

ASSESSING THE FOREIGN INVESTMENT CONTROLS*

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I

CRITIQUE

The objective of the foreign investment controls has been declared to be a reduction of foreign investment outlays so as to improve U.S. international payments. This objective should be pursued under two general constraints: one is the equitable treatment of capital-exporting companies covered by the controls, and the other is avoidance of unnecessary interference in business practice. Criticism can be leveled at the control procedures on the grounds that they are inequitable; the Office of Foreign Direct Investment (OFDI) admits that some inequities still exist and is trying to correct them. Some procedures also seem to interfere unnecessarily with business practice. But these criticisms merely call for improvement in the provisions, not for the abandonment of controls.

The criticism that I wish to make is against the over-all objective of the Government of cutting U.S. foreign investment. The techniques which have been employed are probably either neutral in their impact on international payments or damaging to the U.S. deficit. OFDI does not want to reduce all foreign outlays by U.S. companies, however; capital outlays which are financed from foreign sources (borrowing abroad and depreciation allowances) are excluded from the controls. The foreign outlays which the Government wants reduced are those financed from dollar outflows and retained earnings abroad.

An analysis of the returns to the U.S. balance of payments from foreign direct investment outlays indicates that, on the average, there has been a prompt recoupment of dollar outflows through earnings, sales of capital equipment, and concomitant exports.¹ If dollar outflows are recouped in a short time, every effort should

* This assessment is a substantial revision and updating of an analysis presented to the National Foreign Trade Convention, New York City, Nov. 19, 1968.

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¹ A two-year recoupment was suggested in my study, *Foreign Investment, Exports, and the Balance of Payments*, published by the National Foreign Trade Council in October 1968. The arguments show that the dollar funds in foreign capital outlays are historically less than 30% of total foreign investment expenditures and that the returns to capital, the sales of exports to the affiliate, the return of royalties, and the sale of capital equipment during the initial stages of investment bring back funds in the first two

be made by the control authorities not to reduce foreign investment but to substitute foreign borrowings for dollar outflows and to expand the return of earnings, while permitting sufficient new outflows of equity or parent funds to expand total outlays as much as possible. OFDI objectives, therefore, should be not to interfere with private decisions to expand investment abroad but merely to encourage or require a substitution of foreign borrowing for dollar outflow and retained earnings. If the controls have any other effect, they are likely to affect the payments situation adversely by reducing total returns and lengthening the recoupment period.

The voluntary program (1965-67) emphasized additional contributions to the credit side from all foreign direct investment activities and a reduction of investment outlays by a delay or elimination of "marginal" projects. Under the mandatory program, the Government has shifted its objective to achieving a credit of \$1 billion in dollar outflows and retained earnings compared to 1967. The OFDI claims that it has achieved its 1968 objective. It may, in fact, raise returns of earnings and cut dollar outflows, but it cannot claim that the net effect is a \$1 billion reduction of the deficit. The Commerce Department just does not know what effects this reduction in total investment outlays is having on other aspects of the recoupment process.

Without knowing more precisely the impacts of such an apparent reduction in capital movements of \$1 billion, the Government cannot claim that it is relieving the deficit pressure. It would have to know, first, whether the level of investment outlays abroad would have been larger without the controls—and by enough to recoup the related outflow promptly. Would earnings have been larger, permitting even larger remissions? Would foreign borrowings have been greater or smaller? Did the absence of dollar outflows (parent equity) reduce the level of foreign borrowing or will it in the future? That is, is there an average (long-term) relation of dollar investment to local funds that can be altered in the short run but must be adjusted in the future? Has the shift to foreign borrowing built a backlog of demand for dollars in the future, a demand needed to balance off the forced volumes of foreign borrowing? If so, how long will these levels of foreign borrowing be permissible? And will it be difficult to remove the controls for fear of a rush on U.S. funds or a drastic cut in repatriation of earnings? Does the present reduction of retained earnings cut ability to borrow at commercial banks? How much of the funds available in foreign borrowing is being pulled from funds otherwise destined for the U.S. market so that there is less net gain to U.S. payments from the substitution for direct investment outflows? Finally, what effects have the controls had on exports of investors?

If total investment outlays are reduced by the controls or if foreign borrowing now reduces the ability to invest later, what is gained is a *very* short-term relief (on

years equal to about the amount of the dollar outflow, on the average. See also my article, *Planning For and Against Foreign Investment Controls*, WORLDWIDE P & I PLANNING July-Aug. 1968, at 78.

the order of one or two years) at the price of a loss of credit balances in succeeding years. Thus, even with the *best* procedures, controls are helpful only in the very short run and become damaging quite soon. Their continuation becomes a "self-fulfilling prophecy" in that the deficit is increased (or surplus reduced) by the controls, making it "impossible" or "inopportune" to remove them. We appear to be coming to this position as the controls begin their second "mandatory" year and their fifth since being imposed on a "purely temporary" basis.

Removal of the controls was said by government officials to be feasible only when the dollar is strong enough to bear the burden imposed on foreign investment. Since there are no measures in the offing which are clearly certain to balance international payments, the end of the "temporary" controls does not appear in sight. President Nixon, however, had pledged in his campaign to reduce the stringency of the controls, and in July 1969, OFDI announced a series of changes—retroactive to January 1, 1969—easing the controls.² The minimum investment that can be made outside of quota restrictions has been raised from \$200,000 to \$1 million, thus easing the controls for over 2500 of the 3200 companies reporting investments; this amount can also be invested in any or all of the three scheduled areas. All companies are also now permitted to choose an optional quota of thirty per cent of their 1968 earnings of foreign affiliates; this eases the limitations for some and permits a reallocation of quotas among the three scheduled areas. In addition, measures have been adopted to ease the burden on airlines which were planning to invest in new jumbo jets.

The Department of Commerce has indicated that it anticipates a substantial payments deficit in 1969.³ It did not consider that the easing of investment controls would reduce the deficit. But the Administration has, by its actions, appeared to accept the proposition that continued controls would damage the U.S. payments position. I have argued, along the lines of Professor Fritz Machlup's testimony before the Joint Economic Committee in 1968,⁴ that the reduction of the dollar outflow is likely, itself, to cut the surplus on goods and services.⁵ The mere reduction of capital outflows to correct a deficit is, by this argument, self-defeating.

There is another justification for removing the controls, however—namely substantial evidence that they are worsening the deficit or at least not improving it. Some evidence to this effect can be obtained by an examination of the effects of the controls on total investment outlays, on foreign borrowing and the circular flow of funds, and on exports.

² 34 Fed. Reg. 9061 (1969).

³ E.g., Wall Street Journal, June 16, 1969, at 3, col. 1.

⁴ *Hearings Before the Joint Economic Committee on the 1968 Economic Report of the President*, 90th Cong., 2d Sess., pt. 2, at 394-415 (1968).

⁵ See my study, FOREIGN INVESTMENT, EXPORTS, AND THE BALANCE OF PAYMENTS, *supra* note 1. The point is that the outflow of the U.S. funds for imports, aid, and so on, is being pulled back through foreign borrowing. Without the dollar surpluses, the borrowing levels would probably be lower.

II

EFFECTS ON TOTAL INVESTMENT ABROAD

The principal damage to payments arises if total foreign outlays are reduced—as a result of the controls—below what they otherwise would have been. In this instance, there is an absolute loss to payments, after the recoupment period, compared to what would have been gained through the investment. Although one cannot know what would have been the situation apart from the controls, the rate of increase of expenditures on plant and equipment abroad declined during 1967-68—*i.e.*, during the period of imposition of guidelines and controls—with that in manufacturing expected to level off in 1968 and with 1969 expected to show no increases in annual outlays. This is the one potential consequent of controls that should have been avoided.

But rather than avoid a reduction of foreign investment projects, the Department—in the voluntary program—urged the dropping or delay of marginal projects (“marginal” by whatever criteria the investing company wished to employ—not necessarily marginal to the balance of payments). The Department reported that many companies had agreed to delay or cut off such projects. And companies desiring to invest abroad for the first time were discouraged from investigating potential opportunities.

Whether or not as a direct result of the controls, annual outlays abroad have increased much more slowly than formerly. The most recent data on expenditures abroad indicate that investments in plant and equipment abroad rose three per cent in 1968 over 1967 and are expected to rise seven per cent in 1969 over 1968. But these levels of increase are substantially lower than the twenty per cent average annual increase in the years 1964-1966. And there is a close correlation in the drop-off with the stringency of controls. In the Schedule A area, where the controls are least severe, expenditures were expected to rise by more than twenty-one per cent in both 1968 and 1969. In Schedule B countries, where controls are more severe, increases of five and seven per cent are expected for the two years. And in Schedule C countries, where dollar outflows are virtually prohibited, expenditures for 1968 dropped by ten per cent and are expected to remain at that level for 1969.⁶

If the increase in outlays would have slowed anyway, the controls are not themselves to blame. But every effort should have been made to encourage investment in ways which would reduce the period of recoupment and not to encourage a drop in outlays abroad. For, if one could assume that the pre-1966 rate of growth would have continued without the guidelines and controls—a *large* assumption—the payments position of the United States is already hurt by the loss of contributions from

⁶ 49 SURVEY OF CURRENT BUSINESS March 1969, at 15-16.

lower investment outlays in 1966 and 1967. By 1969 or 1970 there will be a cumulative loss on the credit side.

Some provisions of the controls directly tend to decrease the level of new investment abroad—for example, the requirement that repayment of foreign borrowing be counted in the quota. A reduction tends to occur because the parent is faced with a decision to draw on its present annual quota plus some of its future quota in the form of foreign borrowing. Its future quota for net new investment will be smaller. Thus, to borrow abroad, it must have a high premium factor for present investment as compared to future investment.

For there to be no association between present and future investment, the different investment requirements must be disconnected—that is, incrementally separated—and both the Treasury and Commerce departments have assumed incremental separation of investments. In fact, they are not always separated. An investment this year may well require investments in future years to maintain profitability. Programs of investment are usually multi-year in concept. The linking of future and present quotas through the repayment requirements causes companies to cut their investment programs so as to be certain to complete them in the future. In other words, a high premium on future investments under existing projects over new projects will cut the level of present investment projects. Over-all expenditures will drop, and gains from investment abroad will be cut in future years—worsening the payments position.

One can understand OFDI's necessity for preventing an investor from borrowing in one year and repaying the next, raising his outflow substantially—and thus avoiding the controls. Even so, the effects of these controls will be—at some time in the near future—*not* to shift financing from dollars to foreign funds so much as to reduce total outlays.

If the controllers had kept their eye firmly fixed on the objective of substituting foreign for parent financing, they would not have become so mixed up in the various restraints on different forms of foreign borrowing.⁷ The regulations consider that a swap of parent-company stock for stock of an affiliate is a transfer of capital, with no offset in the quota. A sale of parent stock abroad, however, is a transfer with an offset equal to the value of the shares. And borrowing abroad under convertible debentures is an immediate offset by the amount of the borrowings utilized, with a transfer of capital being recorded from the parent only when the conversion into shares occurs. Finally, borrowing abroad under nonconvertible debentures is an offset, with a later transfer of capital only when the debentures are repaid.

Yet the same purchase of a foreign company may be effected in each instance

⁷ See, e.g., OFDI General Bulletin No. 1, Interpretative Analyses and Statements §§ B312(b), (c), 33 Fed. Reg. 15173 (1968) [hereinafter cited as GEN. BULL. No. 1]. References in this document are keyed to the sections of the regulations themselves, which are codified in 15 C.F.R. pt. 1000 (1969). See also OFDI General Bulletin No. 2, 33 Fed. Reg. 15834 (1968).

with precisely the same immediate results on U.S. payments—that is, *no* outflow of dollars. From the standpoint of the regulations, however, an investor would be better to sell shares publicly and purchase a company outright—or issue debentures to achieve the same purpose. Is there any basis for the distinction in terms of payments pressures?

The distinction lies in the ability of the foreign holder of parent-company shares to sell them for dollars. He cannot do so for some time under convertible debentures. The OFDI will permit a delay in the assignment of a transfer if the U.S. investor can demonstrate that the foreign holders of shares in a swap will hold them for a given period; the assignment occurs when they are released.⁸ But what points to an early resale of the shares for dollars? Even if they are sold publicly, what is the likelihood of redemption in the U.S. market? Does a mere increase in the available shares abroad mean a one-for-one drain of dollars? Are there not sufficient U.S. shares abroad and enough prospective purchasers to permit substantial redemptions if the holders so desire. Whatever danger there is, it is the same for each form noted above. Yet, under some, an offsetting inflow is created before the debit of a capital transfer. And with a swap there is no such offset. Under all, the potential drain of dollars is quite indefinite, but their different treatment means that the ability of the parent to supply equity to support foreign borrowing is reduced in some techniques while not in others.

The same absence of a clear balance of payments objective is seen in the OFDI position that a capital transfer occurs if an affiliate sells parent shares to another foreign national. For example, if the affiliate has paid \$200,000 for shares from the U.S. parent and then sells them to another foreigner for \$500,000, the parent is deemed to have made a capital transfer of \$200,000,⁹ while the affiliate has windfall earnings of \$300,000. The maximum potential drain on U.S. dollars is \$500,000 since the purchaser can presumably sell the shares to U.S. citizens for that amount, but this is not the transfer amount debited against the parent. The parent is so debited despite the fact that there is no outflow. And there is no credit for the fact that the parent obtained \$200,000 at one time from the sale. The OFDI's rule here cuts the level of investment, whereas it should be concerned to increase foreign financing.

Another adverse effect on investment outlays arises in the differential treatment of uses of funds held abroad. If the parent places \$1 million in a foreign bank to backstop a loan of the same amount to an affiliate by the bank, the amount pledged is counted as a capital transfer.¹⁰ But had the same amount already been on deposit in the foreign bank, and was later required to be held there to backstop a loan, it is not counted as a transfer. Contrarily, had the parent withdrawn its deposit abroad

⁸ See GEN. BULL. No. 1, § B312(p).

⁹ See *id.* § B312(h), Example (35).

¹⁰ See *id.* § B312(l), Example (50).

and loaned the \$1 million directly to the affiliate, a transfer of capital occurs and is debited against parent's quota¹¹ despite the fact that the funds never flowed through U.S. payments.

Another provision which tends to cut foreign borrowing is that which charges the parent with a capital outflow if an affiliate transfers a liability to a foreign creditor from itself to the parent. This would expand the ability of the affiliate to borrow; but the parent's quota is charged even before repayment by the parent and before dollars flow out through the balance of payments.¹² But if the parent had borrowed the funds itself, the transfer would have counted against it only when the loan was repaid.¹³

A final provision which reduces the volume of funds available to the parent for investment is that relating to repatriation of foreign earnings.¹⁴ The necessity to return earnings obviously cuts the available funds abroad, but that is the intent, since the remission helps the U.S. balance of payments. But there is an additional reduction of available funds which does not pass into the credit side of U.S. payments arising from the necessity of the affiliate to pay to foreign governments a withholding tax on dividends sent to the parent. This tax would otherwise not have been paid, *and* it is an additional burden on earnings of the affiliate that does not help the U.S. payments position. Some companies are having to borrow funds to meet the repatriation requirements, thus cutting into their ability to expand investments abroad out of foreign borrowings.

The necessity to pay U.S. taxes on the repatriated earnings also reduces the total funds available for investment, thereby reducing the attractiveness of foreign expansion. The provision is, therefore, a tax measure which cuts into calculations of after-tax earnings on foreign investment. It is a measure which has not had the approval of Congress and was, in fact, rejected by that body in the 1962 Revenue Act.¹⁵ The Administration, therefore, has achieved by a control program what it could not gain in direct legislation in 1962—a reduction in the attractiveness of foreign investment. The intent at the time and the result now are certainly to reduce the level of foreign outlays compared to what they would have been in the absence of the controls. The final impact, therefore, is to worsen the deficit in the very near future rather than to improve it.

III

CIRCULAR FLOW

The foreign financing encouraged by the controls appears to benefit payments

¹¹ See *id.* § B203(a).

¹² See *id.* § B312(i).

¹³ See *id.* § B312(j).

¹⁴ See *id.* § B306.

¹⁵ REPORT OF THE SENATE FINANCE COMMITTEE ON H.R. 10650, THE REVENUE ACT OF 1962, S. REP. NO. 1881, 87th Cong., 2d Sess. 78-85 (1962).

by substituting for U.S. dollars. But if funds which would have come to the U.S. market are diverted to Europe or if U.S. capital is pulled into Europe to supply demands abroad, the benefit is reduced. The authors of the Treasury-sponsored study of recoupment downgrade the significance of roundabout transfers of funds induced by U.S. borrowing abroad.¹⁶ They disregard arguments supporting the idea that funds pulled into one market (in Europe) may be drawn from another (the United States). And they overlook the interest of the financial community in making such circular transfers to gain the best return. They assert that

The element of truth in this argument is difficult, perhaps impossible, to quantify. The apparent tradeoff between U.S. capital outflows and overseas borrowing which was prompted by the 1965 voluntary restraint program may have been partly offset through round-about dollar drains. But the practical importance of such offsets seems doubtful. For expositional simplicity, the following discussion assumes that offsets do not exist.¹⁷

Although admittedly difficult to quantify, these offsets are of potentially great practical importance. The authors admit that, if the level of offset activity is known, the significance of foreign borrowing is reduced by this amount.

Despite the difficulty of determining the total circular movement of funds, there is evidence that funds from Canada were shifted in substantial amounts to Europe in the early part of 1968, causing a roundabout drain on the U.S. market, which was supplying Canada. So long as there are openings in the wall built around capital markets, funds will seep or flow through. We must conclude that some of the benefit of foreign borrowing is reduced by a pull of funds into the European market which would either have stayed in the U.S. (or Canada or other countries) or by the attraction of dollars that would otherwise have found their way into the U.S. capital market. Efforts to close normal capital circuits result in loss of equity and in damage to the U.S. payments position.

IV

EFFECTS ON EXPORTS

The major techniques of reducing the period of recoupment of foreign investment are through cutting the outflow of dollars and raising the return of earnings—as we have been discussing. But some outflows are made in the form of exports of goods, equipment, or intangibles. These provide an instant offset (recoupment) of part or all of the outflow of dollars. But no allowance is given in the control procedures for capital equipment contributions. Rather, capital equipment exchanged for equity of an affiliate is treated simply as a dollar outflow¹⁸—the credit is recorded in the

¹⁶ G. HUFBAUER & M. ADLER, *OVERSEAS MANUFACTURING INVESTMENT AND THE BALANCE OF PAYMENTS* (1968).

¹⁷ *Id.* at 13.

¹⁸ See GEN. BULL. No. 1, § B312(a).

over-all merchandise (export) account and not as a return to the parent. The justification is that the investor *could* have borrowed the funds abroad and purchased the U.S. equipment, raising the credits for exports. But this action on the part of the investor would actually reduce the volume of credit available to him and would cut the level of total investment outlays.

Since there is a full recoupment *and* since a dollar contribution is often needed to bring forth local funds, such investments should be readily allowed—*outside* of any quota of capital outflows. Equally, any capital outflows which can be shown to finance an equal amount of capital equipment sales should be exempted from the control quotas. Without such an exemption, a premium is placed on buying the equipment abroad because of the supplier credits obtained from the seller— which adds to the foreign borrowing and does not count against the dollar quota until repaid. The rationalization of the control authorities that funds could be borrowed abroad and spent for U.S. capital equipment is undercut by commercial practice. This practice alters the capital equipment investment outlay relationship and extends the recoupment period.

Although capital equipment is not excluded from “transfers of capital” to an affiliate, services rendered gratis by the parent to an affiliate are excluded *if* the services are primarily for the benefit of the parent.¹⁹ If they are for the benefit of the affiliate in its normal operations, they must be counted as a transfer. These distinctions are left to the decision of the OFDI, upon the evidence. But the very concept of benefits to the affiliate separable from benefits to the parent is contrary to the objectives and practices of the multinational enterprise, which is to consider the activities of all affiliates (especially those in Schedule Areas C and B) and of the parent as an integral whole. Whatever is done for affiliates *is* done for the parent. Such a regulation puts a premium on proving that the affiliate is very closely tied to the parent—a relationship that host governments find bothersome already. The controllers have lost sight of their objectives and gone to meddling!

The control over intercompany financing of exports reduces the benefits of investment by altering trade relationships. A U.S. parent cannot increase its credits to an affiliate to finance exports to it without having this charged to his quota of permissible dollar outflows. But these credits provided an immediate export of goods—a 100 per cent offset. Safeguards would be necessary to prevent these credits from becoming long-term contributions to affiliate capital, but the inclusion of increases in such loans in permissible quotas reduces the possible dollar contributions to equity and reduces the available local financing. If the U.S. investor chooses to use his quota to support local borrowing, he cuts the trade effect and *extends* the recoupment period, partly offsetting the effect of the local borrowings.

Finally, a transfer of intangibles for equity of the affiliate is not a transfer of

¹⁹ See *id.* § B312(e).

capital if the normal pattern of the parent is to obtain equity for such things as patents, trademarks, technical know-how, and so on.²⁰ But if this swap is abnormal behavior, a capital transfer occurs. This regulation penalizes the company which finds this swap profitable for the first time—that is, discovers a company which is willing to grant payment in the form of equity. Here, form is clearly placed over substance. It should make no difference to the OFDI whether the pattern is normal or not. The question is what the impacts on payments are. If the investor can increase equity abroad without adding to U.S. payments pressures, he should be encouraged to do so. He would then add to future credits in the balance. In sum, investors should be helped to avoid the controls by techniques which do not raise dollar outflows or reduce former levels of earnings remissions.

V

REMOVING THE CONTROLS

Not all of the adverse impacts of the controls have been delineated in the foregoing examples. It should be the objective of companies subject to them to assess carefully the impacts on the total level of foreign investment and on other elements of the recoument process. The necessity to control a variety of situations which would permit “escapes” from the controls increases the adverse impacts of the controls by penalizing ingenuity in obtaining financing without causing a dollar outflow. Concern with avoidance as well as evasion increases the complexity of the controls and dampens total foreign investment. A determination of substantial adverse impacts should help demonstrate the damaging effects of the controls. Evidence that foreign financing is draining funds which would otherwise likely be drawn into the U.S. market or is siphoning off funds from the United States through third markets would also illustrate the complexity of applying such controls effectively.

Regardless of the international payments situation, if the controls are demonstrably shown to increase the deficit, the Government should be eager to remove them. But the overhang of foreign financing will be a serious obstacle. Measures must be developed for preventing a rush of U.S. dollars to pay off foreign borrowing before it becomes normally due and to prevent a flood of dollars eager to escape possible future controls. This can be accomplished by phasing out the repayment of foreign borrowing according to a pre-arranged schedule or encouraging a roll-over of debt—if necessary by Government subsidy of the interest differential. The problems of removing the controls are complex, but they get more difficult with time and the complexity is less than that of continuing them.

The OFDI's own analysis of the regulations runs to fifty-four finely printed pages and would require many man-hours to decipher, much less to comply with. Not

²⁰ See *id.* § B312(o)(5).

even the OFDI's own staff agree on what the provisions mean. Given the probability that the controls are becoming nonproductive if not counterproductive, given the costs of imposition, and given the propensity to complicate and rarify the regulations as special cases are discovered in a fruitless search for equity, it would seem to be the counsel of wisdom to admit that there are some situations that are not worth attempting to control. A government hesitates to make such an admission of impotence, particularly in the face of dire predictions by itself of the dangers of not rectifying a critical deficit in payments. But it is the measure of wisdom to face the alternatives available and choose the most effective ones—not simply those which are politically palatable or somewhat appealing to other countries.