rapidly. U.S. direct investment abroad has a book value of over \$90 billion versus only \$15 billion of foreign direct investment in the U.S. The investment of foreign capital in the U.S. is not a new phenomenon; it is the large volume of investment that is new. European and Japanese businessmen are flocking to the U.S. in record numbers - acquiring land, and industrial and service facilities; building new factories; buying divisions and subsidiaries of U.S. companies; and making tender offers for publicly owned companies.

This report examines:

- The amount of foreign direct investment in the United States.
- Why foreigners invest in the U.S.
- Who is investing in the U.S.
- The balance of payments effects of this investment.
- The role of States and the Federal Government in attracting foreign direct investment.

This report does not deal with foreign portfolio investment in the United States, i. e. investment in stocks, bonds and other securities. The term foreign direct investment covers those investments in which a foreign company builds new industrial or commercial facilities, acquires control of a going business, or otherwise makes a long term investment for the purpose of actively controlling and operating a business.

Amount of Foreign Direct Investment in the United States

Recent activity by foreign industrial firms, especially those from Canada, Japan and Germany, in acquiring plant sites in the United States indicates that the upward trend that began in 1966 and was interrupted in 1971 and 1972 has resumed in 1973. The value of foreign investment



in the United States at the end of 1973 may be as high as \$15.9 billion, an increase of \$1.5 billion over 1972. Of this \$1.5 billion increase, \$1 billion will be net capital inflows.

The value of foreign direct investment in the U.S. rose \$708 million in 1972 to \$14,363 million at yearend, following a rise of only \$385 million in 1971. The 1972 increase consisted of reinvested earnings of \$548 million and net capital inflows of \$160 million. The latter is a net of \$302 million in new investments and outflows of \$142 million in other capital accounts, mostly intercompany accounts.

The value of foreign direct investment in the U.S. increased substantially in the period 1962 to 1972, from \$7.4 billion at yearend 1961 to \$14.4 billion at yearend 1972. The rate of growth showed a marked increase after 1966: From yearend 1961 to yearend 1966, foreign direct investment grew an average of \$332 million per year, while from yearend 1966 to yearend 1972, it grew an average \$893 million per year. These figures correspond to annually compounded growth rates of about 4 percent and 8 percent respectively. (U.S. direct investment abroad has been growing at a rate of around 10 percent). Additional data on the historical trends of foreign direct investment in the U.S. may be found in the attached excerpts from the Survey of Current Business published by the Department of Commerce.

The two main components of the annual addition to the foreign direct investment position in U.S. enterprises have been net capital inflows and reinvested earnings; valuation adjustments have been small. Of the approximately \$7 billion added to the value of foreign direct investment in the years 1962 through 1972, \$2.7 billion came from net capital inflows while \$4.3 billion were reinvested earnings, and there were about \$100 million in valuation adjustments.

Why Foreigners Invest in the U.S.

Why should foreigners invest here, and why should there be



such a dramatic increase in the amount of foreign direct investment in the United States? In broad terms, Europeans and Japanese companies have been seeking to establish themselves in the United States, just as American companies have moved abroad to be closer to the markets for their goods and services.

However, the most important reason for the increase in direct investment has been the devaluation of the dollar. Successive devaluations of the dollar and the decline in the dollar since the last devaluation have sharply boosted the purchasing power of many foreign currencies in terms of the dollar.

There are a great many other reasons for the increase in foreign direct investment in the U.S., including:

- A higher rate of inflation abroad. McGraw Hill Publications Co. forecasts that overall inflation in 1974 will be 6.6 percent in the Common Market, 7.5 percent in Japan and 4.0 percent in the U.S. The virus of inflation is spreading worldwide, but it remains lower in the U.S.

- Shortage of labor in some countries. In recent years Northern European firms have had to import labor, principally from Southern Europe.

- Improvement in U.S. productivity.

- Shortage and high cost of land for expansion abroad. U.S. plant-site land costs are lower than in many areas located in more densely populated nations.

- The rise of protectionism in the United States and the threat of U.S. import restrictions and other trade barriers. (U.S. companies have made many investments abroad for precisely this reason, e.g. in the case of the Common Market.)

- The persistent U.S. balance of payments deficit, the result of which is the enormous foreign holdings of dollars. Investment in the U.S. provides a good outlet for these dollars owned by foreign companies.

- Rising labor costs abroad. Hourly compensation in the U.S.



has increased at an annual average rate of 6.7 percent since 1967. In Canada hourly wage rates have risen 8.1 percent since 1967. In Japan, they are up 17 percent. Today the average West German factory worker makes \$1.00 less than his American counterpart. Two years ago the wage differential was \$2.00, according to the Bureau of Labor Statistics. Another way of measuring the extent of the change is to convert 1972 unit labor costs into dollars at the exchange rates prevailing as of June, 1973. From 1970 U.S. unit labor costs increased by only 3 percent. On the other hand, Italian costs went up 36 percent, French costs 44 percent, Belgian costs 52 percent, and both Japanese and German unit costs 60 percent.

-A declining stock market which has put the cost of buying the earning power of many American firms at bargain basement levels. Many U.S. stocks are selling today at record low prices in relation to earnings. Foreigners can therefore buy cheap stocks with cheap dollars.

-Countries which have policies of providing incentives for companies to invest abroad. Japan gives tax breaks to companies investing in new U.S. ventures.

-The 1967 Securities and Exchange Commission action, in which it modified its rules regarding financial reporting of foreign-owned U.S. firms. The new regulations allow such firms' accounting practices to deviate from those commonly employed by U.S. firms in order to mesh better with those of their foreign parents.

-The merger movement among European firms. Given the scale of the U.S. economy, the size of the required investment in the U.S. is large by European standards. The larger, merged firms have been better able to meet the U.S. market challenge since the late 1960's.

In its brochure on foreign direct investment, the Bank of America identifies other advantages and reasons for foreigners investing in the U.S.:



-Facilities in the United States put non-U.S. firms within the world's richest market and enhance their ability to compete for U.S. business.

-Firms with facilities in the United States have more ready access to the large U.S. equity and debt markets than those in overseas locations.

-Numerous industrializing communities in the United States have programs to encourage new industry by assisting in its financing, location and employee training.

-It gives non-U.S. firms a close-up look at methods being formulated to respond to the environmental and consumer-protection concerns now arising in the United States and aids overseas management to prepare for the time when these issues will be primarily considerations in their home countries.

-It is easier for such firms to keep abreast of and to incorporate new technology developed in the United States. (Of course, the foreign firms also bring technology when they come into the U.S.)

-It enables overseas firms to become privy to and utilize management and marketing techniques originating here.

Of course there are some fears of foreign companies about investing in the U.S., including:

-Antitrust laws, despite assurances from the U.S. Government that the laws' intent is to preserve - for foreigners and Americans alike - a competitive, non-cartelized economy.

-Securities and Exchange Commission reporting requirements, though this fear has eased since 1967, when the SEC modified its rules.

-Unions. European and Japanese companies, which are more accustomed to congenial attitudes of company unions, are wary of militant U.S. unions.

Immigration regulations. Foreign businessmen have run into some difficulty bringing managerial and technical workers to this country.



-Foreign companies think that the U.S. is too big a market. They think in terms of national markets, the kind that they are used to. In its assistance programs, the Department of Commerce shows foreign companies how regional and area markets within the U.S. market can be worked out, where every point in that market can be within one day's shipping to principal customers.

Who is Investing in the United States

At the end of 1972 the country with the largest direct investment in the U.S. was the United Kingdom, with \$4,581 million out of a total of \$14,363 million. In second place was Canada, with \$3,612 million. Over 84 percent of the total foreign direct investment in the U.S. is held by four countries: United Kingdom, The Netherlands, Canada and Switzerland.

At yearend 1972, the foreign direct investment in the United States was as follows:(in \$ millions):

Canada	\$ 3,612
Europe	10,441
United Kingdom	4,581
European Economic Community	3,874
Belgium & Luxembourg	307
France	321
Germany	807
Italy	108
Netherlands	2,331
Other Western Europe	1,986
Sweden	254
Switzerland	1,595
Other	138
Japan	-132
Latin America and other Western Hemisphere	298
Other	145
Total	<u>\$14,363</u>

Though Japan has greatly increased its investment in 1973, it was not a major factor through 1972. Japan shows a negative balance



in the above table, as debt repayments in 1971 statistically pushed the value of their investment to below zero from \$229 million in 1970. Despite new inflows in 1972, the balance remained negative at yearend. Omitting the loans made by Japanese parent companies to their U.S. subsidiaries, the United States-Japan Trade Council estimates Japanese direct investment in the U.S. to have been \$350-500 million. at yearend 1972.

Despite the acceleration in investment here by foreigners, there has been little change over the period 1962-1972 in the distribution of foreign direct investment by country of ownership.

Manufacturing comprises 50 percent of the total foreign direct investment, while petroleum accounts for 23 percent and insurance and other finance, 17 percent. In 1962, the respective percentages were 38, 19 and 25 percent.

At yearend 1972 the industry distribution was as follows (in \$ millions):

Petroleum	\$ 3,243
Manufacturing	7,228
Insurance and Other Finance	2,411
Trade	523
Other	958
	<hr/>
	\$14,363

Which foreign companies are investing in the United States? The Department of Commerce publishes a "List of Foreign Firms with Some Interest/Control in American Manufacturing and Petroleum Companies in the U.S." This list (attached) shows investments from 21 countries and approximately 600 foreign companies, which own or have major investments in over 900 U.S. companies. The list does not include American subsidiaries of foreign companies in finance, banking and insurance, nor trading companies established solely for sales and service.



The Department of Commerce list continues to expand at a rapid rate. For example, in September, Kawasaki Motors Corp. of Japan announced plans to build a \$20 million plant in the U.S. to manufacture motorcycles. And Volvo of Sweden announced plans to build a \$100 million automobile assembly plant in Chesapeake, Virginia.

Most European owned companies are in the East; most Japanese investments are in the West, notably in Alaska. During the past decade, however, the fastest growth in foreign ownership has been in the South. New York leads the states in foreign owned or controlled firms, followed by New Jersey, South Carolina, Pennsylvania and California.

Most of this report deals with the kind of foreign direct investment where a foreign company builds a new manufacturing facility or otherwise makes an investment to begin a new product line or introduce a product from its own country. However, there has been a dramatic increase in 1973 in another type of foreign direct investment: acquisition of an American company by tender offer or merger, or by purchasing a subsidiary or division of a company. As discussed elsewhere in this report, among the principal reasons for the increase in this type of investment are the low prices in the stock market and devaluations of the dollar. Among the investments made in this manner have been the following:

- A sharply contested tender offer by Liquifin AG, a unit of Liquigas S.p.A., the Italian industrial and petrochemicals company, for 52 percent of the shares of Ronson Corp.

- A \$105 million cash acquisition by Nestle Alimentana SA, the Swiss-based multinational food-products company, of the Stouffer Corp. division of Litton Industries.

- A \$182 million acquisition by an American subsidiary of British-American Tobacco Co. of 23 percent of the shares of Gimbel Brothers, Inc., the department store chain.



-The purchase of 44.9 percent of Franklin Stores, a major discount chain, by Slater-Walker, Ltd. of London.

-A \$290 million takeover bid by Canada Development Corp., an agency of the Canadian Government, for Texasgulf Inc. Texasgulf is fighting this bid in the courts.

-The purchase of Olin Corp.'s aluminum division by the Swiss-controlled Consolidated Aluminum Corp.

-The \$21.8 million agreement whereby United Dominions Trust Ltd., Britain's largest financial house, acquired 90 percent of Commercial Trading Co., a privately owned, New York based commercial financing firm.

-Britain's Lloyd's Bank is moving into California with a \$115 million agreement to purchase nearly all of the stock of the First Western Bank and Trust Co.

The Japanese are closely trailing the British in investment aggressiveness. Besides buying up real estate, vast stretches of timberland, coal and copper mines in the U.S., the latest Japanese venture involves an agreement to purchase for \$125 million, 50 percent of the aluminum processing subsidiary of American Metal Climax Inc.

Four Japanese companies are estimated to have an investment of about \$126 million in timber operations in Alaska alone. Japanese companies, as pointed out in the attachments, are eagerly investing in hotels, golf courses and other resort properties, farmland, and land for industrial parks, warehousing operations, fast-food restaurants and residential housing.

The Japanese have not yet joined the British in the tender offer approach to direct investment, as it has not been the traditional Japanese business style.

The Middle East oil producing countries are beginning to accumulate large amounts of dollars from sales of petroleum, and they could



amass a hoard of over \$100 billion by 1980 according to many estimates. These Middle East countries are not a factor in foreign direct investment in the U.S. due to the political climate and their usual preference for portfolio investment. How much these countries may invest in the U.S. is as yet unknown.

To complete the picture of foreign direct investment in the United States would be activity by Communist countries - the Soviet Union is reportedly investing heavily in real estate in the Washington metropolitan area, as well as in the San Francisco bay area.

Balance of Payments Effects

There are several ways in which foreign direct investment in the United States affect the balance of payments.

First there is the inflow of dollars for the investment itself. In the balance of payments terminology this is described as new investment, consisting of the first reported capital inflow to establish or acquire a new company or operation in the U.S. and the cost of acquisition of additional shares of existing companies. The average annual amount of new investment in the period 1962-1972 was \$264 million, and the amount in 1972 was \$302 million.

However the key figure in the balance of payments is not new investment but net new investment (or net capital flow), which is a net of the new investment and various outflows including such items as loan repayments and intercompany accounts. The net new investment by foreigners averaged \$250 million per year in the period 1962-1972. The estimate for net new investment in 1973 is \$1 billion, but it could vary considerably from this figure depending on the outcome of several large deals which are still being negotiated or litigated.

The net new investment inflow for the period 1962-1972 was:

1962	\$132 million	1967	258
1963	-5	1968	319
1964	-5	1969	832
1965	57	1970	1,030
1966	86	1971	-115
		1972	160



The decline in 1971 is attributed to the international monetary crisis that occurred in that year causing potential foreign investors to postpone their investments. The low amount of investment in 1972 was a result of the continuing international monetary uncertainty.

The second important factor in foreign direct investment in the U.S. is the outflow of dollars to foreign countries in the form of dividends and other payments. Foreigners have been investing in the United States for many years, and as a result there is an outflow of dollars in dividends, branch earnings and interest payments. This outflow, which can be termed "foreigners' balance of payments income", averaged \$470 million per year over the period 1962-1972.

Most current analyses of foreign direct investment in the U.S. say that in the short run such investment will have a positive effect on the U.S. balance of payments. However in the long run repatriated dividends and other payments will more than offset these increased flows resulting in a negative effect on the balance of payments, as has been the case with the United States abroad.

In 1972 the U.S. new foreign direct investment abroad was \$3.4 billion while earnings on all U.S. investment abroad were \$10.4 billion, a \$7 billion positive effect on the U.S. balance of payments. This large income returned to the U.S. was a result of the over \$90 billion in investments U.S. companies have abroad.

Hence by the nature of the investment process, foreign direct investment in the U.S. will eventually be a negative factor in the U.S. balance of payments. If in the long run U.S. investment abroad has been good for our balance of payments, then it is clear that foreign investment in the U.S. will be in the long run bad for our balance of payments. The magnitude of U.S. investment abroad is so large that income on our investments abroad will always exceed foreigners' income on their investments here. Hence the overall effect of direct in-



vestment in both directions will remain positive.

The overall effect of foreign direct investment in the U.S. is the net of (a) net new investment and (b) foreigners' balance of payments income. The total net new investment in the U.S. for the period 1962-1972 was \$2.7 billion while the foreigners' balance of payments income was \$5.2 billion. Therefore there has been a substantial net outflow as a result of foreign direct investment in the last eleven years, as shown in the following table (outflows are shown as minuses):

	<u>Outflows - Foreigners Balance of Payments Income</u>	<u>Inflows - Net New Investment</u>
1962	\$ 2242 million	\$ 132 million
1963	-284	-5
1964	-269	-5
1965	-367	57
1966	-436	86
1967	-443	258
1968	-468	319
1969	-518	832
1970	-552	1,030
1971	-739	-115
1972	-857	160
totals	<u>\$-5,175</u>	<u>\$2,749</u>

In 1973 the foreigners' balance of payments income could be around \$900 million. Therefore, with net new investment of around \$1 billion, the overall effect of foreign direct investment in the U.S. on our balance of payments in 1973 may be a positive \$100 million.

As shown above, during the period 1962-1972 the overall effect of foreign direct investment on our balance of payments was negative. However with the large increase in the amount of foreign investment, the inflows of new investment into the U.S. should exceed the outflows for some years to come. At some point the outflows will begin to exceed the inflows, as has been the case for other countries which have had U.S. investment.



It is very important to keep the differences in the inflows and outflows clear. The outflows (foreigners' balance of payments income) will occur whether or not there is any inflow (net new investment). The outflow is income on previous investments. Therefore the estimated net new investment of \$1 billion in 1973 is correctly viewed as an almost unrelated boost in the balance of payments and a reduction in the foreign overhang of dollars.

The U.S. balance of payments also benefits from the import savings that usually occur when the foreign firm begins manufacturing products here in lieu of exporting to the US. A good example of this effect is the planned Volvo automobile assembly plant. Volvo automobiles for the U.S. market will be produced here rather than exported from Sweden to the U.S. (though initially most of the parts to be assembled will be brought into the U.S.).

Another related effect is that exports may result from new direct investment. In the case of Volvo, automobiles may be exported to other countries in the Western Hemisphere from the U.S. rather than from Sweden. Hence the new Volvo plant and similar plants may reduce imports and also increase exports. But specific data on the effects of import substitution and new exports are not available in U.S. balance of payments statistics .

Role of States and the Federal Government

The efforts of the Department of Commerce are mainly directed at encouraging and assisting foreign direct investments in the United States by the industrialized nations- Western Europe, Canada and Japan. The Department of Commerce has two Industrial Development Attaches in Europe to spearhead this program. One is headquartered in Paris, with responsibility for activities in Germany, France, Switzerland, Austria, Italy and Spain. The other is in Brussels, handling United



Kingdom, Belgium, The Netherlands and all of Scandinavia. Also the commercial sections of the U.S. embassies in these nations are actively working with individual investors as well as doing local promotional work aimed at increasing the number of potential investors.

The Department of Commerce feels that their most productive effort is the "Invest-in-U.S.A." conferences, which they arrange in Europe and Japan. These conferences are designed to provide potential investors with basic facts about investing and doing business in the United States and to provide a forum in which State industrial development agencies can have face-to-face meetings with the potential investors.

The Department of Commerce also organizes State Reverse Investment Missions. These missions, often led by the State's Governor, are made up of experts from the States who are capable of providing fairly detailed data pertaining to industrial plant locations. The missions prospect for new investors, as well as follow up on leads provided by the Department of Commerce.

The Department of Commerce does not encourage or have anything to do with foreign tender offers or takeovers of American companies, an activity which has increased considerably in 1973.

The Department of Commerce does not recommend that special incentives to foreign investors be offered by the Federal Government. In view of the rising trend of foreign investment in the U.S. and the awareness of industrial firms in Canada, Japan and Europe of the need to produce here in order to maintain their market positions and to produce here inside potential trade barriers, Commerce officials feel that incentives are unnecessary.

Most states offer a wide variety of incentives to companies to locate in their states (not just foreign companies, but U.S. companies as well). The incentives include tax credits and exemptions, worker training and recruitment, financing assistance, and plant site location services,



including state-built industrial parks. Some states maintain permanent offices in Europe to scout potential investors.

As stated in the Council on International Economic Policy Annual Report (March 20, 1973):

The United States has always had a policy of welcoming foreign investment. While total foreign holdings here amount to less than half of comparable American investment abroad, these inflows of capital are nevertheless regarded as having a significant and beneficial impact on our income, employment and our balance of payments.

There are no monetary exchange controls on such foreign investments and no requirements limiting the repatriation of capital or of earnings. Our embassies abroad, as well as special missions from individual states, actively encourage foreign direct investment in this country.

U.S. antitrust laws are sometimes cited as restrictive of foreign investment. Like other U.S. laws, however, antitrust regulations apply with equal force to all U.S. domiciled firms, regardless of the nationality of their ownership.

The Department of Commerce prepared an "Informal Survey of Legal Provisions Affecting Foreign Investment in the United States" in March, 1971 (attached). This survey points out that the basic general policy of the United States is to admit and treat capital on a basis of equality with domestic capital. However, in examining possible variations from this general policy, it should be noted that a substantial portion of the jurisdiction over doing business in the United States belongs to the states. Federal laws concerning foreign investment in the U.S. generally apply to enterprises considered sensitive either because of a close relationship with national defense, because they play a fiduciary role, or because they involve the exploitation of certain natural resources. Such enterprises include fresh water shipping, domestic radio communications, domestic air transport, hydroelectric power and mineral exploitation on Federal lands.



As the level of foreign direct investment in the United States increases, there may be a rising concern that foreigners may take over or dominate the U.S. economy and industry. But in fact fears of foreign domination or control are unfounded.

Foreign direct investment in the U.S. is miniscule compared with the total U.S. economy and will remain so. For example, gross private domestic investment in the U.S. (from the GNP accounts) in 1972 was \$178 billion, while net new investment from abroad is expected to be around \$1 billion in 1973. The total foreign investment in the U.S. of \$14.4 billion at yearend 1972 is insignificant compared with total assets of all corporations in the U.S. of \$2.4 trillion and total net worth of \$728 billion (as of 1969, the most recent figures available).

The value of foreign direct investment in the U.S. may grow at an annual rate of around 8 to 10 percent on a base of \$15 billion. At this rate of growth it does not seem likely that foreigners will ever come close to controlling U.S. industry. In fact foreigners may have more cause for concern about U.S. investment abroad, which is growing at an annual rate of close to 10 percent on a 1973 base of over \$90 billion.

There is certainly the possibility that foreign companies by investing in the U.S. may at some time control large shares of some markets in the U.S. (In fact in some cases now foreign companies have substantial shares of markets without direct investment, e.g. the export of compact cars to the U.S. and raw materials such as nickel of which the U.S. does not have sufficient supplies). But is unlikely that foreign companies could control many markets or industries given the enormous size of the U.S. economy compared with the potential amount of foreign investment in the U.S.

Americans are now getting the opportunity to see what other countries have experienced - investment from abroad. For years U.S. business has invested abroad and as a result has leading market shares and percentages of invested capital in many industries in many foreign



countries. It is likely that the reverse will happen on a lesser scale in the United States.

There is no cause for alarm that foreign interests will dominate or control the American economy. U.S. investment abroad has been good for the United States and for the world economy; foreign investment in the United States will be good for our economy and the world's.

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FOREIGN INVESTMENT IN U. S. STOCKS AND BONDS

STAFF REPORT

of the

SUBCOMMITTEE ON INTERNATIONAL FINANCE
COMMITTEE ON BANKING AND CURRENCY

HOUSE OF REPRESENTATIVES
93rd CONGRESS, FIRST SESSION

November 1973



P R E F A C E

During the last two years the world has been in a state of monetary crisis - seemingly a perpetual crisis. The U. S. dollar has been a major cause, participant, and victim of this crisis. Twice during this two-year period the Subcommittee on International Finance has processed legislation modifying the value of the dollar. And during this period the Subcommittee has held special hearings to review the progress toward monetary reform - a reform revolving to a great degree around the problems of the dollar. In fact, the key to the entire problem of a satisfactory monetary system (and reasonable trade arrangements as well) is the rehabilitation of the dollar.

The United States has been having serious balance of payments problems, resulting in enormous foreign holdings of dollars. Current forecasts of the balance of payments situation are not optimistic about a reduction in the amount of foreign held dollars. This "overhang" of dollars is a hurdle to monetary reform and an irritant in the foreign exchange markets.

The problems of the dollar cannot be solved easily or with a single action. While the solutions to the problems can be complex, the essence is simply - bring the dollars home! The U.S. securities markets offer outstanding possibilities to attract some of these foreign owned dollars and thereby reduce the overhang.



FOREIGN INVESTMENT IN U. S. STOCKS AND BONDS

CONCLUSION

The Staff of the Subcommittee on International Finance recommends legislation to eliminate the withholding tax imposed by the United States on interest and dividend payments to foreigners. Removal of this tax will play a significant role in the rehabilitation of the U. S. dollar by reducing the enormous overhang of foreign-owned dollars. It may also attract new foreign capital into important housing and other securities markets which are short of capital.

* * * *

Since the 1930's the United States has imposed taxes at a rate of 30% on interest and dividend payments to foreigners. This tax has inhibited the flow of capital into the United States and has produced little tax revenue. In a letter to Chairman Gonzalez, Mr. Nicholas A. Rey, Vice President of Merrill Lynch, Pierce, Fenner & Smith wrote that elimination of the tax would be an important stimulus to significantly increased flows of foreign long-term capital to the United States. Elimination of the tax on interest and dividend payments to foreigners would:

- Help bring home substantial amounts of the over \$80 billion held in private hands abroad.
- Yield significant benefits to the U. S. balance of payments.



-Increase the flow of funds into the U. S. real estate and building industries by making such fixed income investments as mortgages and real estate investment trust shares attractive to foreigners.

-Increase foreign investments in U.S. corporate bonds and yield oriented common and preferred stocks such as those issued by U. S. utility companies.

-Tend to reduce interest rates in the United States.

-Help to re-establish the United States as an international financial center by making U.S. investments competitive with the Eurodollar and Eurobond markets which are not subject to withholding taxes.

Paul Heffernan wrote in The Money Manager of July 23, 1973:

"As for stocks and bonds issued in the United States under the Securities and Exchange Commission surveillance, the 30% withholding tax enforced by Uncle Sam on interest and dividend income to foreigners has become an anachronistic deterrent to any reduction of the overhang of foreign-owned dollars that right now is admittedly the most formidable barrier to the dollar winning lasting stability in the foreign exchange market. This depression-born official tax psychosis continues to prevail, seemingly unmoved by the reasons for the collapse of the dollar in the international market and the need for applying resuscitatives when called for."

The United States imposes taxes at a flat 30% rate on gross interest and dividend payments to foreigners. The tax is withheld at the source of the dividend or interest payment. The 30% rate has been



reduced or eliminated for residents of a number of industrialized countries with which the United States has double taxation treaties. In no case is the tax rate below 15% for dividends even for countries for which the tax treaties have entirely eliminated the withholding tax on interest income.

The United States does not have tax treaties with many of the countries which are potentially significant sources of investment capital for the U. S., e.g., Hong Kong and countries of the Middle East and Latin America. And it is doubtful that the U. S. will have tax treaties with these countries in the foreseeable future.

Many market observers feel that without this tax, foreign held dollars would flow more readily into the U. S. securities markets. The U. S. markets have a breadth, depth and variety of investment media found nowhere else in the world. In the last fifteen years, foreigners have been net purchasers of U.S. corporate securities in every year but two. However, foreigners have purchased stocks principally for their growth potential (there is no capital gains tax for foreigners). Removal of the withholding tax on dividends may therefore greatly increase capital flows into U.S. equities since many foreigners are also yield oriented.

Foreigners have made only minimal investment in interest-bearing debt securities in the United States. Those foreigners wishing to purchase fixed income dollar investments can invest in the Eurodollar market where there is no withholding tax. Removal of the U.S. withholding tax would permit the purchase of a variety of debt securities including corporate bonds, convertible bonds and mortgages.



It is impossible to make an accurate prediction of the extent to which sales of U.S. securities to foreigners would increase if withholding taxes were removed. According to the New York Stock Exchange, one of the leading brokerage firms took a survey of its international office managers on this issue. Almost all of the managers felt significant increases in sales of U.S. corporate stock to foreigners would result. The estimated increases ranged from 10 to 30 percent. Indications were that removal of the tax would open a new market for foreign purchases of U.S. utility common and preferred stocks.

While there is no guarantee that removal of the tax will result in a greatly increased flow of funds, the cost to the U.S. Government would be insignificant. Total income from the withholding tax was less than \$200 million in 1969, the latest year for which data is available. And of this amount only about \$20 million was attributable to the tax on interest payments. Much of the remaining \$180 million may be due to inter-corporate dividends. Hence, the tax collected on dividend and interest payments to foreign portfolio investors must be considerably less than \$100 million. Revenue losses from elimination of the tax may well be offset by increases in the income tax collected, as greater income is generated in the U. S. economy from the new investment here.

It may be argued that elimination of the withholding tax would be unfair to the ordinary U.S. citizen, who pays income tax on dividends and interest income. However, under the international principles of taxation, individuals should be subject to tax in their country of



residence. The U.S. has already removed the tax for citizens of some countries, so complete elimination of the tax would not be a real change in tax principle. The benefits to be gained from removal of the tax should far outweigh any feelings of discrimination by U.S. citizens.

If the U.S. withholding tax on foreigners is lifted, other countries will not necessarily follow suit. U.S. citizens may continue to be taxed by foreign countries on their dividends and interest income. Unilateral elimination of the withholding tax may reduce the leverage of the U.S. in obtaining similar tax benefits for U.S. citizens in foreign countries. However, it would not reduce the possibility of negotiating thorough tax treaties in the long run with those countries which want treaties.

A popular argument against removal of the tax may be that it would promote tax evasion by U.S. citizens, according to Merrill, Lynch, Pierce, Fenner & Smith. People may argue that removal of the withholding tax would tend to stimulate tax evasion by Americans who would send their money abroad and reinvest it in the United States. It is highly doubtful that a 15 to 30% withholding tax can be much of an obstacle to tax evasion when compared with U.S. income tax rates. Moreover, the real incentive already exists in that there is no capital gains tax on foreign investment in the United States. The way to prevent tax evasion is through continued and enhanced enforcement of the law in the United States, improved reporting requirements by U.S. citizens and through the exchange of information with tax authorities of other countries which is built into U.S. tax treaties. In addition, it should be possible



to draft the withholding tax elimination legislation in such a way as to have the taxes reapply at the discretion of the President after a reasonable period of time to countries which are unwilling to exchange tax information with the United States.

Critics may raise the argument that removal of the tax would encourage the takeover of U.S. companies by foreigners. This is unlikely since most corporate takeover strategies would not be based on just the earning of dividends, which would be sent home to the foreign country. The profit and other financial calculations made by a foreigner in deciding whether to take over a U.S. business would not depend on the existence or removal of the tax. In fact in many cases foreigners would reinvest the profits in the business in the U.S. rather than repatriate them in the form of dividends to their own country where they would be taxed. However, to meet the objective of attracting foreign held dollars into U.S. stocks and bonds, it would not be necessary to remove the withholding tax on dividends paid by subsidiaries to their foreign parent companies.

There may be disadvantages in removing the withholding tax, but these seem insignificant compared to the potential benefits. The positive effect on the U.S. balance of payments would range from hundreds of millions to billions of dollars. An increase of just 30% above the net amount of stocks purchased in 1972 would result in a new inflow of \$680 million. The investment by foreigners in interest-bearing securities has been so low in the past that it is difficult to extrapolate in calculating a potential increase. But given the size of the Eurobond market and the



amount of foreign-owned dollars which would be attracted to interest-bearing securities, the increase would certainly be in the hundreds of millions of dollars.

These dollars would be attracted into the United States at a low cost. If the withholding tax on intercorporate dividends were not removed, the cost to the Treasury may be less than \$100 million. Yet the taxpayers should benefit by much more than this through the reduction of interest rates, the flow of funds into the mortgage and utility securities markets, and the many positive effects of a stronger dollar.

* * * * *

Attachments

Letter from Nicholas A. Rey, Vice President, Merrill Lynch, Pierce, Fenner & Smith Inc. to Chairman Henry B. Gonzalez, Subcommittee on International Finance. August 15, 1973.

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August 15, 1973

The Honorable Henry B. Gonzalez,
Chairman
Subcommittee on International Finance
of the Committee on Banking and Currency
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

In Mr. Anderson's absence I am taking the liberty of responding to your letter of August 3 concerning the U.S. withholding taxes on interest and dividend payments to foreigners.

We strongly believe that elimination of these taxes would be an important stimulus to significantly increased flows of foreign long-term capital to the United States. It would:

- help to bring home substantial amounts of the over \$80 billion held in private hands abroad;
- yield significant benefits to the U.S. balance of payments;
- increase the flow of foreign funds into the U.S. real estate and building industries by making such fixed income securities as mortgages and real estate investment trust shares attractive to foreigners;
- increase foreign investments in U.S. corporate bonds and yield oriented common and preferred stocks such as those issued by U.S. utility companies;
- tend to reduce interest rates in the United States;



Mr. Henry B. Gonzalez
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-- help to re-establish the United States as an international financial center by making U.S. investments competitive with the Eurodollar and Eurobond markets which are not subject to withholding taxes.

1. The Taxes

As you may know, since the 1930's, the United States has imposed taxes withheld at the source at a flat 30% rate on gross interest and dividend payments to foreigners. However, the 30% rate has been reduced or eliminated for residents of a number of industrialized countries with which the United States has double taxation treaties. Attached is a list of the countries with which the U.S. has treaties and the applicable withholding tax rates. The average U.S. withholding tax is around 15% for residents of these countries.

The U.S. does not have treaties which reduce the tax with the vast majority of countries around the world among which are numbered some very substantial sources of funds for investment in the United States, for example, Hong Kong, and the countries of Latin America and the Middle East. In view of the history of unsuccessful attempts to negotiate treaties with many of these countries, it is doubtful that the withholding tax rates could be reduced in the foreseeable future through a negotiation of treaties with a significant number of additional countries.

While the Swiss tax treaty reduces the rate to 15% on dividends and 5% on interest, these rates apply only to Swiss residents. Thus, under the treaty, when an Arab or Latin American invests in the U.S. through his Swiss account, Switzerland withholds additional amounts and remits them to the United States in order to bring the tax paid by such investors to the 30% rate. It is important to note that the vast majority of funds available in Switzerland for investment in the United States is for the account of non-Swiss residents.



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In many cases, foreign nationals can credit against their domestic tax bills withholding taxes paid to the United States. However, the procedures involved are cumbersome and, therefore, do not facilitate the free flow of funds to the United States particularly in the case of individual foreign investors.



2. The Effects of Elimination

While it is not possible to project an exact dollar figure for the increase in investment in the U.S. which would result from removal of the taxes, it could well be several billions of dollars over time. As you know, foreigners already have a strong appetite for U.S. equities. Their net purchases of U.S. common stocks were \$697 million in 1970, \$836 million in 1971 and \$2.268 billion in 1972. However, these stocks have generally been bought for their growth potential. There is no U.S. capital gains tax applicable to foreigners. Removal of the withholding tax on dividends would greatly increase flows into U.S. equities as substantial numbers of foreigners are also yield oriented. In particular, it would open several important new markets for foreign purchasers including utility common and preferred stocks and real estate investment trust shares, two industries which are in dire need of new sources of funds, if their ever increasing capital expenditures are to be financed at reasonable costs.

Investments by foreigners in interest-bearing debt securities have been minimal. While accurate statistics which would measure these flows are not available, the closest approximation indicates that net foreign purchases of U.S. bonds were \$347 million in 1970 and \$233 million in 1971. In 1972 net sales of \$81 million were made.¹ These purchases are so low to a considerable degree

¹These figures are from line 67, Table 6, U.S. balance of payments article, Survey of Current Business, June 1973, U.S. Commerce Department. Both the Treasury and Federal Reserve monthly bulletins give statistics which seem to show substantially higher foreign bond purchases. It is important to note that these latter statistics include purchases of Euro-bonds issued by U.S. companies and U.S. bonds acquired by international organizations, neither of which are subject to U.S. withholding tax and, therefore, must be excluded for this purpose.

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because of the U.S. withholding tax, since foreigners interested in fixed income dollar investments can buy Euro-dollar bonds which carry no withholding tax. Dollar denominated Euro-bond sales in the past five years have averaged \$2.4 billion and were \$3.9 billion in 1972. Removal of the tax on interest, would for the first time permit substantial purchases of U.S. debt securities including corporate straight and convertible bonds as well as mortgages and government bonds. This will occur even if interest rates in the U.S. are somewhat lower than abroad because there is a shortage of first-class, liquid investments outside the United States.

3. Implications for U.S. Tax Policy

The effect on U.S. Treasury revenues of the removal of the taxes would be slight. Total income from these taxes was less than \$200 million in 1969, the latest year for which data is available. Of this amount only about \$20 million was attributable to the tax on interest payments, an indicator of the small size of foreign investment in interest bearing U.S. securities. Of the remainder, a significant portion was due to inter-corporate dividends paid by subsidiaries to their foreign parent companies, a tax which would not need to be removed to meet the objectives outlined herein. In addition, revenue losses from removal of the taxes, should be more than offset through the income tax as greater income is generated in the U.S. economy from additional investment here.

Some have argued that removal of these taxes would discriminate against American citizens who would, of course, continue to be subject to U.S. income tax on their debt and equity investments. However, it is a principle of international taxation that individuals should be subject to tax in their country of residence and/or nationality. In any event, the benefits to be derived for the United States in this time of monetary crisis and high interest rates far outweigh any such discrimination. Moreover, removal of the withholding tax would not be unprecedented since our tax treaties already reduce or eliminate the taxes for foreign residents in several countries. In a sense, this move would eliminate existing



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discrimination as between foreigners from different countries. In addition, it is important to note that the U.S. capital gains tax does not apply to foreigners. Finally, the United States would join a significant group of industrialized countries, with which we must compete for funds, which do not tax interest paid to non-residents.

Others have argued that removal of the withholding tax would tend to stimulate tax evasion by Americans who would send their money abroad and reinvest it in the United States. It is highly doubtful that a 15 to 30% withholding tax can be much of an obstacle to tax evasion when compared with U.S. income tax rates ranging as high as 70%. Moreover, the real incentive already exists in that there is no capital gains tax on foreign investment in the United States. The way to prevent tax evasion, of course, is through continued and enhanced enforcement of the law in the United States, improved reporting requirements by U.S. citizens and through the exchange of information with tax authorities of other countries which is built into U.S. tax treaties. In addition, it should be possible to draft the withholding tax elimination legislation in such a way as to have the taxes reapply at the discretion of the President after a reasonable period of time to countries which are unwilling to exchange tax information with the United States.

It is also argued that the United States would reduce its ability to negotiate future double taxation treaties because if it unilaterally relinquished the right to withhold tax on interest and dividends it would reduce its leverage to exact similar concessions from other countries. The United States already has treaties with most industrialized countries. Developing countries, with whom the U.S. generally does not have treaties, are unwilling for economic and political reasons to diminish their ability to tax dividends and interest paid to investors abroad, because this would lead to additional profits remitted abroad. In the face of this, the willingness of the United States to reduce taxes withheld from citizens of less developed countries does not seem to provide much leverage in any case.

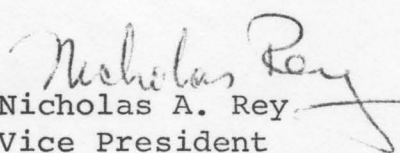
* * *



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We very much hope that the above information will be of interest to you. If you have any further questions or if we can be of further assistance to you on this important matter please let us know.

Very truly yours,


Nicholas A. Rey
Vice President

NAR/lr

Attachment



Table of Tax Treaties

Tax Treaties In Effect Between the
United States and Foreign Countries

Country	Rate of U.S. Tax Withholding at Source		Estate Tax Treaty	Gift Tax Treaty
	Dividends	Interest		
AUSTRALIA	15%	30%	Yes	Yes
AUSTRIA (Except Mortgage Interest)	15%	-0-	-	-
BARBADOS*	15%	30%	-	-
BELGIUM	15%	15%	-	-
CANADA	15%	15%	Yes	-
CONGO, REPUBLIC OF	15%	15%	-	-
DENMARK	15%	-0-	-	-
FINLAND	15%	-0-	Yes	-
FRANCE	15%	10%	Yes	-
GERMANY, FED. REPUBLIC OF	15%	-0-	-	-
GREECE	30%	-0-	Yes	-
IRELAND	15%	-0-	Yes	-
ITALY	15%	30%	Yes	-
JAMAICA*	15%	30%	-	-
JAPAN	15%	10%	Yes	Yes
LUXEMBOURG (A)	15%	-0-	-	-
MALAWI*	15%	-0-	-	-
NETHERLANDS	15%	-0-	-	-
NETHERLANDS ANTILLES (A)	15%	-0-	-	-
NEW ZEALAND	15%	30%	-	-
NIGERIA*	15%	30%	-	-
NORWAY	15%	-0-	Yes	-
PAKISTAN	30%	30%	-	-
RWANDA	15%	15%	-	-
SIERRA LEONE*	15%	30%	-	-
SOUTH AFRICA, UNION OF	30%	30%	Yes	-
SWEDEN	15%	-0-	-	-
SWITZERLAND	15%	5%	Yes	-
TRINIDAD and TOBAGO	25%	30%	-	-
ZAMBIA*	15%	-0-	-	-
UNITED KINGDOM (B)	15%	-0-	Yes	-
SO. RHODESIA (as U.K. colony)	15%	-0-	-	-
OTHER U.K. COLONIES**	15%	30%	-	-

*Former colony of United Kingdom, now independent. The U.K. Treaty as it was extended to this colony continues to apply.

**Aden, Antigua, British Honduras, Dominica, Falkland Islands, Gambia, Grenada, Montserrat, (St. Christopher, Nevis & Anguilla Federation), St. Lucia, St. Vincent, Seychelles, U.K. Virgin Islands.

(A) Payments to corporations in Netherlands Antilles and Luxembourg are subject to 30% tax unless special requirements contained in the treaties are met. The Netherlands Antilles includes Aruba, Bonaire, Curaçao, Saba, St. Eustatius and the Netherlands part of St. Martin.

(B) United Kingdom includes only Great Britain (England, Scotland and Wales) and Northern Ireland, but excludes the Channel Islands and the Isle of Man.

Withholding at 30% is required on lump sum payments from qualified pension or annuity plans, except to residents of Canada, Germany, Sweden and United Kingdom. For these countries, the treaty and regulations should be referred to for details.



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U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON INTERNATIONAL FINANCE OF THE COMMITTEE ON BANKING AND CURRENCY

NINETY-THIRD CONGRESS

WASHINGTON, D.C. 20515

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August 3, 1973

B4a

Mr. Harry Anderson
Chairman
Merrill Lynch International
One Liberty Plaza
New York, New York 10006

Dear Mr. Anderson:

The Subcommittee on International Finance is concerned about the foreign holdings of U.S. dollars and the resulting monetary instability. In a Forbes magazine article, you suggested a method of bringing many of these dollars back to the United States: get rid of the withholding tax on interest paid to foreigners on domestic corporate bonds. You say that the U.S. levies this tax, but it does not produce revenue for the Treasury because we don't sell bonds as a result of this tax.

I would very much appreciate your providing us with additional information on your idea, e.g., the pros and cons, the amount of corporate bonds which are being sold to foreigners now and the amount which might be sold if the tax were removed, the cost to the Treasury of such a plan, and the possible reactions of the U.S. and foreign bond markets.

Thank you for your time and courtesy, and with best wishes, I remain

Sincerely yours,

Henry B. Gonzalez
Member of Congress
Chairman



THE New York Stock
Exchange

July 30, 1973

James J. Needham
Chairman and
Chief Executive Officer

The Honorable Henry B. Gonzalez
Chairman
Subcommittee on International Finance
U.S. House of Representatives
Washington, D. C. 20515

Dear Mr. Gonzalez:

I am delighted to respond to your letter of July 19th asking for data on foreign purchases of stocks and bonds, as well as your request for ideas we may have on attracting additional foreign investment into the United States securities markets.

One of my first official acts as the Chairman of the New York Stock Exchange was to establish an Advisory Committee on International Capital Markets. That Committee's primary function is to propose policies which will strengthen the role of the United States as a world capital center. This Committee includes some of the most distinguished and knowledgeable individuals in the area of capital markets and international finance, as well as prominent men who have served at the highest levels of government. A list of its members is attached.

To assist the Committee in its deliberations and administrative work, an International Finance Division has also been established at the New York Stock Exchange. The table below, which shows historical data on foreign purchases and sales of domestic securities, was prepared by this Division.



Foreign Purchases and Sales
of Corporate and Other Securities
(In Billions of Dollars)

Year	Stocks			Bonds			All Securities
	Purchases	Sales	Net Foreign Purchases	Purchases	Sales	Net Foreign Purchases	Net Foreign Purchases
1958	\$ 1.4	\$ 1.5	\$ (.1)	\$.4	\$.3	--	--
1959	2.2	1.9	.4	.4	.3	\$.1	\$.4
1960	2.0	1.8	.2	.4	.4	.1	.3
1961	3.1	2.7	.3	.3	.4	(.1)	.2
1962	2.3	2.1	.1	.3	.4	(.1)	.1
1963	2.7	2.5	.2	.3	.2	--	.2
1964	3.1	3.4	(.3)	.5	.3	.2	(.2)
1965	3.7	4.1	(.4)	.7	.6	--	(.4)
1966	4.7	5.1	(.3)	1.6	.5	1.0	.7
1967	8.0	7.3	.8	2.2	1.9	.3	1.1
1968	13.1	10.8	2.3	4.4	2.5	2.0	4.2
1969	12.4	10.9	1.5	3.1	1.9	1.2	2.7
1970	8.9	8.3	.6	2.5	1.5	1.0	1.6
1971	11.6	10.9	.7	2.9	2.3	.7	1.4
1972	14.3	12.1	2.1	4.7	2.8	1.8	4.0
1973							
Jan. -							
May (p)	5.5	4.2	1.3	3.0	1.2	1.8	3.1

p = Preliminary

Note: Numbers may not add up due to rounding.



As you can see, net foreign purchases of domestic securities have consistently had a favorable impact on our balance of payments since 1966. Moreover, since the mid-sixties, foreign activity in U.S. securities has mushroomed. The estimates of future foreign activity in the equity markets which the NYSE had prepared in 1971 (see Perspectives on Planning enclosed) now appear on the low side. The current uncertainties prevailing in the international money markets and the lack of confidence in the dollar make predictions about the level of future foreign interest extremely hazardous.

The starting point for attracting additional foreign investment has to be the pursuit of prudent fiscal and monetary policies by our government. Foreign investment will not materialize to its fullest unless uncertainties surrounding the future strength of the U.S. dollar are laid to rest. To restore foreign confidence in the dollar, the United States must achieve a surplus in its international balance of payments, which in turn requires a major reduction in our rate of inflation.

There is one major area where I believe our government can take action to attract additional foreign investment into this nation's securities markets. This is the withholding of taxes on interest and dividend income received by foreigners. While some progress has been made in recent years regarding tax treaties between the U.S. and other nations, there remain many countries for which no such treaties have been concluded. For example, tax treaties have not been agreed upon with nations located in the Middle East. This can serve to restrict large inflows of capital from an area of the world where huge monetary reserves will be accumulating into the 1980's.

At the present time, foreigners hold over \$80 billion in U.S. dollars. We strongly believe that potential inflows of foreign-held dollars overwhelm any revenue loss from a unilateral repeal of withholding taxes (the U.S. obtained just over \$190 million from the withholding tax in 1969). Moreover, we feel that attempts by U.S. citizens to avoid taxes by this channel can be resolved through appropriate administrative machinery.



The effect that imposition of a tax on interest and dividends received by foreigners can have on discouraging portfolio investment by such parties is acknowledged by governments which have such taxes. In order to reduce foreign inflows, the German government levied a withholding tax on foreign owned German bonds in 1969. This attempt turned out to be successful. It stands to reason if withholding taxes have checked foreign inflows, their elimination should encourage such flows.

It is impossible to make an accurate prediction of the extent to which sales of U.S. securities to foreigners would increase if withholding taxes were removed. However, one of the leading brokerage firms took a survey of its international office managers on this issue. Almost all the managers felt significant increases in sales of U.S. corporate stock to foreigners would result. The estimated increases ranged from 10 to 30 percent. Indications were that removal of the tax would open a new market for foreign purchases -- U.S. utility common and preferred stocks.

In summary, I believe that the withholding tax is a deterrent to foreign participation in the U.S. securities markets. Its repeal would assist both our balance of payments and securities markets significantly.

If I can be of any further assistance, please let me know. Furthermore, the staff of our Research Department, particularly Dr. William C. Freund, Vice President and Chief Economist, would be delighted to respond to an invitation to meet with you or any members of your staff regarding programs to attract additional foreign investment into the U.S. capital markets.

Sincerely yours,

James J. Huedba

Enclosures



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CLAIR W. BURGNER, CALIF.

B4a

Mr. James J. Needham
Chairman of the Board
New York Stock Exchange
11 Wall Street
New York, New York 10005

Dear Mr. Needham:

The Subcommittee on International Finance is very concerned about the enormous foreign private holdings of U.S. dollars and the projected increases in these holdings. One significant means of attracting many of these dollars back to the U.S., is the purchase of stocks and bonds in the securities markets here by foreign investors.

I would appreciate your providing me with data on the historical and forecasted purchases of stocks and bonds by foreign investors. I would also like your comments on methods of attracting more foreign-held dollars into the U.S. securities markets, especially if there is a role for the U.S. Government.

Thanking you for your assistance, I remain

Sincerely yours,

Henry B. Gonzalez, M.C.
Chairman



Dividend Withholding Tax on Foreign-Held Securities Stymies
Inflow of Capital

By Peter J. Tanous, Vice President of Smith Barney & Co.

(The Money Manager: October 23, 1973)

At a time when free trade is a topical subject, the United States still imposes restrictive measures on both the inflow and outflow of capital.

The reasons for imposing limitations on the outflow of capital are familiar: the U.S. has had a serious balance of payments problem in recent years. As a result, the Interest Equalization Tax was imposed in 1963 as a "temporary measure" and has been maintained, in somewhat modified form, ever since.

In addition, in 1968, the Office of Foreign Direct Investments was established and administered provisions for a mandatory system to restrict the dollar outflow for direct investment abroad.

The IET imposes a tax on American investments in securities of other countries - except for Canada and a number of less-developed countries - to the effect of discouraging investment abroad.

It seems reasonable to assume, however, that if the U.S. wants to discourage an outflow of capital it ought to be interested in encouraging an inflow of capital. Yet, paradoxically, there is a law that has just the opposite effect: the withholding tax on interest and dividends on U.S. securities held by foreigners.

The withholding tax has been in effect since 1913 when it was made part of the Internal Revenue Code of 1913. One can surmise the many reasons that prompted its inclusion but the most likely derived from a sense of fairplay.

At that time, Americans were about to be subjected to a true income tax, a measure that was of obvious limited popularity. Interest and dividends on securities were included as taxable income.

So, the reasoning undoubtedly went, if Americans owning American securities were obliged to pay a tax on their income from those securities, then it would be unfair to allow foreigners owning American securities to escape tax on them.

Furthermore, since the U.S. would not have the authority to tax foreign nationals living in their own countries, the only way to achieve the same result would be to tax the interest or dividend before it left the country: hence, the withholding tax.



Over the years, the original tax has been modified in separate tax treaties with different nations but by and large, the withholding tax is either 15% or 30% on dividends and, in most cases, 30% on interest.

When the draftsmen of the original tax legislation included the withholding tax, they probably could not have foreseen the effects the tax would have on this country's balance of payments 60 years later. Oddly enough, this effect is only beginning to be recognized now.

As capital markets developed in this century, Wall Street emerged as the financial center which provided essential ingredients of opportunity, information, and liquidity. The New York Stock Exchange attracted a growing foreign interest and in the late 1960s, net capital flows in U.S. stocks purchased by foreigners reached very sizable proportions.

In the early part of that decade the net inflow on foreign purchases of U.S. stocks was generally in the \$200 million to \$400 million range. In 1967 it exceeded \$700 million and in 1968 hit a record \$2.2 billion. The net capital inflow declined after 1968 to \$1.4 billion in 1969, \$626 million in 1970, \$731 million in 1971, and surged again to \$2.1 billion in 1972.

While this dramatic rise in foreign interest was occurring, the withholding tax was acting as a disincentive to foreign investors who were primarily interested in income. If the United States was going to withhold 15% or 30% of the interest and dividends, then clearly the U.S. market was not the place to go for income.

In the meantime, as foreigners' interest in our equity markets was growing, a parallel development was occurring abroad. The Interest Equalization Tax reduced U.S. interest in foreign securities at a time when, in retrospect, investments abroad would have served American investors well.

On the other hand, this measure provided a dramatic growth to the Eurobond market. This growth was fueled by the fact that Europeans were penalized by the withholding tax when they bought U.S. securities; thus, high-yielding, dollar-denominated securities became quite attractive.

The Eurobond market (in dollars and other currencies) grew from less than \$200 million in the early 1960s to more than \$6 billion in 1972. There is now an estimated \$25 billion in Eurodollar bonds outstanding.

The rapid growth of the Eurobond market created some new problems, particularly because most of the Eurobond issues were relatively small and there was little in the way of an aftermarket. A few firms geared up to trade Eurobonds but the markets remained



thin and bond orders in excess of 50 or 75 bonds often encountered resistance.

Most of the Eurobonds were taken up by European banks and placed in clients' portfolios. A number of bond funds were created by major banks throughout Europe. Today, Eurobond funds alone count assets of about \$3 billion, including those bond funds managed by the three largest Swiss banks.

George Dunesme, of the Banque de Bruxelles in Brussels, manages one of the largest bond funds in Europe, the Renta Fund, which has \$400 million in assets. His problem is typical of major bond buyers overseas - large amounts of funds invested and a limited aftermarket in which to maneuver.

His dilemma and that of other European money managers is twofold: the Eurobond market offers little selectivity as compared with the U.S. bond markets while the burgeoning size of their funds forces them to make sizable commitments in a single issue.

Moreover, the aftermarket liquidity problem, particularly in convertible bonds, appears to be getting worse. As Mr. Dunesme says: "How can you expect a bond trader to maintain an inventory of 4 3/4% convertible bonds when he must pay 12% short term interest to carry it?"

Mr. Dunesme, and undoubtedly many other managers, are eager to place money in the U.S. bond markets but, of course, the withholding tax forestalls their participation. Because the U.S. bond market is by far the most liquid in the world and because this market also offers the greatest selectivity, most money managers are willing to enter the market at some sacrifice in yield.

It is true that the yields in the Eurobond market are often higher than yields for comparable credits in the U.S., but the withholding tax makes the sacrifice too great.

Clearly there is a firm desire on the part of foreign money managers to invest their yield-sensitive funds in the United States. As our balance of payments begins to improve, we could well use the support that would result from the repatriation of a substantial amount of dollars to our bond markets.

It may be a worthwhile exercise to speculate on just how much money would come back to the United States if the withholding tax were eliminated. There are several ways to look at these possibilities.

For one, in 1972 foreigners had net purchases of U.S. corp-



orate bonds of \$1,788 million despite the disincentive of the withholding tax. We do not know, however, what percentage of these purchases were in convertible bonds, where the yield is of less importance than the capital gains prospects.

Second, there is an estimated \$25 billion in long term Euro-dollar bonds now outstanding. If the withholding tax were removed, and these bondholders were free to invest in the U.S. without penalty, one can probably conservatively estimate that 10% to 20% of these bondholders would want to invest directly in the U.S. bond markets.

This alone would provide a \$2.5 to \$5 billion boost in our balance of payments. This is but one source of potential new investors.

In the U.S. bond markets, \$19.4 billion in new corporate bonds were issued in 1972. Again, if we assume conservatively that 10% of this total could be placed abroad without the withholding tax, we gain another \$2 billion or so in inflow.

In 1972, there were \$3.29 billion dollars in new long term issues floated in the Eurobond market. It can be assumed that a sizable number of Eurobond investors would opt for the U.S. bond market over the Eurodollar market if they could.

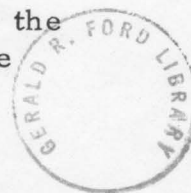
In other words, the very first year that the withholding tax is removed, we might expect an improvement in our balance of payments of perhaps \$4 billion to \$6 billion.

So far, it appears that no one can lose from the removal of the withholding tax. Foreign investors would gain the diversity and liquidity they seek, U.S. securities dealers would gain a significant new clientele, and most importantly, our balance of payments would be served with a welcome gain. It appears indeed that there is nothing to lose.

However, the fact that the withholding tax does exist has resulted in some revenue to the United States. The amount of revenue received by the U.S. Government in 1970 through withholding on interest and dividends of securities held by foreigners was \$200,133,000 on income earned abroad of \$1,458,985,000.

Although the statistics are not broken down, it is probably safe to assume that the bulk of this revenue is derived from withholding tax on dividends of stock purchased by foreigners essentially for capital gains, not income. In any case, these revenues would be lost if the withholding tax were eliminated.

There are some extenuating factors. According to the Internal Revenue Service, an astounding 655,893 documents were filed by withholding agents in 1970 alone in order to administer the tax. The elimination of the withholding tax would also mean the



elimination of this imposing paperwork burden, and the expense associated with it.

It may be fair to state that the net loss of revenue will be a small price if it can secure a multi-billion dollar annual inflow to help our balance of payments. But compelling as the case for the removal of the withholding tax may appear, it has attracted surprisingly little attention until recently. Now, at least the issue is being discussed.

Rep. Wilbur Mills, chairman of the House Ways and Means Committee, is known to be considering the removal of the withholding tax. Rep. Henry S. Reuss, chairman of the Joint Economic Subcommittee on International Monetary Affairs, is aware of it.

Recent testimony by securities industry officials before Sen. Lloyd M. Bentsen, Jr.'s Subcommittee on Financial Markets suggests that as much as 15% to 30% more U.S. common stock could be sold abroad if the withholding tax were ended.

But although press reports have noted the possible effect on the stock market, no mention has been made of the bond business, which would be the beneficiary of the end of the tax.

It is important that the issue is now being discussed, it deserves the active support of the investment banking and brokerage community, obviously from those firms who stand to gain importantly from a significant foreign investment in our bond markets.

Furthermore, it should be comforting to know that an effort on the part of the industry to eliminate the withholding tax will have an effect that goes beyond the self-serving benefit, in that a substantial boost to our balance of payments is likely to ensue.

The effort can be carried even further in the spirit of the true liberalization of capital flows. The Interest Equalization Tax has now been on the books for ten years. It has been renewed several times and is currently scheduled to expire on June 30, 1974.

Early this year, members of the Securities Industry Association's International Finance Committee appeared before the House Ways and Means Committee which was then considering the question of the renewal of the IET.

The SIA committee did not, at that time, ask for the complete elimination of the IET in view of its possible value in upcoming trade and monetary talks, but it did propose some modifications.

The proposed changes were based on persuasive evidence presented by the SIA committee that the IET was not an effective deterrent to capital outflows.



Indeed, as Anthony M. O'Connor, a first vice president of Smith Barney and a member of the SIA committee, pointed out, when a foreign security attracts investor attention in the U.S. the IET does not act to inhibit investment in it.

An extreme example is the fact that U.S. investors have been willing to purchase shares of Sony at a premium price of more than 50% on the Japanese market price. The premium is due to Japanese restrictions on foreign ownership but nevertheless the example illustrates the willingness of American investors to pay that premium for a stock they believe in.

As the sophistication of the U.S. institutional investors in international investment grows, this trend can only accelerate.

We can assume, nevertheless, that the elimination of the IET would cause some outflow of dollars from the United States. The outflow would, however, undoubtedly be dwarfed by the inflow we can expect from the removal of the withholding tax on U.S. securities held by foreigners.

There is, accordingly, a practical case to be made for the joint removal of the IET and the withholding tax in the hopes it would yield the following results:

- A substantial inflow of funds to the U.S. stock and bond markets.
- A needed improvement in our balance of payments, thus enhancing the value of the dollar in overseas markets, and encourage yet further investment in U.S. securities.
- Provide a vast new market for U.S. bonds and high-yielding stocks and the revenues generated from the sale thereof.
- Through the elimination of the IET, provide a truly international capital market with free access and movement in both directions, and return the international financial markets center to the United States.

As was said earlier, it is fortunate that this subject is receiving some attention at the appropriate legislative levels. It now is incumbent on the securities industry to lend its full support to the efforts to end the withholding tax and the IET.

There is much to be gained by all parties affected by the taxes - investors, the securities industry and not least, the national interest.



APR 13 1974

The Honorable
Peter M. Flanigan
Assistant to the President for
International Economic Affairs
The White House
Washington, D. C.

Dear Peter:

I have no difficulty with the general thrust of your paper, "U.S. Policy and Objectives on International Investment," but I do have a few comments on some of the sections.

Under General Investment Objectives on page 2, where the term "established investors" is used under II, I presume this is meant to refer to foreign investors. In III of that section it might be better to say "foreign investors are not subjected to special inducements or constraints," rather than suggest they be protected from politically motivated inducements in general (since our interest is not directed against national policies adopted to influence over-all investment activities, but to insure that such policies are applied without discrimination).

The paragraphs at the top of page 3 concentrate on the imposition of exchange controls as a form of governmental interference with market forces. In many cases, including our own, the restraints on the investments take the form of quotas rather than the application of exchange controls per se, and I would suggest that these paragraphs be broadened to take that fact into account. In the second paragraph on that page, reference is made to actions affecting the competitiveness of enterprises controlled by foreign investors "in their local business activities;" I would strike that last phrase since we would also be concerned with discrimination against foreign-owned companies in the conduct of their foreign operations. An example would be restricting their access to local capital markets for purposes of investing abroad.

At the bottom of page 3 and the top of page 4, some of the concerns that governments have with foreign investments in their territory are identified. We might recognize more explicitly



Mr. Flanagan

Page 2

here that there is great concern in some countries about the extent to which key sectors of industry are controlled abroad, and that some internationally agreed criteria might be developed as guidelines in this area.

The question of fair and equitable treatment of the taxes paid in total and to various countries by the multi-national corporations is attracting a great deal of attention these days and perhaps deserves more than a passing note at the top of page 8.

I trust these comments will be useful. Since I am interested in this issue, I hope you will keep me informed of further developments.

Sincerely yours,

(Signed) Arthur

Arthur F. Burns

SP:cm
4/11/76



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date July 17, 1975

To Governor Wallich

Subject: Committee on Foreign Investment

From Donald B. Adams *DBA*

in the United States

The cabinet-level Committee on Foreign Investment is scheduled to meet on Friday, July 18 to try to establish an Administration position towards a recently announced deal involving the Rumanian government and a U.S. coal company.

According to my information from a member of the Committee's supporting office at Commerce, the Rumanians and Island Creek Coal Company (a subsidiary of Occidental Petroleum) have initialed a \$15 million agreement forming a joint venture to exploit some coal fields in the United States. The Rumanian government has not been receptive to Committee efforts to delay the deal pending a Committee review of its potential effects on U.S. national interests. Thus, this situation is the first test of the Committee's effectiveness in carrying out its mandate when the government with which it is supposed to negotiate is recalcitrant.

It is noteworthy that the Committee learned of the planned deal only through the American Embassy in Bucharest. Thus it is evident that the Committee's intention to rely for information on established bilateral commissions (such as those with Iran and Saudi Arabia) may prove inadequate.

cc: Chairman Burns ✓
Governor Holland



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

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OFFICE OF THE CHAIRMAN

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cc: Chairman Burns
Governor Holland

