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The Foreign Direct Investment Controls

Ruey-Fen Sung

University of Georgia School of Law

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THE FOREIGN DIRECT INVESTMENT CONTROLS

by

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THE FOREIGN DIRECT INVESTMENT CONTROLS

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CHAPTER I

INTRODUCTION

Foreign direct investment is the primary engine of economic development. The factors influencing a country's governmental policy of foreign direct investment at an international level constitute a wide and complex subject. This subject in my country--Taiwan, Republic of China, has been receiving increasing attention, for we now face the problems of balance of payments deficits, how to strengthen the N.T. dollar and improving the functions of foreign direct investment etc. There is a regulation "Regulations Governing the Screening and Disposal of Outward Investment and Outward Technical Cooperation Projects" which was promulgated by the Executive Yuan of Republic of China on January 3, 1980, and simply provides some controls of foreign direct investment. In order to cope with the problems mentioned above, we are discussing how to revise the "Regulations Governing the Screening and Disposal of Outward Investment and Outward Technical Cooperation Projects" or remove it now. We know whether the foreign direct investment should be controlled depends upon the diversity of situations which every country has. But, in early 1970, the United States also had similar problems which my country faces now, therefore, I will examine the "Foreign Direct Investment Regulations" (FDIR) of U.S. enacted in 1968 to evaluate how the United States coped with the problems now facing
my country. I will analyze circumstances under which the United States implemented and revoked the FDIR as well as review the FDIR's contents and effects.

1.1 Background and Motive of the United States Foreign Investment

According to H. Peter Gray (1), the U.S. historical development of foreign investment is marked by three stages. Prior to World War I, most international investment was of the portfolio type. By 1914, U.S. foreign direct investment amounted to only $2.65 billion. Generally, direct investment activity was of the type going from colonial powers to their possessions. The second period, the inter-war years, was characterized by little direct investment. The U.S. undertook some investment activity abroad following World War I especially in the automotive industry. American direct investment in 1929 totalled $7.2 billion with 1,057 foreign subsidiaries (446 in Canada alone) but the international economy was rocked by the depression so little incentive existed for undertaking foreign direct investment. Instead, most businesses were engaged in activity geared toward increasing domestic production and employment. The third period, post World War II, is the stage during which foreign direct investment emerges as the most significant form of long term business activity.

Following World War II, the United States was in a superior position with respect to technological progress and economic productivity. In order to stimulate post-war international economic recovery the Truman and Eisenhower administrations provided
inducements for American firms to go abroad. Foreign aid from the
U.S. under Eisenhower came in the form of private investment as it
benefitted not only the international economy but the American economy
as well. Other factors accounted for the expansion of U.S. foreign
direct investment in the years following World War II including: (a)
tariffs, quotas and currency controls which limited foreign markets
for American produced goods; (b) reduced transportation rates on
locally-produced goods and lower productions costs; (c) excess
capacity in durable goods industries which led American firms to look
to foreign markets for investment opportunities; (d) expectation of
higher profits from manufacturing in countries with fast-growing
economies; and (e) lower corporate income taxes and attractive
depreciation allowances in certain countries (2).

Although statements are often made to the effect that the United
States is not foreign investment minded, today the United States is
the leading capital export nation of the world. The United States has
made available to foreign countries billions of dollars in public and
private investment for economic development (3). The rate of foreign
investment has been higher since World War II, but from the end of
World War I, United States capital has played an important role in the
development of foreign resources and industries. New direct United
States investments abroad rose in 1947 to a level which has since then
been maintained with only minor fluctuations. Outstanding portfolio
investments abroad declined in 1946 but have since risen, particularly
because of large purchases of Canadian securities since 1950.
Aggregate exports of private long-term capital have therefore shown a
tendency to increase during the period. The first series shown for the United Kingdom reflects the relative ease of the capital market during 1947-1949, following the receipt of the United States loan in 1946 (4). It seems probable, however, that the outflow of private capital at the time largely represented short-term funds; the trend of long-term capital exports may be more accurately reflected in the capital issues for overseas account which have tended to rise over the entire period considered.

United States private capital invested abroad at the end of 1952 amounted to about $21 billion, of which $14.5 billion represented direct investments, computed at book value, and $6.5 billion, portfolio investments at their market value. During the seven years 1946-1952, the recorded gross outflow of private investment capital was $9.2 billion, of which sum direct investment accounted for $8.2 billion and portfolio investment for $1 billion. These figures reflect the drastic change in the capital market since the decade following World War I, when portfolio and direct investments appear to have been expanding at approximately the same rate. In the mid-1920's capital exports resulting from the flotation of new capital issued in the United States—chiefly in the form of dollar bonds of foreign governments, though also including some corporate issues which counted as direct investment—amounted to about $1 billion annually. Most United States investment in foreign countries since 1930 has been in the form of direct investment (5).

It is usual to classify the motives for foreign direct investment into nature resource-oriented, market-oriented and factor-oriented
investment (6). Natural resource-oriented investment is obviously trade-oriented or trade-generating, for it results from the investing country's desire to increase imports of its comparatively disadvantageously produced or domestically unavailable commodities, and causes growth in vertical specialization between producers of manufactures and primary products. There is the problem that integrated production and marketing are monopolised or oligopolised by big multinationals in oil, copper and other resource goods, leaving smaller benefits to those countries endowed with natural resources.

Market-oriented investment can be subdivided into two categories. Foreign direct investment induced by trade barriers in the host country is trade-oriented but in a different way from the trade-oriented investment. In this situation, heavier tariffs on final products, for example, lead to the substitution of exports of final products for the export of parts and components, intermediate materials, machinery, equipment and technology necessary to the production of final goods from the investing country. This type of foreign direct investment meets the recipient country's interest in promoting import-substituting activity, not necessary intended to be competitive in the international market, and therefore results in some waste of resources because of the degree of protection provided to the final goods production. But, if the import-substitution industry grows successfully towards export orientation, then foreign direct investment of this type turns out to be factor-oriented investment. Factor-oriented investment is also trade-oriented. As wages in the advanced investing country become higher year by year relative to
capital and as new products—usually more capital- and knowledge-intensive than traditional goods—are created one after another, it becomes profitable and rational for the advanced country to contract its own traditional, labor-intensive industries and transfer the location of production to low-wage countries where cheaper labor costs prevail. Thus, corresponding to a dynamic change in comparative advantage, such foreign investment assists the reorganization of the international division of labor and promotes the growth of trade between labor-scarce and labor-abundant countries. It should be noted that the factor-oriented investment is aimed at establishing an export base, rather than import substitution, and the development of exports to the investing country as well as third markets (7).

Furthermore, the decision to invest abroad depends on an enterprise's strategy. The selection of a suitable strategy which determines the enterprise's growth and change begins in identifying the opportunities and risks. The environmental influences which are relevant to strategic decisions are essentially technological, economic, social and, not least, also political in kind. In all these categories change is taking place at varying rates—probably fastest in technology, less rapidly, but still at considerable speed, in politics (8). Such continuous change in the environment of business necessitates permanent surveillance and monitoring of an enterprise's activities. The decision to invest abroad requires therefore a thorough understanding of the foreign environment. A full investigation and analysis of the economic, social and political
situation is necessary before setting up a subsidiary, entering a market with a certain product, establishing links with local capital, hiring local staff and managerial resources and negotiating with national governments or labor representatives. Therefore, the enterprise's strategy is also a motive of United States foreign investment.

1.2 Meaning of "Foreign Direct Investment"

Foreign direct investment is an acquisition, expansion, or establishment of an existing business operation or construction of new enterprises abroad. It was characterized by at least 25% equity or managerial control over a business concern in a foreign country. One leading U.S. corporate executive described direct investments in the following terms:

'Direct investments are investments in plants to make things, and in warehouses, sales offices and people. This is what direct investments are. They are businesses.' (9)

Any investment and lending which satisfied anyone of the following conditions is classified as overseas direct investment: (a) the dispatch of executives; (b) the supply of manufacturing techniques; (c) the supply of raw materials and inputs; (d) the purchase of products from the invested firm; (e) financial aid; (f) the conclusion of the contract as general sales agent; and (g) the establishment of permanent economic relations with firms abroad (10).

Generally, a foreign direct investment is an investment in a foreign country where the investing party (corporation, firm) retains
control over the investment. A direct investment typically takes the form of a foreign firm starting a subsidiary or taking over control of an existing firm in the country in question. The OECD Code of Liberalization of Capital Movements defines direct investment as "investment for the purpose of establishing lasting economic relations with an undertaking such as, in particular, investments which give the possibility of exercising an effective influence on the management thereof" (11). The definition thus centers upon the concept of control and leaves to governments—who have varying criteria in this regard—to decide what level of foreign participation in the capital of an enterprise constitutes a direct rather than a portfolio investment. It should be made clear, on the other hand, that the concept of control is not sufficient to fully understand the phenomenon of direct investment: in many cases it is indeed not so much a movement of capital involved in direct investment as an international movement of technique or organization. Capital is, most of the time, only the complementary factor of production in a direct investment.

A primary objective of foreign direct investment is to continue attempts to extend free trade allover the world. Free trade means that each country, on the premise that neither labor force nor capital is transferred internationally, promoted international divisions of labor along the line of comparative costs. That is to say, the principle of trade tells us how each country can develop in the international economy. Foreign direct investment should then complement the lack of capital or management skills of the host
country. The cheap production which was not possible previously because of the lack of these elements is then possible. So, based on the new comparative costs, harmonious trade can grow. The role of direct investment, as it promotes the structural adjustment, is to establish this harmonious trade (12).

It is a salient feature of foreign direct investment that the investor wants to retain control over his investment. Control, however, is a legal concept, not too useful for economic analysis. It might therefore be better to say that one of the main determinants of direct investment has to do with technological superiority or superior managerial skills, i.e., with a distinctive capacity of the foreign enterprise (13).

There are three primary ways for a direct investment to take place. One is through the takeover of a firm through the purchase of the stock of the firm by foreign investors. This may not lead to the replacement of management by a foreign management team, but it would lead to some effect on the behavior of management as discussed earlier regarding control. The second way direct investment takes place is through the formation of a new firm in the host area. This usually results in a subsidiary wholly-owned either by an individual firm or a consortium. Management for such a firm is supplied by the parent firm(s) so investment thus involves the international transfer of an entrepreneurial-technical resource complementary to capital accompanying the capital transfer. The new firm is supplied money capital by the parent(s), or from borrowing in the host area to purchase assets which can be acquired through purchase of an existing
firm, or through the construction of new facilities in the host area (14).

Therefore, a "direct investor" is a person within the U.S. who owns or acquires, directly or indirectly: (a) a 10% voting interest in a foreign corporation, (b) a 10% interest in the profits of a partnership organized under the laws of a foreign country, or (c) a 10% interest in a business venture conducted within a foreign country. The direct investor can be an affiliated, associated or family group (15).

The Foreign Direct Investment Regulations (FDIR) apply to the "direct investor" (DI), any individual or business concern within the United States that directly or indirectly owns, holds, or acquires a 10% or greater interest in an incorporated or unincorporated foreign entity. Three fundamental requirements are imposed on all DIs: (a) annual direct investment must not exceed a level set by general allowables provided for in the Regulations or by specific authorization; (b) liquid foreign balance of affiliated foreign nationals must be held to a level specified in the Regulations; (c) reports reflecting allowables and transactions relevant to foreign direct investment activity must be filed with the Office of Foreign Direct Investments (OFDI), the bureaucracy within the Commerce Department that administers the program (16).

1.3 Meaning of "Affiliated Foreign Nationals"

Generally, any foreign national in which a person within the U.S. owns a direct or indirect interest of 10% or more is considered to be
an "affiliated foreign national" (AFN). The exceptions to this general rule are as follows: (a) a foreign corporation, partnership or business venture, if it is a nonprofit operation engaged exclusively in charitable, educational, religious, scientific, literary or similar activities, (b) a foreign business venture other than a corporation or partnership, if the gross assets of the venture do not exceed $50,000 at any time during the year, or if the venture began during the year and is not expected to continue operations for longer than twelve consecutive months or does not, in fact, continue for longer than twelve consecutive months. Thus, a job site of a construction installation would not be considered a foreign venture if the construction period is twelve months or less.

The FDIR set quotas for "direct investment" by a United States "direct investor" in its "affiliated foreign nations" in any of three groups of countries, or schedule area A, B, and C. Schedule A countries are the less developed countries as defined for purposes of the interest equalization tax; Schedule B countries are Middle Eastern oil countries, most of the industrialized countries of the British Commonwealth, and Japan. Canada, however, although technically included in Schedule B, is for most practical purposes not affected by the FDIR. Schedule C is generally referred to as a "higher"--that is, more restrictive--schedule than Schedules A and B and, similarly, Schedule B is considered "higher" than Schedule A (17).

A foreign national can be an AFN of only one scheduled area. If the AFN conducts its business in more than one scheduled area, other than through a branch, the scheduled area in which business is
conducted for the longest period of time during the year determines to which scheduled area the AFN will be assigned.

A foreign business venture (other than a corporation or partnership) carried on by employees or partners in one scheduled area on behalf of a corporation or partnership organized in a different scheduled area is considered a separate AFN of the direct investor in the scheduled area in which it is operating if gross assets exceed $50,000 (18).

So, "affiliated foreign nationals" are of three significant types: (a) a corporation organized under the laws of a foreign country, and its business ventures within the scheduled area of the country of incorporation, (b) a business venture conducted within a foreign country by employees or partners of the direct investor; and (c) a business venture conducted by a foreign subsidiary outside its scheduled area of incorporation (19).

Therefore, an affiliated foreign national is a business venture, partnership or corporation which is within a foreign country and in which a corresponding direct investor owns an interest of 10% or more. The 10% rule is thus used not only to define the direct investor, but also to determine which of his investments were subject to the Regulations. Positive direct investment within the scope of the Regulations only occurred in transactions involving a direct investor and his AFNs. For example, suppose that x, a person within the United States, owns 80% of company A and 5% of company B, both of which are in Schedule C countries and are unrelated to each other. X is a direct investor because of his 80% interest in company A. However,
only his investment in company A is covered by the Program since company B is not an AFN of X. An exception to this general rule is made where a business venture is conducted on behalf of an AFN by the employees or partners thereof. Such a sub-venture is treated either as a part of the AFN on whose behalf it is conducted, or as a separate AFN of the direct investor, regardless of the extent of the direct investor's interest in such sub-venture. This exception to the general rule prevents evasion of the regulatory scheme through fragmentation of investments in a loose managerial group.

The affiliated foreign national concept is defined to exempt nonprofit organizations and business ventures with assets of not more than $50,000 or which exist or reasonably expect to exist for less than twelve months. The latter exemption is carefully circumscribed by administrative interpretations, and the Secretary of Commerce has retained authority to classify individual transactions notwithstanding the Regulations (20).

1.4 The Importance of Foreign Direct Investment

The importance of foreign direct investment can be gauged in several ways. First, considering the U.S. as the investing country, there is the important development that long-term international business activity has moved away from portfolio investment toward foreign direct investment. Additionally, in terms of measuring the volume of international trade, the dollar value of sales by American foreign direct investments far surpasses the dollar value of export trade from the U.S. Second, a major consequence of foreign direct
investment has been the emergence of corporate structures on a global scale, the multinational enterprise. Third, the importance of foreign direct investment can be evaluated in terms of the benefits derived, not only for the investing firm, but also for the recipient (host) nation as well (21).

Foreign direct investment may help transfer technology and skills, provide management and training of local workers, aid in the creation of indigenous skills in administration, marketing and other business techniques, and "with appropriate safeguards" it can contribute to the growth of local entrepreneurship. It may make for more competitive markets, provide access to international markets, contribute to tax revenues and help fill foreign exchange gaps. Foreign direct investment may also create employment opportunities and it may raise domestic wages. Thus, foreign direct investment would seem to have the potential to contribute much needed resources to developing countries (22).

What is the economic function of foreign direct investments (23)? It is a transmission of a package of "managerial resources" from one country to another. Managerial resources cover various managerial skills, formally as the corps of managers, but more substantively, representing such specialized and technological knowledge as managerial expertise, patents and know-how, sales techniques, abilities in securing raw materials and inputs and in obtaining funds and credit, and the organization for information collection and research and development. The transfer of the managerial resources contributes to develop a new industry and other business activities in
the recipient country where the productivity of these managerial resources is high due to their shortage relative to other factors of production.

The importance of foreign direct investment has significantly increased since World War II. The U.S. cumulative foreign investment at the end of 1975 amounted to $133.2 billion, a figure equal to 8.8% of the GNP. In that year the U.S. investment per capita was $623 (24). It was very remarkable that U.S. cumulative foreign investment exceeded U.S. exports by 1.2 times. This fact suggests that the U.S. evaluates her foreign direct investment as more important than her foreign trade, letting the former substitute for the latter.

Policy makers in most industrialized countries have shown interest in foreign direct investments for reasons other than national security. Direct investments financed by parent firms or individuals in a "source" country have an effect on the balance of payments for both the source and the "host" country (25). Net outflows of direct investment for a country will be reflected in downward pressure on the exchange rate of the investing country, and vice versa for countries experiencing net inflows. For a country attempting to maintain exchange rate parities, this may pose some problems. Controls on direct investment outflows have at times been implemented in an attempt to relieve this pressure during periods of fixed exchange rates.
1.5 Typical American Foreign Direct Investment

The typical American foreign direct investment is described by Raymond Vernon and Stephen Hymer (26). The concern of Vernon and others was to explain how a new product is invented and manufactured on a large scale in leading industrial countries. Exports of this product grow in so far as a "technological gap" exists between the product-developing country and foreign countries. Foreign producers imitate the new technology and follow suit. Then exports slow down and through direct investment an attempt is made to secure foreign markets. When the technology is standardized and widely disseminated and the limit of scale economies is reached, trade based on wage costs, or factor proportions, starts and the country turns to import this product from abroad.

Prior to World War I, the emphasis was on United States investment in natural resources abroad, although considerable investment in Canada in all kinds of manufacturing activity had taken place. After World War I, a considerable part of investment capital was still going into the development of the natural resources of foreign countries, but the emphasis had shifted to investment in manufacturing activities (27).

1.6 The Role of the United States Government and Foreign Governments

The U.S. Government has wisely recognized the importance of foreign investments by U.S. corporations as a means of strengthening the U.S. economy, helping the economic development of other countries,
and helping to balance U.S. payments accounts. This was certainly the viewpoint of the Truman Administration. Parallel with the Marshall Plan and in fact in conjunction with it, investment guaranty programs were developed and investment guaranty agreements were signed with West European countries to encourage foreign investment and to safeguard them against inconvertibility, expropriation, and war damage. During the Eisenhower Administration, there were many proposals for a reduction of taxes on income derived from foreign operations, again as an inducement to investment abroad (28). The Eisenhower Administration's views on this subject were expressed by the Honorable Henry Kearns, Assistant Secretary of Commerce, on December 1, 1958, before the House Ways and Means Committee. He quoted President Eisenhower as saying:

Through increasing two-way international trade and stimulating in every practical way the flow of private investment abroad, we can strengthen the free world including ourselves, in natural and healthy ways.

By doing so, the United States can eliminate the heavy burden of foreign aid which she bears.

The bipartisan support of this view was expressed on March 9, 1965, by former Secretary of the Treasury Douglas Dillion, speaking before the Senate Banking and Currency Committee for the Johnson Administration:

... Whenever anyone asks me what is the major reason you have long-term hope for major improvements in our balance of payments, that is
the reason. It is the return from the private investment that is abroad.

This viewpoint was supported on December 8, 1965, by another spokesman for the Johnson Administration, the Honorable Henry H. Fowler, Secretary of the Treasury, before the U.S. Council of the International Chamber of Commerce:

And we are equally aware--those of U.S. in government as well as those in private business--of the long-term importance to US, the industrial development of other nations by U.S. private corporations (29).

In that time the United States Government indicated the foreign direct investment was very important, in fact, it was limited (30). By far the greatest number of factors of concern to the United States companies related to problems over which the United States government could have little direct control.

Direct investment abroad by U.S. corporations in 1966 was the subject of a U.S. Government Policy calling for "voluntary restraint," (31) because of the persistent U.S. balance of payment deficits. Moreover, the rising tide of nationalism in both developed and underdeveloped countries has created fears of American "colonialization" and, in some instances, "domination" of domestic industries. Some political leaders in the developed countries now believe that they have a diminishing need for foreign capital, technology and management.
In a number of less developed countries, certain political leaders have manifested a distinct preference for government-to-government grants and loans for local- and state-owned enterprises over the entry of foreign private capital. It thus becomes relevant to evaluate the impact of U.S. direct investment on the U.S. balance of payments, employment, economic growth, and the economic development of the recipient countries.

Practically all the problems about which companies were concerned related to matters over which foreign governments had some control. Exchange convertibility, tariffs and trade barriers, stability, foreign government attitude and laws, foreign taxation, labor legislation, and the like, are all matters concerning foreign governments directly (32). Many actions suggested by United States companies will not be easy for foreign governments to accomplish. Some of the problems about which United States companies complain are beyond the direct control of foreign governments. Although a government may make its laws more favorable toward foreign investment, or may adopt a more favorable attitude toward United States companies, it may be able to do little about the balance of payments that account for the exchange inconvertibility which is the main concern of United States investors.

The companies do not always seem to realize that it is not possible for foreign governments to make exchange readily available to United States companies. Many do not seem to understand that in many cases the countries do not have dollar exchange; therefore they cannot make it available. Companies have few suggestions for ways in which
foreign governments can balance their payments and obtain the necessary foreign exchange.

Still there are ways, as the answers to a number of questions have revealed, in which a foreign government can act. Foreign governments can remove certain obstacles and impediments directly under their control if they wish to attract greater United States investment.

Thus, the acceptance and approval of applications for direct investment from a multinational firm seeking to set up operations in a foreign country is not simply a matter of routine. On the host country side of the investment equation policymakers in the recipient nation must address themselves to a number of questions (33). For example, could the local economy have acquired an injection of capital or rejuvenation of resources and productivity on some basis other than direct investment? What is the potential impact of foreign control over local resources? To paraphrase Raymond Vernon, is the existence of foreign-controlled subsidiaries compatible with the need to be master in one's own house? And what of the desire of the investing company's home government? Will the home government seek to pursue political or economic policies (extraterritoriality) through a subsidiary of a home-based parent firm carefully placed somewhere in the host country? Foreign-owned subsidiaries have little or no allegiance to the host nation. What is to prevent the foreign subsidiary from leaving the production site and thus generating economic dislocation? And what of the repatriation of profits from the host country to the home country? Is repatriation to be allowed
and if so to what extent? What are some of the fears and tensions that foreign direct investment generates in the host country? There is first the fear of foreign control of important sectors of the economy. Managerial control, decisions affecting the affiliate—whether it will expand or contract, what it will make, what markets it will service, and so forth—are made not by the local national who may be in charge of local operations but by the foreign parent domiciled in another country.
Endnotes


(2) Id.

(3) Barlow, Foreign Investment and Taxation, Halliday Lithograph Corporation (1955), p. 3.


(7) Id., p. 59.


(10) Kojima, supra note 6 at p. 58.
(11) Grewhich, supra note 8 at pp. 1-2.


(13) Grewhich, supra note 8 at p. 17.


(15) FDIR section 1000.305 (1968); Ernst & Ernst, The Foreign Direct Investment Program, International Business Series (1968), p. 3.


(17) FDIR section 1000.304 (1968).

(18) McDermott, supra note 16 at pp. 502-503; Ernst & Ernst, supra note 15 at p. 4.


(21) Schmidt, supra note 1 at p. 16.


(23) Kojima, supra note 6 at p. 58.

(24) Id., p. 9.


(26) Kojima, supra note 6 at p. 87.

(27) Barlow, supra note 3 at p. 9.

(29) Id.

(30) Barlow, supra note 3 at p. 131.


CHAPTER II
BALANCE OF PAYMENTS

2.1 Meaning of Balance of Payments

The balance of payments statement is a statistical summary of the multitudinous economic transactions carried on each year between residents of the United States and those of all other countries, either as private individuals or business organizations or through their respective governments (1). It encompasses not only the commercial movement of goods, services, and funds between this country and the rest of the world, but also private remittances in the form of personal gifts and donations by charitable agencies, and Government grants, neither of which give rise to financial claims.

The major components of the United States balance of payments are exports and imports; services, which include transportation charges, tourist expenditures, insurance payments, royalties, fees for professional services, and other miscellaneous items; income from investments, namely, interest, rents, dividends, and profits; private investment capital (short-/and/long-term) and U.S. Government transfers (2). Items in each of these categories appear in the balance of payments statement as receipts when the income therefrom originates abroad and is paid to recipients in this country. Similarly, when they represent payments originating in this country and directed to foreign recipients, they are included as expenditures.
The Government transfers category comprises a number of items. On the receipts side, it includes interest on loans and credits extended by agencies of the U.S. Government to foreign governments and international agencies; repayment of principal on such loans and credits; and payments for Government exports of military and non-military goods, including surplus agricultural commodities. On the payment side, this category takes in loans and credits extended to foreign governments, interest paid to foreign holders of Federal obligations, principally Treasury bills and U.S. Government Bonds; expenditures in support of this country's military establishments abroad; pension payments to foreign residents; and foreign aid. Foreign aid, in turn, includes both economic and military grants (unilateral transfers) and loans.

2.2 Balance of Payments Deficit

One of the most serious and pressing economic problems confronting the United States in 1966 was the persistent and substantial deficit in its balance of international payments. This problem had been developing since the final quarter of 1949. The average deficits between 1950 and 1956 were in the magnitude of $1.5 billion. From 1958 through 1964, these deficits had ranged between $3 and $4 billion. In 1965, the deficit was reduced to $1.3 billion (3), but there were many special, one-time factors involved, such as the liquidation of deposits abroad by U.S. corporations and a sharp drop in banking credits to foreigners. A phenomenon that has lasted for 15 out of 16 years clearly cannot be considered temporary.
The persistent deficits in the United States' balance of international payments since 1949 resulted in large outflows of gold and substantial increases in foreign holdings of liquid dollar assets, which were considered to be claims against gold (4). In 1958, the net outflow of gold amounted to $2.3 billion. Gold lost during the three-year period 1959-1961 totaled $3.2 billion (5).

Several analytic studies (6) investigating the linkage between direct investment abroad and the balance of payments have focused on the recoupment period, or number of years required for an initial capital outflow to generate an equal inflow of investment income and net trade receipts (7).

The foreign direct investment affects the balance of payments in the following manner (8): (a) When U.S. direct investment abroad is undertaken there is normally an outflow of capital from the United States. Even though such investment has been financed to a significant extent in recent years by funds obtained abroad, it usually is accompanied by at least some transfer of capital from the parent company. (b) Direct investments abroad generate a stream of earnings in subsequent years, part of which is remitted to the U.S. parent company in the form of dividends, interest and branch profits. There may also be other types of remittance from the affiliates to the parents, such as royalties and fees for the use of patents and managerial services. (c) There is a variety of possible merchandise trade flows generated by U.S. direct investment abroad. Capital equipment may be exported in connection with the establishment or expansion of productive facilities abroad, as well as to meet
replacement needs. There may be exports from the United States of intermediate goods for further processing or assembly abroad by the affiliates. Some goods may be shipped to foreign affiliates for immediate resale, with the affiliates acting chiefly as foreign sales outlets for U.S. products. Foreign direct investment by U.S.-based MNCs may also indirectly stimulate demand for U.S. exports through income effects in the host country. On the other hand, U.S. exports may be displaced by the foreign subsidiaries' production and sale of goods that would otherwise have come from the United States. U.S. imports may likewise be affected by foreign direct investment, as some goods formerly produced by the parents are now produced at less cost by the foreign affiliates and shipped back to the United States. (d) Other items in the balance of payments may be affected such as travel, transportation, payments of interest on foreign borrowings, and other services related to the foreign investment. These items are generally minor relative to capital flows, income on direct investments, and merchandise trade. (e) Direct investment in the United States by foreign-based MNCs also affects the U.S. balance of payments, the effects being more or less the reverse of those generated from foreign direct investment by U.S.-based MNCs. Such investment is small relative to U.S. direct investment abroad, but it has grown considerably in recent years.

Part of the problem in evaluating the balance of payments position of the United States lies in the difficulty of selecting an appropriate measure. Most analysts and officials now appear to agree that the most relevant statistical series is the balance on current
and long-term capital accounts (9). This balance gives the net result
(adjusted for public and private remittances and gifts to foreigners)
of sales to and purchases from foreigners of merchandise, services,
long-term securities, and direct interests in productive enterprises.
The liquidity balance was introduce after World War II as a comparison
between U.S. liquid liabilities to all foreigners and U.S. ability to
payoff these liabilities from gold and other reserves. This measure
subsequently lost much of its relevance because by 1971 liquid
liabilities to foreigners were three times the U.S. reserve stock and
because the dissolution of the gold pool and the establishment of the
two-tier gold price system relieved the United States of any
obligation to intervene in private gold markets. The official
settlements balance is supposed to measure the extent of official
intervention in exchange markets that is required to maintain stable
exchange rate (10), but the validity of this calculation was impaired
by monetary authorities' transaction in the Euro-dollar market.

The balance on current and long-term capital accounts--sometimes
referred to as the basic balance--represents an effort to measure
structural forces influencing the external position of the United
States over the long run. This measure tends to be less volatile than
either the liquidity or the official settlements balance, since it
excludes international flows of most highly liquid assets. In 1970,
the deficit on current and long-term capital accounts totaled $3
billion, up slightly from $2.9 billion the previous year.

Balance-of-payments deficits per se imply nothing whatsoever
about the United States being in or out of equilibrium (11). Under
conditions of world growth the United States generally would be expected to have deficits using either the liquidity or the official settlements definition of the balance of payments. Naturally, the magnitude of U.S. deficits will depend upon the monetary policies of the foreign countries and the United States. Large U.S. deficits will be attained when foreign countries attempt to have tight monetary policies and when the U.S. has an easy monetary policy. Under these circumstances foreigners will attempt to augment their domestic currency money balances by large amounts. Small U.S. deficits or possibly even surpluses will be attained when foreign countries loosen up in the money market and when the United States has a tight money market. U.S. deficits, therefore, depend simultaneously upon U.S. and foreign monetary policies.

Thus, the need for balance of payments adjustments arises from disequilibrium payment position (12). Suppose a nation faces prolonged balance of payments deficits. The capacity to finance a deficit is limited by the stock of international reserves and the willingness of other nations to accept these balances; continued deficits ultimately impose pressures to eliminate the disequilibrium. A nation experiencing surplus balance of payments positions year after year may face undesirable economic growth rates, stimulating the rate of inflation. Surplus nations should adjust to eliminate disequilibriums although, unlike deficit nations, the incentive for the restoration of equilibrium does not tend to be as pronounced. The essential point is that prolonged balance of payments surpluses or deficits are inefficient and must eventually be removed.
The balance of payments deficits have occasioned a great deal of analysis and research seeking causes and solutions (13). Capital outflows in general and U.S. direct investment abroad in particular, which are debit or negative items in the balance of payments accounts, have come under especially close scrutiny. U.S. direct investment abroad more than doubled between 1962 and 1965, leading in the latter year to voluntary, and in 1968 to mandatory, controls, on such capital outflows.

2.3 The Dollar Gap Solution

2.31 The Facts

The importance of the dollar stems from the fact that it serves as an international reserve asset. Part of the reason why foreign central banks and monetary authorities held dollars during the 60s was that, at least in principle, the U.S. Treasury guaranteed that these holdings could be converted into gold at the fixed rate of $35 per ounce. Probably more important in explaining the dollar's continuing appeal are the following facts: It has always been freely convertible into other currencies, the risk of devaluation, a least in the past, has been very low, and finally, the variety of quantity of goods which can be purchased in this country are greater than anywhere else in the world.

These factors were especially important in the 1940s and 1950s when the United States was the only source of a large number of products and when U.S. gold stock exceeded U.S. liabilities to foreigners by a wide margin. Because of foreigners' complete faith in
the stability of U.S. currency, central banks began to hold dollars rather than gold when the United States ran a payments deficit during the 1950s. Since the dollar was as good as gold, there was no reason for holding the shiny, barren metal when one could earn interest by buying short-term bonds, such as U.S. Treasury bills. Hence the fact that New York City provides a very broad money market, making the buying and selling of bonds very convenient and inexpensive, further enhanced the attractiveness of the dollar (14). In addition, the mere fact that most countries maintain the external value of their currency by buying and selling dollars in the foreign exchange market means that the dollar is a natural candidate for reserve currency status.

The United States could make payments to foreigners with its own currency, rather than use its reserves, and the countries which chose dollars rather than gold acquired an asset which was both more convenient to use and more valuable insofar as the interest earnings outweighed the risk of devaluation. Most important of all, the U.S. deficit between 1950 and 1969 was a powerful engine for the creation of international liquidity. It provided a crucial supplement to the gold in the coffers of central banks. Between 1950 and the end of 1966, the stock of monetary gold rose from $35 billion to slightly over $43 billion, or an increase of twenty-three percent. Dollar reserves increased from $4 billion to $13.5 billion, or over 200 percent (15). There is little doubt that, by adding considerably to world reserves, the U.S. payments deficit helped grease the wheels of international trade and finance.
The dominant factor shaping international financial diplomacy since the end of World War II has been the evolution from "dollar shortage" in the immediate postwar years to "dollar glut" since the mid-1950's. Many economists believed that while the dollar was undervalued until the mid-1950's, it then became overvalued until the devaluations of August 1971 and February 1973 (16). Capital outflows during 1970 began to put additional pressure on the dollar. To promote more investment and expansion in the American economy, the United States undertook an easing of monetary policy in the autumn of 1970. But tight monetary conditions in France, Italy, the United Kingdom, and most particularly, Germany encouraged large capital inflows from the United States to these nations. By late 1970, Germany's foreign exchange reserves rose to $13.5 billion—a larger amount than before the 1969 revaluation of the mark and almost twice what they had been earlier in the year (17). Of all the postwar currency crises, the dollar crisis of August 1971 had the most far-reaching implications—making the need for reform of the international monetary system obvious. But there was a wide range of opinion among government officials, the international financial community, and academic economists as to the causes and the cures for the dollar "deficit."

As one authority summarized the period since the war: On August 15, 1971, the United States placed the world on a virtually pure dollar standard by suspending indefinitely the convertibility of the dollar into U.S. reserve assets (18). The postwar monetary system was in its third phase. The first phase lasted through 1958, when only
the dollar among major currencies was convertible into other currencies and into the reserve assets of the issuing country. The second phase lasted from 1959 until August 1971, when the currencies of all major countries were convertible both into one another and into their own reserves. The third phase began in August 1971, when the dollar along with those major currencies became inconvertible into the reserves of its issuing country, it remained convertible into other currencies. So the dollar moved from being the only convertible major currency to being, at least in part, the only inconvertible major currency (19).

2.32 The Facts in Historical Perspective

Certain features stand out in the international monetary history:
(a) From 1950 to the 1971 crisis there was a persistent "deficit" in the United States balance of payments (except for a single surplus in 1957); (b) The foreign holdings of dollar assets rose markedly throughout the period, and the United States gold stock diminished from $23 billion in 1957 to less than $11 billion at the time of the gold crisis in March 1968; (c) But while the "deficit" in the United States balance of payments served to provide additional liquidity to the international monetary system, the very creation of the "deficit" also undermined confidence in the future exchange rate stability of the dollar; (d) Nonetheless, the dollar--possessing some functions of international money--retained a unique position in the gold-and-dollar reserve system. (e) For the United States, however, there was no
readily available mechanism of adjustment to balance of payments
disequilibrium (20).

The basic soundness of the dollar was questioned whenever the
United States gold reserve declined to a level that caused foreigners
to doubt the ability of the United States to redeem outstanding
dollars with gold at the pegged price. Unless the United States
balance of payments position was maintained with some degree of
stability, it was inevitable that foreign ownership of dollars would
increase, thus giving rise to a corresponding increase in United
States liabilities. Even if the relative redemption percentage of
dollars into gold remained constant, the increase in dollars available
in foreign hands alone would result in a more rapid depletion of
United States gold reserves, which, in turn, would generate even less
confidence in the stability of the dollar (21). Thus the attention of
the international community was focused on the United States balance
of payments position and the fiscal policies that it reflected.

The emphasis on control of nuclear weapons and international
liquidity was not purely rhetorical. In the early 1960's these were
precisely the problems that were of major concern to the Kennedy
Administration (22). It was reported that:

The balance of payments remained a constant worry to
Kennedy. Of all the problems he faced as President,
one had the impression that he felt least at home with
this one. He used to tell his advisers that the two
things which scared him most were nuclear war and the
payment deficit. Once, he half-humorously derided the
notion that nuclear weapons were essential to
international prestige. "What really matters," he
said, "is the strength of the currency. It is this,
not the force de frappe, which makes France a factor.
Britain has nuclear weapons, but the pound is weak, so
everyone pushes it around. Why are people so nice to Spain today? Not because Spain has nuclear weapons but because of all those lovely gold reserves." He had acquired somewhere, perhaps from his father, the belief that a nation was only as strong as the value of its currency; and he feared that, if he pushed things too far, "loss of confidence" would descend and there would be a run on gold. But he was determined not to be stamped into restrictive domestic measures, and he brought steady pressures for remedies which would not block expansion at home. The problem perhaps constrained him more in foreign affairs. He thought, for example, that the continuing payments deficit gave France, with its claims on American gold, a dangerous international advantage; and at times he even briefly considered doing things which would otherwise run athwart his policy, like selling submarines to South Africa, in the hope of relieving the strain on the balance of payments (23).

To reach an understanding of the causes of the dollar "deficit" and to appraise the significance of the accumulation of foreign holdings of dollars and the gold outflow, the United States had to first appreciate the special position of the dollar in the world monetary system (24).

Furthermore, in analyzing United States balance of payments policy, many economists have emphasized the international asymmetry in the adjustment of balance of payments disequilibria as between the United States and the rest of the world. A strong statement of this follows (25):

At the moment ••• it is a dollar world, just as 1913 was a sterling world. In the view of some American economists ••• this produces certain asymmetries in financial relationships which are an inherent part of the present system. Put baldly and with some exaggeration, these are:
(a) The dollar is the world medium of exchange, unit of account, store of value, standard of deferred payment. It is the vehicle currency through which French francs are transferred into Deutschmarks, for example, and lire into Danish kroner. No other currency performs a similar role on a similar scale.

(b) If the dollar is a world money, the United States is a bank and not a firm as other countries are. The difference between a firm and a bank, of course, is that the liabilities of the former are expected to be paid off at regular intervals, while those of the latter are passed from hand to hand as money, and tend to be permanent in fact, despite being "demand" in form. To the extent that a country is a bank and not a firm, its balance of payments must be viewed from a different perspective, with equilibrium, deficits and a surplus measured on a different basis.

(c) The dollar is a money's money, a numeraire for foreign exchanges, and cannot be regarded as other currencies. It cannot float, except as other currencies float against it, and its value is the reciprocal of the value of all other currencies, not its price in one.

(d) The United States can change the value of gold, but not the price of the dollar. Other countries can readily change the value of their currencies against the dollar, but not the price of gold.

At the close of World War II, the economies of the principal competitors of the United States, Europe and Japan, were in a state of ruin. Their production capabilities had largely been destroyed and their monetary reserves were virtually depleted. Physical and financial reconstruction became the first order of business, and the influential "new economists" of that day believed that reconstruction could only be accomplished by a massive infusion of aid to Europe in the form of grants. European Recovery Program grants were favored over loans because of the then accepted theory that there would be a permanent deficit relationship between the European monetary position and that of the United States. These supposedly incurable imbalances
in international trade would result in a dollar shortage abroad, and it was feared that the imposition of additional debt on European nations would lead to an economic collapse similar to that of the thirties. Thus a decision was made to solve the problem of debt repayment by not creating debts in the first place.

By 1956, it became apparent that Europe and Japan were well on their way to economic recovery. The monetary reserves of European nations were growing, and the United States was experiencing only moderate payments deficits averaging slightly more than $1 billion per year. At first, the deficit was welcomed because it portended the alleviation of the dollar shortage that the economists believed otherwise insoluble. In 1958, however, an alarming deficit of $3.4 billion appeared, and dwindling gold reserves became a greater menace than world dollar shortages (26). In retrospect, the grants-instead-of-loans policy carried out under the Marshall Plan was described as one of the "monumental blunders of economic forecasting" of all time. If the economic planners had placed more confidence in the eventual success of their programs to rebuild the European economy, many of the dollars held by foreigners would have been returned to the United States in the form of loan repayments.

On November 1, 1978, the President of the United States announced a radical program of support for the dollar (27). This program was a departure from his previous policies which were constrained by fear of causing a domestic economic recession. The new policies were made necessary by dramatic events in the financial markets during the week of October 23, 1978. Decline of the dollar in the world exchanges
suggested panic dumping the dollar holdings. It was not only the depreciation of the dollar, but, also the rate of depreciation of the dollar that forced a broad program of support.

2.4 United States Balance of Payments programs

By 1960, the United States balance of payments problem had so increased in severity that governmental action could no longer be avoided. The initial attack was launched by President Kennedy in 1961 against the "abuse of foreign 'tax havens' by American capital abroad as a means of tax avoidance." Pursuant to his request, Congress enacted the Revenue Act of 1962, which in part sought to eliminate the preferential treatment enjoyed by American capital abroad by imposing a tax on earnings of controlled foreign corporations (28). Numerous administrative programs were also inaugurated for the purpose of increasing American exports, reducing foreign exchange costs of military expenditures abroad, and increasing the inflow of foreign investment capital.

2.41 The Interest Equalization Tax Act of 1963

In order to reduce capital outflow, the Revenue Act of 1962, amended the tax code to make certain investments in developed foreign countries less attractive and encouraged repatriation of earnings of controlled foreign corporations. The Interest Equalization Tax (IET) was enacted in 1963 to equalize the cost of raising equity capital in United States and abroad and to discourage foreign sales in the United States of foreign equity or debt securities (29). This measure
represented the first direct restriction imposed by the American government on the free international mobility of capital and money.

In essence, the Interest Equalization Tax of 1963 was designed to offset higher foreign interest rates through the imposition of an excise tax on the acquisition of foreign debt obligations and securities (30). The stated purpose of the IET was to bring the cost of long-term financing in the United States by foreign concerns into better alignment with the higher costs prevailing in foreign markets (31). The interest rate differential was narrowed by the imposition of a flat excise tax on the purchase of foreign stocks or debt obligations. The IET was not intended to eliminate completely foreign portfolio investments, but rather to moderate the outflow of capital to a level in harmony with investment considerations other than interest rate differentials.

Originally, a "temporary" tax measure with an intended existence of only two years, the IET was latter extended for the second time to end on July 31, 1969. Further, revisions of the IET make it an even more valuable control device by giving the President discretion to adjust the tax rate within a range equivalent to an annual interest cost of zero to one and one-half percent. All foreign business transactions, however, were not included within the scope of the IET. The principal exemptions from the tax were direct foreign investment (32), investments in less-developed countries, and export financing. These exemptions were justified on the grounds that the IET was not applicable to normal international business transactions and was
intended to relieve balance of payments pressures only by means of compensating for interest rate differentials.

2.42 Voluntary Program of Foreign Investment and Credit Restraints

The Voluntary Foreign Credit Restraints Program, designed to curb foreign lending by financial institutions, was also announced as part of President Johnson's 1965 Balance of Payments Message (33). Guidelines designed to restrain the growth of foreign credit and reduce liquid balances held abroad were established by the Federal Reserve Board for both bank and nonbank financial institutions. Both groups were also asked to observe a system of priorities according to which attention would be given first to application by American firms for export credits, secondly to applications from less-developed countries for nonexport credits, and lastly to applications from Canada, Japan, and the United Kingdom, which depend largely upon the United States as their principal source of financing.

In order to stem the rapidly increasing outflow of private capital expressly excluded from the lET, in February, 1965, President Johnson invited some 370 business leaders to the White House to discuss the payments problem. He asked for their "voluntary" cooperation in a plan to reduce dollar outflows and repatriate foreign earnings and liquid foreign balances (34). Ultimately, some 900 companies were asked to participate in the Voluntary Cooperation Program. The companies were asked to establish balance of payments ledgers and to improve their payments contribution by some fifteen to twenty percent each. The Secretary of Commerce emphasized that the
program applied only to investment in industrial countries and did not change the government's policy of encouraging investment in less developed areas. The Department of Commerce guidelines included abandoning or deferring plans for future direct investment, resorting to foreign capital markets for funds, and accelerating repatriation through dividends. Each business was asked to make quarterly reports to the Secretary of Commerce. According to the Department of Commerce these voluntary restraints proved successful in curbing the outflow of private capital (35), and attributing the simplicity of the credit controls (36). Nevertheless, critics maintained that the program was not effective to the degree claimed and, further, that it was detrimental to the relations between the United States and nations subject to the program's restraints. It was agreed, however, that one clearly beneficial outgrowth of the program was the creation of European financial syndicates capable of supplying American companies with capital for use in foreign operations.

2.43 Foreign Investors Tax Act of 1966

The Foreign Investors Tax Act of 1966, which complemented the 1963 program by approaching the balance of payments problem from the opposite direction-encouraging foreigners to invest in the United States. Prior to this enactment, a foreign corporation, in addition to paying tax on the profits of its American operations, also had to include unconnected investment earnings in normal corporate income. The Act established a separate preferential tax rate for income "not effectively connected" with business operations in the United States.
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According to the Treasury of the U.S., this preferential treatment of foreign corporations encouraged them to invest in domestic stocks, and was responsible for the reversal from a deficit to a surplus in the balance of payments account for stock transactions (37).

The Act exempted from income taxation interest received from domestic banks, savings and loan associations, and insurance companies, and applied a flat 30 percent tax rate, rather than imposing progressive domestic rates, on United States-source income that was not "effectively connected" with a trade or business in the United States (38). Also, foreign investors were enabled to trade on United States exchanges without being considered as engaged in a United States business and subject to income taxation by this country.

So, the Foreign Investors Tax Act of 1966 was passed to provide further balance of payments relief by attracting foreign portfolio investment capital to the United States. Under the Act, income from portfolio investments of foreign investors is taxed at a lower rate than income from American business investments. Although whatever success the Act enjoyed may be partially attributable to the favorable tax treatment, it is more likely that foreign investors were attracted by the comparative political and financial stability of the United States. Regardless of the reasons, the inflow of foreign portfolio capital was increased (39) substantially after the Act was passed, but not enough to correct the balance of payments deficits.
2.44 The Balance of Payments Action Program of 1968

On January 1, 1968, President Lyndon B. Johnson brought into being a new legal specialty (40). On that date, he signed an executive order prohibiting any "direct or indirect transfer of capital to or within any foreign country or to any national thereof outside the United States." The prohibition was directed to "any person subject to the jurisdiction of the United States" who "owns or acquires as much as a 10% interest in the voting securities, capital or earnings of a foreign business venture." The executive order further authorized the Secretary of Commerce to implement its provisions, and pursuant to this authority the Secretary on the same day published the Foreign Direct Investment Regulations (FDIR) and established the Office of Foreign Direct Investments (OFDI) within the Commerce Department to administer the Regulations.

President Johnson announced the decision to impose mandatory controls on foreign direct investments (41). The statement outlined a seven-point program designed to bolster confidence in the dollar and to deal with the balance of payments deficit. Four of the seven measures were described as "temporary" of which two--compulsory restraints on direct investment abroad and additional controls on foreign lending by American financial institutions--became effective immediately (42). Along with an appeal to business and labor for wage-price restraints and avoidance of export-crippling work stoppages, the President directed that further study be undertaken or appropriate legislation be introduced for the other five measures.
The goal of the mandatory controls for 1968 was a one billion dollar reduction in the foreign direct investment balance of payments category from the 1967 level of $3.7 billion. The actual reduction was more than twice as much, but this accomplishment was more than offset by the virtual domination of the nation's traditional trade balance surplus. Although an overall balance of payments surplus was achieved for 1968, this was regarded as due to transitory factors and not a fundamental improvement (43).

The Regulations have been roundly criticized, publicly and privately, both at home and abroad. The legal authority underlying the Regulations was attacked as at best questionable. It has also been charged that direct investment controls contravened the nation's international legal and treaty obligations and represented an unsound and harmful foreign policy. The control and curtailment of foreign investment was challenged as an ill-advised economic policy, which in fact harmed this country's balance of payments. The Congress itself had embraced this point of view and called upon President Nixon to terminate the Regulations at the earliest possible date (44). On the other hand, the program's supporters, in addition to refuting the above contentions, stressed that the program's purpose was not to restrict direct investment, but only to shift its financing from United States sources to foreign sources. Statistics were marshalled to prove that investment was not diminished but actually increased.

The remainder of this thesis seeks to define and analyze the relevant legal and policy issues that the Regulations raised and attempts to evaluate the purposes, the effectiveness, and the wisdom of the program in light of the monetary crisis with which it was designed to deal.
Endnotes


(2) Id.


(4) For more details see Machlup, supra note 1 at pp. 93-109.


(6) Id., p. 168.


(8) Committee on Finance, United States Senate. supra note 5 at p. 168.


(10) Id.


(13) Committee on Finance, United States Senate, supra note 5 at pp. 168-175.


(15) Id., p. 22.


(17) Id., p. 138.

(18) Id., p. 98.

(19) Id.

(20) Id.


(22) Meier, supra note 16, p. 99.

(23) Id., p. 98.

(24) Id., p. 100.


(26) Young, supra note 21 at pp. 424-425.

(28) Young. supra note 21 at pp. 429-430.


(31) Young, supra note 21 at p. 430.

(32) INT. REV. CODE section 4915(a).

(33) Young, supra note 21 at p. 431.


(35) As a measure of the program's effectiveness the Department of Commerce of the United States noted that the balance of payments contribution of the participating countries was improved by 23% and the overall deficit was reduced to $1.3 billion--the smallest deficit since 1957.

(36) Young, supra note 21 at p. 432.

(37) During the period 1964 through 1966 foreigners sold $1.1 billion more U.S. corporate securities than they bought. This trend reversed in 1967 when the same account showed a surplus of $753 million. During the first seven months of 1968, the surplus increased to $1.2 billion. Wall St. Journal, Oct. 14, 1968, at 1, col. 6.

(38) McDermott, supra note 33 at p. 495.

(39) The net foreign purchase of American corporate securities substantially increased from a negative $461 million in 1965 to a
positive $703 million in 1966. For the first nine months of 1967 the net purchases by foreign residents reached $1,044 million.


(41) The validity of the Act has been upheld on the ground that the power to coin money includes the power to prevent its outflow from the United States. Perry v. United States, 294 U.S. 330 (1935).

(42) Young, supra note 21 at p. 433.


(44) In theory the controls are supposed to be temporary: "I do not know of any responsible government executive or businessman who wants to see OFDI become a permanent monument on the bureaucratic landscape." Speech by Don D. Cadle, Department Director of OFDI, August, 22, 1968.
Restrictions of foreign direct investments varied depending upon the nationality of the AFN. The nations of the world were divided into three classifications—Schedule A, B, C as mentioned above. Despite the broadly worded prohibitions, there were certain foreign direct investments excluded from the scope of the Regulations. If a DI's total positive direct investment was less than $200,000 per year, he was outside the scope of the Regulations, and compliance with the balance of payments program was not mandatory.

General and specific exemptions to the investment restrictions were provided for by the Regulations. A general exemption of "authorization" was an exemption contained in the Regulations or issued pursuant thereto and published in the Federal Register. A specific authorization was an administration ruling granted at the discretion of the Office of Foreign Direct Investment (OFDI) upon application by a DI. Of course, persons who did not have a sufficient interest in a foreign enterprise were not DI's and, therefore, were not within the scope of the FDIR. Organizations that otherwise fulfilled the requirements of an AFN were specifically excluded if the operations were solely of a charitable, educational, scientific, cultural or nonprofit nature.
All banks and financial institutions that were subject to the Foreign Credit Restraint Program of the Federal Reserve were exempt from the provisions of the FDIC if so certified by the Board of Governors of the Federal Reserve System. Another exemption was created when, as a result of negotiations between the United States and Canada, the Regulations were amended to authorize unlimited direct investments in Canadian AFN's.

Furthermore, the FDIC prohibited direct investment during any year in the investor's affiliated foreign nationals except within the investor's general authorization limits, the "allowables," or as permitted on application by specific authorization or exemption. Except where permission was given to measure compliance on the basis of the investor's fiscal year, direct investment was computed on the basis of the calendar year in order to coincide with the nation's balance of payments reporting. However, the investor could elect to treat dividends from incorporated affiliated foreign nationals—a reduction of direct investment—which were received within sixty days after the end of each year as received during the preceding year. Also, the investor could allocate foreign borrowing proceeds to direct investment—reducing the latter—after year end if the proceeds were available at year end and the allocation was reported on the investor's annual report to OFDI due within 120 days after year end.
3.1 The Elements of Foreign Direct Investment

The two components of direct investment were "transfers of capital" to the investor's affiliated foreign nationals and "reinvested earnings" of the investor's incorporated affiliated foreign nations (2). Although, in their earlier phases, there were distinctions between these two components in many significant respects, the two were subsequently merged in measuring compliance with investment allowables. Thus, for most purposes, the significant figure was the net totals, and the investor could deduct the available proceeds of long-term foreign borrowings expended in making transfers of capital or allocated to such transfer or to reinvested earnings.

3.11 Transfers of Capital

What is a transfer of capital? The first version of the Regulations characterized a transfer of capital in terms of--a transfer of capital! "The term 'transfer of capital' shall mean a transfer of capital ••• to or on behalf of, or for the benefit of an affiliated foreign national ••• " Several examples of such transfers by a direct investor were given in most general terms, including a "net contribution to the capital" of an AFN, an "acquisition of an interest in, or an increase in net interest in" an AFN, a "net increase in loans or advances upon open account" to an AFN, the acquisition of bonds or other debt of an AFN to the extent that such amount exceeded the AFN's acquisition of the direct investor's obligations, and the discharge by the direct investor of its own
obligation incurred by guaranteeing or assuming that of the AFN (3). Aside from being left somewhat in the dark throughout as to what a transfer of capital was really all about, the direct investor was told that particular transactions constituted transfers of capital, while the transactions themselves were described in net terms. The important question then became: How should one calculate a transfer of capital with respect to an active foreign subsidiary with which the direct investor was constantly engaged in matters of business? Did a transfer of capital occur whenever the direct investor's net position was positive? These were questions of moment, for both the Executive Order and the Regulations spoke in terms of certain transactions involving transfers of capital being flatly "prohibited," and carried criminal sanctions (4). On the other hand, the worldwide $100,000 authorization made no reference to particular transactions or to transfers or to transfers of capital, speaking only of direct investment in the prescribed amount being authorized. The provisions authorizing direct investment by scheduled area on the basis of prior investment were phrased in terms of transfers of capital resulting in direct investment.

It was understood at OFDI that "transfers of capital" were a constituent element of "direct investment," and that those transactions which increased the direct investor's equity interest in the AFN or which increased the indebtedness of the AFN to the direct investor were "transfers of capital" whatever the form of the transaction. There was a great deal of confusion to be cleared away in giving expression to such an idea. For example, an early
explanation or summary of the Regulations issued by the Commerce Department mentioned an exemption for "current transactions." In fact, no such exemption was stated in such terms throughout the Regulations; apparently, the drafters felt that the references to "capital" were obviously exclusive of that which was not capital and, after all, current expenses simply were not transfers of capital. This characterization of current expenses found support in the International Monetary Fund Agreement, which refers to payments in connection with foreign trade and other current business as "payments which are not for the purpose of transferring capital." Despite the initial ambiguity, then it was agreed that money sent abroad to pay the rent on the foreign branch office or the salaries of its personnel was a "current payment," an expense of business, and not a transfer of capital (5).

Generally, a transfer of capital referred to any transaction involving funds or other property that increases or decreases a DI's aggregate equity, profit, or debt interest in an AFN (6). Transfers of capital by a DI to an AFN were regarded differently, however, from transfers of capital by an AFN to a DI. The FDIR defined the transfers of capital by a DI to an AFN in very broad terms, concentrating more on the substance rather than the form of the transactions. The following examples were listed in the Regulations, but were not, however, meant to be exhaustive:

Acquisition by a DI of an equity or profit interest in an AFN, acquisition by a DI of any item of indebtedness or liability of an AFN (including loans or advances on open account such as export credit sales); a contribution by a DI to
the capital of an AFN; the satisfaction by the DI of any debt owed by the DI to an AFN; the reduction of an equity interest in the DI held by the AFN; the repayment of any long-term foreign borrowing; the complete or partial satisfaction by the DI of any debts of the AFN, whether or not guaranteed or assumed by the DI; a transfer by the AFN of any equity or debt interest in the DI held by the AFN; and a lease of property by the DI to the AFN not expected to be returned within the year and having a useful life of a year or more. On the other hand, transfers of capital by an AFN to a DI were defined in substantially more limited terms, and the specific transfers enumerated in section 1000.312(b) were defined as the only transactions considered transfers.

Current non-capital transactions which were excluded from any computation of direct investment included increases in the equity interest of any incorporated AFN because of reinvestment of AFN earning, changes in the value of assets resulting from their reappraisal, loans to AFNs that were guaranteed by a DI, the payment of interest and other expenses currently due in connection with borrowings, rental payments currently due, royalty payments currently due under license agreements, and transfers of patents, trademarks, and other intangible rights or interests. A current transaction involving immediate cash payment for goods sold or services rendered were not, then, a transfer of capital. If, on the other hand, a DI sold goods on credit or rendered services on account, its debt investment was increased and the transactions were a capital transfer. Subsequent payment by an AFN was, of course, also a transfer.

In other words, the term "transfers of capital," one of two components of direct investment, referred to a change in the equity and debt position of a direct investor. A change in holdings of debt of the direct investor was also regarded as a transfer of capital, but
these were relatively uncommon as, by definition, the direct investor needed to hold at least a ten percent interest in each affiliate (7).

Capital may flow in either direction. As funds are contributed or loaned by a direct investor to its affiliates there is an outward or "positive" transfer of capital. As the affiliate repays indebtedness or is liquidated there is a "negative" transfer. It is the net outward flow, or net positive transfer of capital, within a compliance period which the Regulations limited as one of the two components of direct investment.

Contributions to the capital of or loans to incorporated affiliated foreign nations by direct investors were the most common types of capital transfers, but were not necessarily formal stock purchases or loans. It was sufficient if funds or property were transferred to the affiliate without an offsetting transfer of funds or property by the affiliate, e.g., the sale of merchandise on open account to an affiliate results in a transfer of capital. The leasing of property to an affiliate also was regarded as a transfer of capital if the property had more than a one-year life and was not to be returned within that period.

Noncapital transactions with affiliates (or with third parties on behalf of affiliates) did not enter into the capital transfer computations. Such transactions included the payment of interest, the payment of rent, the payment of license royalties, the making of a guarantee, a reappraisal of assets, the reinvestment of corporate earnings, or the transfer of patents, copyrights, trademarks, trade names, trade secrets, technology, proprietary processes, proprietary
information or similar intangibles or any rights or interests therein or applications or contracts relating thereto (except under unusual circumstances).

Acquisitions of interests in affiliated foreign nationals from third parties were considered to represent a transfer of capital unless the transferor of the interest was a direct investor. The transfer was deemed to be to the place where the affiliate was located, not to the place where the transferor of the interest was located. If the transferor was a direct investor there was no transfer of capital, but the transferee becoming a direct investor by virtue of the acquisition succeeded to the transferor's investment position with respect to the acquired interest. Where a direct investor came to be such through gradual acquisition of the requisite ten percent interest in an affiliate, a special rule picked up all capital transfers in the twelve months preceding the date on which the ten percent ownership level was attained. Dispositions of interests in or obligations of an affiliated foreign national were regarded as negative capital transfers only if the transferee of the interest was a foreign national or, in certain cases, a bank or other financial institution.

Other third-party transactions could result in a transfer of capital. If the direct investor discharged the obligation of an affiliated foreign national to a third party, pursuant to a guarantee or otherwise, a transfer of capital to that affiliate was deemed to result. Likewise, if the investor made a deposit with a foreign bank or otherwise transferred securities or obligations of a nonaffiliated
foreign issuer to secure the transfer of funds or property by a foreign party to the investor's affiliate, there was deemed to be a transfer of capital to that affiliate. And, if the direct investor repaid a long-term foreign borrowing the proceeds of which were expended in making or allocated to an earlier direct investment in an affiliate, that repayment was deemed to be a transfer of capital to the place of the affiliate to which the borrowing proceeds were allocated at the time. A refinancing of such a borrowing by its renewal, extension, or continuance or by a replacement long-term foreign borrowing was not considered a repayment, but the delivery of equity securities pursuant to conversion rights granted to holders of the debt was regarded as a repayment.

Cross-schedule, interaffiliate capital transfers entered into the investment calculations of the Regulations only if at least one of the affiliates was majority-owned by the direct investor. If that was the case the transfer was regarded as flowing from the transferor to the direct investor (a negative investment) and thence from the investor to the transferee (a positive investment). Interaffiliate capital transfers were also disregarded, even with majority-ownership of either or both by the direct investor, if the transfer resulted from an ordinary arm-length trade credit extended by one affiliate to the other paid within twelve months, provided neither affiliate was Canadian.

In the case of unincorporated affiliates, net capital transfers during any period to (or from) an unincorporated affiliated foreign national were measured by the increase (or decrease) in the direct
investor's share of the net assets (disregarding any debt or ownership relationship with the direct investor) of the affiliate. If an unincorporated affiliated generated income and this was not remitted to the investor, net assets increase and a transfer of capital was deemed to have occurred to the extent of the investor's share of those earnings. On the other hand, these earnings did not enter into the reinvested earnings component of direct investment. Similarly, if funds were loaned or contributed to the unincorporated affiliate by the direct investor, net assets increased since the equity or debt change was ignored and a transfer of capital was deemed to have occurred. However, in the case of unincorporated affiliates, such as partnerships and joint ventures, which were not wholly-owned by the direct investor, transfers by co-owners did not enter into these computations and the direct investor's transfers were fully included despite the investor's less than 100 percent interest in the affiliate's net assets.

A transfer of capital could be charged to the account of a direct investor in some circumstances even if the investor was not a party to the particular transaction involving the transfer (8). This occurred when the direct investor owned at least fifty percent of one or both of two AFNs in different scheduled areas; if one of these AFNs made a transfer of capital to the other, the direct investor was deemed to have a negative transfer of capital from the transferor and a positive transfer of capital to the transferee.

The purpose of charging the direct investor with transfers of capital arising out of such a transaction between its AFNs was to
insure that an investment was associated with the scheduled area in which the funds were ultimately used. Thus, where the direct investor had less than fifty percent control of both parties, he was not charged with the transfers of capital because he theoretically could not control them. Conversely, where the direct investor did control at least one of the parties, he was generally (9) charged with the full value of the transfers.

Thus, the prohibited transfer of capital matured into a balance sheet concept (10): the direct investor's outflows and inflows during the period in a given schedule area were totalled and offset against one another. If the inflow figure was larger, the investor had a "negative" net transfer of capital in that area, for which no authorization was required. If the outflow figure was larger, the amount by which it was larger was the "positive" net transfer of capital which, as a constituent element of direct investment, had to be authorized under the Regulations. A direct investor could not be prosecuted for a single transaction, because any single transaction might be of no net effect since it could be offset before the end of the year either by the transaction being undone in such time or by another transaction involving a transfer of equal or greater amount to an AFN or AFNs in the same scheduled area. Accordingly, the Regulations prohibited "a positive net transfer of capital" as well as "positive direct investment" which was in turn defined in terms of "net transfer of capital."

So, a net transfer of capital was defined in terms of all of a direct investor's AFNs in a particular scheduled area. From a balance
of payments point of view, it mattered not at all whether a direct investor had one AFN or hundreds in a particular country or area. What was of importance was the sum total of transactions to a particular country or area. For the foregoing reason, the separate identities of all of a direct investor's foreign business operations within the same scheduled area were ignored, for their numbers did not affect the sum of the transactions between the direct investor and his AFNs in the area. A French subsidiary could loan money to a German branch operation of the direct investor or could create a Swiss holding company and transfer to it the capital stock of the subsidiary's corporate operations in Sweden, Spain, Belgium and Italy. No net transfer of capital had been made by the direct investor to its AFNs in Schedule C (11). The Swedish, Spanish and Italian companies could pay dividends to the Swiss holding company while the Swiss company lent money to the Belgian company; these inter-company transactions in the same scheduled area were ignored under the Regulations. Even the dividends would not be treated as a net transfer of capital by the direct investor to its AFNs in Schedule C, and whether the Schedule C AFNs had earnings or not, for purposes of the Regulations, would be determined as though all the AFNs in Schedule C were one company (12).

3.12 Reinvested Affiliate Earnings

In addition to a direct investor's net transfer of capital to a schedule area, the direct investor's share of the retained, or "reinvested" earnings of its AFNs in the scheduled area had to be
included in the calculation of the investor's total direct investment (13). The Regulations gradually clarified the method of computing earnings reinvested in AFNs. Originally, reinvested earnings were defined as "the earnings of an affiliated foreign national available at any time for distribution and not so distributed." The definition, which applied only to incorporated AFNs because the earnings of an unincorporated AFN fell within the definition of a net transfer of capital, was substantially more detailed. The reinvested earnings component of a direct investor's total direct investment in a given scheduled area was defined as the direct investor's share of the aggregate net earnings of all the investor's AFNs in the instant scheduled area, less all dividends distributed by them to the direct investor or to AFNs of the investor in other scheduled areas, and augmented by dividends received by the instant AFNs from AFNs of the direct investor in other scheduled areas and also by "earnings remitted" to the instant AFNs by their extra-area branches. In general, then, it may be said that under the Regulations earnings were considered reinvested unless they had been distributed as dividends. It is not clear whether a distribution with respect to stock by an AFN having losses would be treated as a dividend for purposes of the Regulations when all the direct investor's AFNs in the same scheduled area had net earnings and none of such AFNs declared a dividend. If the distribution was a dividend, then it reduced the aggregate reinvested earnings of the direct investor in the area. If the distribution was not a dividend because, with respect to the particular AFN, the distribution represented a return of capital, then
the distribution had to be included in calculating net transfers of capital. Such various possibilities reduced somewhat the extent to which the Regulations could be relied upon as a guide to the amount of reinvested earnings.

The principal difficulty implicit in this definition of reinvested earnings was the elusive nature of the concept of earnings. The Regulations were no more vague in setting forth the rules to be applied in determining earnings than they had to be, considering the amount of argument such determinations had caused in both the tax and accounting fields. Essentially, the Regulations provided from the outset that earnings of AFNs were to be calculated in accordance with generally accepted accounting principles, in particular those which had been used by the direct investor in preparing its reports to stockholders (14).

So, earnings (or losses) of incorporated affiliates were to be computed in accordance with accounting principles generally accepted in the United States and consistently applied (15). U.S. taxes and foreign dividend withholding taxes were ignored. For the purpose of determining compliance with schedule area allowables the investor's share of earnings (and losses) of all incorporated affiliates in that schedule were combined, excluding from the computation (a) dividends to those affiliates from other incorporated foreign affiliates of the investor and (b) earnings of those affiliates from unincorporated affiliates of the investor in different schedule areas.

To compute reinvested earnings, this combined earnings (or loss) figure was (a) reduced by the sum of the dividends paid to the direct
investor by such affiliates and the direct investor's share of the dividends paid by such affiliates to the investor's affiliates in other schedule areas, and (b) increased by the sum of the investor's share of dividends paid to the affiliates in the schedule area in question by the investor's incorporated affiliates in other schedule areas and the investor's share of all earnings deemed to be remitted to the affiliates in the schedule area in question by unincorporated affiliates in other schedule areas (16). Earnings of unincorporated affiliates were deemed to be remitted to the extent they exceeded the affiliate's growth in net assets.

Dividends were calculated before deducting foreign withholding taxes. They were considered "paid" when entered on the books of the recipient as paid in cash or subject to payment on demand. There was a provision for electing to treat dividend paid within sixty days after the end of the year as having been paid during such year if this treatment was followed consistently in reporting to OFDI.

For transactions involving incorporated AFNs, the reinvested earnings component of positive direct investment had to be considered as well as the net transfer of capital (17). Reinvested earnings were defined essentially as the direct investor's share of all earnings of an AFN minus his share of dividends paid. Special computations were made where incorporated AFN's earnings were attributable to an incorporated or unincorporated AFN in another scheduled area, or where dividends were paid to such entities.
3.2 Investment Allowables

The controls prohibited direct investment during any calendar year except as generally authorized by the Regulations or specifically authorized by OFDI upon individual application. The Regulations authorized unlimited investment in Canada. For the remainder of the world the direct investor could choose any of three general authorization limitations, informally described as "allowables" (18):

(a) A worldwide minimum investment allowable of $1,000,000.

(b) A set of "earnings" allowables which are determined separately for each of three country groups, schedules A, B, and C. The allowable for each schedule area is an amount equal to thirty percent of the annual earnings of the direct investor's affiliated foreign nationals in that schedule area in the preceding year.

(c) A set of "historical" allowables which are determined separately for the three country groups and are based upon investment experience there in the 1964-1966 period. Unused earnings and historical allowables in one schedule could be passed "downstream" (from C to B or A and from B to A) to other schedules. The historical allowables could also be passed "upstream" subject to a ceiling equal to the earnings allowable in the higher schedule. Finally, to the extent not utilized in the year at all, the historical and earnings allowables could be carried over to the next year. Some direct investors had historical allowable carryovers from 1968 which could be added to 1969 historical or earnings allowables. A supplemental worldwide "incremental earnings" became available in 1970.
The worldwide $1,000,000 minimum allowable was substantially more generous than the comparable 1968 minimum investment authorization, which was set initially at $1,000,000 and later increased to $2,000,000. With a single exception, worldwide annual direct investment (exclusive of Canada) was netted to determine whether the limitation had been exceeded. The exception was that if the investor's affiliated foreign nationals (both incorporated and unincorporated) had an aggregate annual loss, this loss could not be subtracted in computing whether worldwide investment exceeded the $1,000,000 limitation.

Since investment was determined after netting out any proceeds of long-term foreign borrowings expended in or allocated to such investment, it was possible for firms with substantial foreign operations as well as medium and small firms to make use of the minimum allowable. However, if net investment exceeded the $1,000,000 minimum allowable ceiling, the allowable was lost altogether. And, if the minimum allowable was used but net worldwide investment fell short of $1,000,000 there was no carryover of unused allowables to later years. Also, any 1968 historical investment allowable carryovers were lost if the minimum allowable was used in 1969.

The earnings allowable in each schedule area was an amount equal to thirty percent of the direct investor's share of the aggregate net earnings of its affiliated foreign nationals, both incorporated and unincorporated, in that schedule area in the preceding year. The election to utilize the earnings allowables had to be made for all
three schedule areas if made for anyone. However, it was binding only for the year for which it was made.

The historical investment allowables likewise were separate investment allowances for each of the three schedule areas which could be elected annually for the three schedules together. In Schedule A the allowable was an amount equal to 110 percent of the direct investor's average 1965-66 annual direct investment in Schedule A. In Schedule B the allowable was an amount equal to sixty-five percent of the direct investor's average 1965-66 annual direct investment in Schedule B. In Schedule C the allowable was the lesser of (a) an amount equal to thirty-five percent of the direct investor's average 1965-66 annual direct investment in Schedule C or (b) an amount computed by applying to the direct investor's share of the current year's earnings of its Schedule C incorporated affiliated foreign nationals a percentage which was equal to the average percentage of its share of Schedule C incorporated affiliate earnings which were reinvested in 1964-66, inclusive.

The earnings or historical allowables could be utilized to cover any combination of capital transfers and reinvested earnings. Unused allowables could be passed downstream from Schedule C to Schedule B or A and from Schedule B to A. Unused historical allowables could be passed upstream subject to an overall limitation in the upper schedule equal to what the earnings allowable for the upper schedule would have been had it been elected. To the extent not so exhausted by the downstream or upstream shifts, unused earnings or historical allowables for 1969 or later years could be carried forward to the
succeeding year within the same schedule area to supplement earnings or historical allowables in those years. Also, unused 1968 historical allowables could be used to supplement 1969 earnings allowables in the same schedule area.

The "incremental earnings allowable" was a supplemental general investment authorization (19). It was a worldwide investment authorization in an amount equal to the excess of (a) forty percent of the difference between the investor's share of the total earnings of its affiliated foreign nationals (exclusive of Canada) in the current year and the average (but not less than zero) annual earnings of such affiliates in 1966-67, over (b) the investor's minimum allowable, earnings allowables, or historical allowables for the current year, whichever was highest.

3.3 Repatriation Requirement

In addition to the restrictions on direct investment, the Regulations required that all direct investors repatriate, by June 30, 1968, so much of their liquid foreign balances as on that date exceeded the average end-of-month amounts of such balances during 1965 and 1966. After June 30, 1968, the Regulations imposed a continuing requirement that end-of-month liquid foreign balances be kept at the 1965-66 average. The term "liquid foreign balance" included foreign bank deposits and short-term financial assets such as negotiable or readily marketable instruments, and such balances needed to have nothing to do with the direct investor's direct investments. Indeed, to the extent that such balances were invested in foreign businesses,
they would not be liquid foreign balances of the direct investor (20). This repatriation provision thus applied only to direct investor's funds held abroad which were not themselves direct investments. It should be noted that such funds, as well as funds held abroad by Americans other than direct investors, could be "long-term" within the meaning of the Interest Equalization Tax and hence subject to that tax. However, the Regulations explicitly excluded such long-term holdings from the provisions dealing with liquid foreign balances; these provisions applied only to obligations with a period of not more than one year remaining to maturity when acquired by the direct investor, or obligations which were redeemable in full at the option of the investor within one year.

Originally, the Regulations embodied the further requirement that each American direct investor at least once each year repatriate "to an account owned by such direct investor denominated in U.S. dollars at a domestic bank" an amount representing the earnings of AFNs equal to the same proportion of the earnings of such AFNs attributable to such direct investor's interest therein as was repatriated during the three-year period 1966-66, or an amount that would bring direct investment outflows for the year in line with the direct investment targets prescribed with respect to the particular scheduled area in which the AFNs were located. The Regulations required the larger of the two amounts to be repatriated. Considered together with the limitations on transfers of capital, the repatriation requirement meant in Schedules A and B that the direct investor would have to cause its AFN to declare a dividend, and then send back to the AFN so
much of the dividend as was permitted as a transfer of capital. In Schedule C, the repatriation requirement meant that reinvestment of earnings to an amount not greater than thirty-five percent of the base period direct investment was actually further limited by the AFN's average dividend-to-earnings ratio during the three-year base period governing repatriations. This repatriation scheme was subsequently revoked with respect to Schedules A and B, though it remained in the provision governing the Schedule C authorization.

3.31 Foreign Investment Earnings

With respect to Schedule A or B areas, repatriation of earnings retained by an AFN was not required if the DI's total positive direct investment did not exceed the general authorization of the Regulations. The DI's direct investment was, therefore, the algebraic sum of the net transfer of capital and the reinvested earnings in AFN's in Schedule A and B countries. A different repatriation requirement was applicable to Schedule C countries because only reinvestment of earnings was authorized in this area. The net effect was that reinvestment of earnings could not exceed thirty-five percent of the average direct investment by the DI in Schedule C AFN's during 1965 and 1966; or the same ratio of the DI's share of earnings in Schedule C AFN's as was invested during the years 1964-66, whichever was the lesser. Therefore, a DI with a negative or a zero average direct investment in a Schedule C area during 1965-66 or with a zero reinvestment ratio, would not be entitled to reinvest any earnings in its incorporated Schedule C AFN. Consequently, DIs lacking base
period status had to repatriate one hundred percent of the earnings of its AFN or apply for a hardship specific authorization.

The repatriation requirements made it imperative that tax lawyers and executives coordinate tax planning with the Regulations in order to avoid unnecessary tax consequences. For example, where reinvested earnings exceeded the direct investment ceiling for a scheduled area, the repatriation had to be from the AFN in the country with the greater potential foreign tax credits, all other factors being equal (21). In any event, the forced repatriation of earnings was a form of involuntary conversion that was inconsistent with United States tax policy. Although a DI could generally determine the form and source of the repatriation, thus reducing to some extent the tax consequences, the traditional privilege of a taxpayer to control the timing of repatriated corporate earnings was preempted.

3.32 Liquid Foreign Balances

The Regulations limited the amount of liquid foreign balances (other than direct investment liquid foreign balances) that a DI could hold at the end of any month to the average amount held by the DI at the end of each month during the base period of 1965 and 1966. The DI was required to maintain books and records that permitted separation and identification of all transactions involving the proceeds of foreign borrowing received and the amount thereof held as foreign balances, liquid foreign balances, and direct investment foreign balances. The Regulations further provided that if a DI held a direct investment liquid foreign balance at the end of the year, he would be
prohibited from making any positive direct investment in Schedule A and B areas. This severe sanction was directed toward DI's who were retaining the proceeds of long-term foreign borrowings—i.e., direct investment liquid foreign balances—theoretically in anticipation of making transfers of capital to AFN's. Because proceeds of borrowings did not have an adverse effect on United States balance of payments, the Regulations sought to promote their use as the primary source of direct investment funds, and the prohibition sanction provided the incentive to assure compliance by DI's. Nevertheless, these prohibitions could be avoided by the DI's certifying that had retained direct investment liquid foreign balance been utilized, it would have created a substantial probability of material adverse United States or foreign tax consequences, or would have contravened express contractual representations or restrictions related to the long-term foreign borrowing (22). Regardless of the source or amount of liquid balances retained by a DI, investments of these funds in an AFN were subject to the restrictions imposed upon the direct investment of United States-based funds.

Liquid foreign balances were defined to include bank deposits, negotiable instruments, non-negotiable instruments, commercial paper and foreign securities. These foreign balances, however, had to be redeemable at the option of the DI, be readily marketable or transferable, not be subject to foreign exchange control restrictions, and not be pledged as security for any borrowing. The "liquid foreign balances" subject to this month-end limitation consisted of foreign balances other than (23) (a) foreign balances representing the
proceeds of long-term foreign borrowings not allocated to direct investment; (b) Canadian balances; (c) certain nonredeemable, nontransferable, and nonmarketable foreign securities acquired by the direct investor before June 30, 1968; (d) bank deposits and foreign debt securities, with a period of more than one year remaining to maturity when acquired by the direct investor and not redeemable by the direct investor within such period; (e) foreign balances subject to restrictions of a foreign country on liquidation and transfer; and (f) foreign balances pledged or hypothecated in connection with borrowings by the direct investor or its affiliated foreign nationals.

And, under certain circumstances, moreover, foreign balances held by persons other than a direct investor would be deemed "held" by a Dr (24). If (a) liquid foreign balances held by another "principally formed or availed of" for such purpose; or (b) held by another (such as a foreign affiliate of the direct investor), and returnable to the direct investor on demand without material conditions, and not related to the business needs of the holder, they were deemed to be held by the direct investor.

3.4 Foreign Borrowing and Repayment

Direct investment made with the proceeds of "long-term foreign borrowings" by the direct investor or to which such borrowings are "allocated" by the direct investor were not counted in determining whether the investment allowables were exceeded. However, repayments of such borrowings counted as a form of direct investment subject to the controls (25). Moreover, in most cases the direct investor had to
repatriate to the United States by the end of each year all long-term foreign borrowing proceeds not physically invested at that time.

3.41 Foreign Borrowing

Perhaps the most important means by which a direct investor could finance expansion abroad and channel funds to AFNs was by long-term foreign borrowing. The FDIR imposed no restrictions on such borrowings and, in fact, encouraged it (26). For example:

(a) the proceeds of long-term foreign borrowing invested in AFNs or allocated as an offset against positive transfers of capital to AFNs were deducted in calculating net transfers of capital for the year; the amount of authorized direct investment was not affected to the extent of such proceeds; or

(b) if the direct investor filed a certificate with the OFDI, his right to repay the borrowing in future years was preserved, even if such repayment required the direct investor to exceed his authorized direct investment.

Since the Regulations provided for the reduction of positive transfers of capital by the proceeds of long-term foreign borrowing, the investment of such proceeds did not result in a net transfer of capital; a net transfer of capital occurred when the borrowing was repaid. The transfer was then deemed to be a transfer of capital to the schedule area into which the proceeds of the borrowing were originally expended or allocated. The scheduled area from which the funds were borrowed or to which the repayment was made was not significant.
3.411 Long-Term Foreign Borrowing

"Long-term foreign borrowing" meant a borrowing by a direct investor from any foreign national (other than an affiliated foreign national) with an original maturity of at least 12 months from the original date of the borrowing (without regard to provisions for acceleration upon default or provisions contained in convertible debt instruments which permit conversion within 12 months from the original date of the borrowing) including, but by no way of limitation, an extension of credit by any such foreign national to the direct investor in connection with the purchase of property (including securities) by the direct investor from such foreign national (27). For example, a direct investor acquired a business building in France from a French national. The terms of payment required the immediate payment of $50,000 in cash, the balance of $500,000 to be paid over a ten-year period pursuant to a ten-year mortgage. The ten-year mortgage constituted a long-term foreign borrowing.

With respect to FDIR, a foreign borrowing had to be "long-term"—that is, with a minimum maturity of 12 months—in order to be deducted from net transfers of capital. If any payment on the debt principal was due within 12 months, no part of the borrowing was considered long-term. Where more than one debt instrument was involved, however, the direct investor could show that the original and later payments were made with respect to separate borrowings. With respect to convertible obligations, the original maturity would in most cases have to be seven years and, except in a public offering, the conversion privilege might not be exercisable within three years.
(28). Moreover, to qualify as a long-term foreign borrowing, a transaction had to satisfy certain conditions. The lender had to be a foreign national (not an AFN), and the borrowing had to have an original maturity date of at least 12 months or be expressly renewable for a total term of at least 12 months from the original date and not expected to be repaid, in whole or part, within that period. In addition, borrowings on or after June 10, 1968, had to satisfy at least one of four other conditions (29): (a) the borrowing was made from a foreign bank; (b) the borrowing was from or guaranteed by a foreign country or agent thereof (but not primarily commercial entity of a foreign government operating privately within the business sector); (c) the borrowing had an original maturity of at least three years and acquisition of the debt obligation by United States residents or nationals was, under normal circumstances, subject to the lET; and (d) the lender agreed that for at least three years or until maturity, whichever occurs first, it would not sell or transfer the debt obligation to a United States resident or national or to Canada persons or to anyone whom the lender had reason to believe would do so (30).

3.412 Dates in Determining if Borrowing is Long-Term

There were three significant dates to be considered by direct investors when examining prior as well as future borrowing (31).

(a) Borrowing prior to January 1, 1968, was considered to be long-term if it had an original maturity of 12 months or more and no payments or principal were made during the 12-month period.
(b) Borrowing on or after January 1, 1968, was considered to be long-term if the conditions set forth in (a), above, were met or if there were express provisions for renewal, extension or continuance for at least 12 months and the direct investor did not reasonably expect to make any payments of principal within that 12-month period.

(c) Borrowings on or after June 10, 1968 (which would be of most interest to direct investors) was considered to be long-term if in addition to the conditions set forth in (b) above, one or more of the following conditions was satisfied:

1. The lender was a foreign bank.

2. The lender or guarantor was a foreign country or agency thereof.

3. The borrowing had an original maturity of three years or more and results in the payment of interest equalization tax by the direct investor (unless such payment is exempt or excluded from tax under the provisions of the Internal Revenue Code and such exemption or exclusion was not foreseeable when the borrowing was made).

4. The lender agreed in writing not to sell or transfer the debt obligation (resulting from the borrowing) to a resident or national of the U.S. other than a domestic bank, a Canadian person or to any person whom the lender had reason to believe would sell or transfer such obligation to such persons.

For example: On December 1, 1968, U.S. corporation A acquired 100% of the outstanding stock of a Schedule B corporation for $1,000,000. The contract called for an immediate payment of $100,000 in cash with the balance payable January 1, 1972 (i.e., more than three years later).
Although the U.S. corporation had made a transfer of capital of $1,000,000, the $900,000 balance not due until January 1, 1972 constituted a long-term foreign borrowing and, therefore, reduced the transfer of capital in the year of acquisition to $100,000. When the balance was paid, the payment would constitute a $900,000 transfer of capital to the Schedule B area.

3.413 Refinancing

The direct investors could refinance a long-term borrowing by renewal or extension of the term of the borrowing, or by a new borrowing from the same or another lender. This did not constitute a repayment of the original borrowing or the making of a new borrowing. For example: (a) Direct investor originally borrowed $1,000,000 on a long-term basis from Bank A. Prior to the date the loan became due for payment, the direct investor renewed the loan for an additional 12 months. This renewal did not constitute a repayment of the loan. (b) A direct investor borrowed $1,000,000 from Foreign Bank A on a long-term basis. Subsequently, the direct investor enters into a new long-term borrowing agreement with Bank A to borrow an additional $3,000,000. The direct investor uses $1,000,000 of the $3,000,000 proceeds to liquidate the previous loan. The liquidation of the first loan does not constitute a repayment of that loan. Thus, the direct investor is deemed to have a new long-term borrowing of $2,000,000.

It is evident that the direct investor receiving a specific authorization to make transfers of capital on condition that he refinance his obligation abroad within a specified period was only
being authorized specifically to do what the Regulations provided
generally that he might do. However, early amendments to the
Regulations established the rule that a transfer of capital could not
be offset against foreign borrowings made after the date of the
transfer unless made within ninety days before the borrowing and in
the same year and "as part of one transaction or a group of integrated
transactions" (32). Inasmuch as direct investors with specific
authorizations conditioned on "mandatory refinancing" were given an
extended period of time within which to refinance—often as much as to
the end of 1968—a specific authorization so conditioned did have the
function of waiving the ninety days requirement during the period that
it remained in the Regulations.

3.414 Short-Term Foreign Borrowing

Short-term foreign borrowing was less than 12 months (33). If a
short-term borrowing was executed prior to January 1, 1968, and the
proceeds were invested during 1967, the repayment constituted a
transfer of capital. A short-term foreign borrowing after January 1,
1968, constituted a transfer of capital at the date the proceeds were
invested in an AFN.

3.42 Repayment

The FDIR provided that a direct investor's repayment of long-term
foreign borrowing would be treated as a transfer of capital by the
direct investor. The repayment of short-term borrowings was treated
as a transfer of capital only if the proceeds of such borrowings were expended in making transfers of capital in 1967 (34).

Although a repayment of long-term foreign borrowings, in most cases, would constitute a positive transfer of capital and would reduce the amount of direct investment allowable in a particular scheduled area, the repayment by the direct investor of certain borrowings, including borrowings of an AFN, was authorized without limitation. Such repayments included the following (35):

(a) The repayment of a borrowing obtained by the direct investor was authorized without limitation if the borrowing was a long-term foreign borrowing,

(1) obtained before January 1, 1968, the proceeds of which were transferred or allocated in making transfers of capital to AFNs on or after January 1, 1965. The repayment of a long-term foreign borrowing during the current reporting period would not constitute a transfer of capital if the proceeds of such borrowing were invested in an AFN prior to January 1, 1965.

(2) obtained on or after January 1, 1968, but before June 10, 1968, provided that a certificate was filed pursuant to such borrowing.

(3) obtained on or after June 10, 1968, provided that a certificate is filed.

(4) obtained by issuing convertible debt obligations of the direct investor (issuance of stock upon conversion constitutes repayment). However, such conversion will be deemed to be a transfer of capital in the year following the year in which the conversion
takes place, i.e., the amount of the transfer will not reduce the direct investor's authorized direct investment until the following year.

(b) The repayment by the direct investor of a borrowing obtained by an AFN of that direct investor would be authorized without limitation if the borrowing was

1. obtained from a bank or guaranteed by the direct investor prior to January 1, 1968, or
2. obtained from a bank on or after January 1, 1968, pursuant to a fixed loan commitment or line of credit (or renewal or extension thereof) established before January 1, 1968, or
3. guaranteed by the direct investor on or after January 1, 1968, provided that a certificate was filed by the direct investor, or
4. obtained by issuing debt obligations of the AFN convertible into stock of the direct investor (issuance of stock upon conversion constitutes repayment).

In addition, a transfer to an AFN by the direct investor pursuant to a guarantee to enable the AFN to repay its own borrowings was generally authorized, provided that a certificate was filed by the direct investor.

3.421 Filing a Certificate

Prior to making a foreign borrowing or a guarantee of a borrowing by an AFN, the DI had to satisfy the certification provisions of the FDIR. A certificate had to be delivered to the Secretary of Commerce
attesting that the DI believed, on the basis of the then existing facts and circumstances, that he (a) would not make any transfers of capital in connection with the repayment of the borrowing within seven years or (b) would make transfers of capital within the seven-year period, but also had grounds to believe that these transfers would be within the general authorizations (36). And, the certificate had to contain the amount borrowed or guaranteed; the principal amount due each year; and, the name of the lender or underwriter in the case of a public offering (37).

To prevent the flow back into the United States of debt obligations resulting from foreign borrowings, certain conditions had to be met in order for a borrowing to be deemed a "long-term foreign borrowing" (38). If the borrowing was not from a foreign bank or guaranteed by a foreign nation, to qualify as a long-term foreign borrowing it had to have at least a three-year maturity date or be subject to the Interest Equalization Tax. Otherwise, the lender had to sign an agreement that he would not sell the debt obligation to Canadian citizens or to residents or nationals of the United States for a period of three years or until final maturity, whichever occurred first.

Accordingly, the direct investor could give the required certification if it either could extend at its option or had an assurance that the original or another bank would favorably consider a request prior to the original maturity to refinance the loan to the seven-year maturity, barring an adverse change in the direct investor's business and financial condition (39).
3.422 Possible Pitfalls

Although long-term financial borrowing provided many of the answers to financing foreign operations, there were certain pitfalls a direct investor had to keep in mind (40). The absence of base-period experience could mean that the direct investor would be required to repatriate all of the earnings of the AFNs in excess of the $200,000 allowable, unless negative transfers of capital could be created to offset current earnings. As a result of having to repatriate all of the earnings of AFNs and not being able to make net positive transfer of capital, the direct investor might not be able to repay the loan without violating the Regulations.

If the direct investor did have base-period allowables, it was important to review the possibility of using excess allowables in one scheduled area to repay loans in other schedule areas. Such excess could only be carried downstream, i.e., from area C to A or B or from area B to A.

A direct investor considering guaranteeing the borrowing of an AFN had to again consider base-period experience in that schedule area, since the AFN would have to repay such borrowing out of earnings allowed to be reinvested.
Endnotes


(2) Ellicott, supra note 1 at p. 52.

(3) FDIR section 1000.312 (1968).

(4) FDIR section 1000.701 (1968).


(7) Ellicott, supra note 1 at pp. 52-54.


(9) The direct investor will not be charged with the transfers if the transaction is the extension of a trade credit in the ordinary course of business between his AFNs and at arms length.

(10) Lancaster, supra note 5 at pp. 104-105.

(11) FDIR section 1000.505 (1968).

(12) Lancaster, supra note 5 at p. 106.

(13) FDIR section 1000.306(a) (2) (1968).

(14) Lancaster, supra note 5 at pp. 120-121.

(15) Ellicott, supra note 1 at p. 54.

(16) Id., p. 55.
(17) Note, supra note 8 at p. 157.

(18) Ellicott, supra note 1 at pp. 48-49; McDermott, supra note 6 at pp. 514-520.

(19) Ellicott, supra note 1 at p. 57.

(20) FDIR section 1000.203(a) (1) (1968); Lancaster, supra note 5 at pp. 89-90.

(21) Young, supra note 1 at p. 439.

(22) Young, supra note 1 at p. 440.

(23) Ellicott, supra note 1 at p. 62.

(24) Id., p. 49; McDermott, supra note 6 at pp. 522-523.

(25) Ellicott, supra note 1 at p. 49.


(27) Id., p. 32.


(29) McDermott, supra note 6 at p. 509.

(30) A direct investor must also comply with special bookkeeping and reporting procedures with respect to any borrowing. Long-term foreign borrowings, the uses to which the borrowing proceeds have been put, and the earnings of the DI from the investment of such proceeds in AFNS, must be separately identified.

(31) Ernst & Ernst, supra note 26 at p. 33.

(32) Lancaster, supra note 5 at pp. 91-92.

(33) Ernst & Ernst, supra note 26 at p. 34.
(34) Lancaster, supra note 5 at pp. 114-115.

(35) Ernst & Ernst, supra note 26 at pp. 36-37; McDermott, supra note 6 at pp. 510-511.

(36) Young, supra note 1 at p. 438.

(37) Ernst & Ernst, supra note 26 at pp. 37-38.

(38) Young, supra note 1 at p. 438.


(40) Ernst & Ernst, supra note 26 at p. 38.
CHAPTER IV

ASSESSING THE FOREIGN DIRECT INVESTMENT CONTROLS

The obvious objective of foreign direct investment controls is a reduction of foreign investment outlays so as to improve international payments. This objective should be pursued in accordance with two general guidelines (1): one is the equitable treatment of capital-exporting companies covered by the controls, and the other is avoidance of unnecessary interference in business practice. The U.S. Foreign Direct Investment Program performed two undeniable services. First, the Regulations created a vastly increased awareness of the balance of payments problem, particularly in the business community. Corporate executives were forced to consider the impact of their transactions in balance of payment terms. In the process of adapting to the Regulations they learned the techniques for minimizing the adverse impact of their foreign transactions. It was conceived as a temporary measure to achieve a reduction in the United States balance of payments deficit of $1.0 billion in 1968 from the 1967 level of over $3.5 billion (2). Unquestionably, the program had a substantial immediate impact upon the United States balance of payments, particularly in light of the prohibition against new direct investments in Europe—the primary area of American foreign investment. The validity of this prediction became apparent: the second-quarter results for 1968 showed a payments deficit of only $170
million. The second benefit was the knowledge gained by the administrators of the Program. At the beginning of the effort, the accounting techniques employed to adjust international monetary reserves had never been matched with the commercial transactions they were supposed to represent. The Program fostered added insight into this correlation and, as a result, gave additional meaning to the balance of payments statistics. This knowledge was a cornerstone of a better and more permanent solution to the balance of payments problem (3). 

Removal of the controls was said by the United States government officials to be feasible only when the dollar was strong enough to bear the burden imposed on foreign investment. Since no measures quickly became apparent to balance international payments, the end of the "temporary" controls did not appear as quickly as initially expected. 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. The minimum investment that can be made outside of quota restrictions was raised from $200,000 to $1 million, thus easing the controls for over 2500 of the 3200 companies reporting investments; this amount could also be invested in any of all of the three scheduled areas. All companies were also permitted to choose an optional quota of thirty percent of their 1968 earnings of foreign affiliates; this eased the limitation for some and permitted a reallocation of quotas among the three schedule areas. In addition,
measures were adopted to ease the burden on airlines which had planned to invest in new jumbo jets.

The Department of Commerce of the United States indicated that it anticipated a substantial payments deficit in 1969 (4). It did not consider that the removing of investment controls would reduce the deficit. There was another justification for removing the controls, however, namely substantial evidence that they were worsening the deficit. Some evidence to this effect was apparent from an examination of the effects of the controls on total investment outlays, on foreign borrowing and the circular flow of funds, on exports and statutory authority.

4.1 Effects on Total Investment Abroad

To begin with, at least the ostensible purpose of the investment controls, as OFDI had emphasized again and again, is not to restrict expansion of investment—only to shift its financing from domestic sources to foreign sources. Moreover, while "direct investment" was reduced $2.2 billion in 1968 (from $3.7 to $1.5 billion), the U.s. government claimed that overall investment, including that financed by foreign borrowings, had not only been largely unaffected by the Regulations but had in fact increased (5). Companies were able to obtain foreign financing with little difficult and the cost differential of borrowing on foreign capital markets, which is slight largely because there is no "compensating balance rule," does not affect the decision to invest.
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 consequence of controls that should have been avoided.

But rather than avoid a reduction of foreign investment projects, the United States Department of Commerce—in the voluntary program—urged the dropping or delay of marginal projects. The Department of Commerce 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 had increased much more slowly than formerly. The most data on expenditures abroad indicated that investments in plant and equipment abroad rose three percent in 1968 over 1967. But these levels of increase were substantially lower than the twenty percent average annual increase in the year 1964-1966. And there was a close correlation in the drop-off with the stringency of controls (6).
Some provisions of the controls directly tended to decrease the level of new investment abroad, for example (7), the requirement that repayment of foreign borrowings be counted in the quota. A reduction occurs 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.

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 (8). 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. Conversely, had the parent withdrawn its deposit abroad and loaned the $1 million directly to the affiliate, a transfer of capital occurs and is debited against parent's quota despite the fact that the funds never flowed through U.S. payments.

A final provision which reduces the volume of funds available to the parent for investment is that relating to repatriation of foreign earnings (9). 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 had to borrow funds to meet the repatriation requirements, thus cutting into their ability to expand investment abroad out of foreign borrowings.

4.2 Circular Flow

The principal danger posed by the Regulations was the reduction of future inflow of capital from foreign investments. The return of income from past foreign investments has consistently been a positive contributor to United States balance of payments to the extent of nearly $2.0 billion a year (10). The U.S. government's position has been that this inflow of capital will continue even without additional foreign investment; moreover, an increase in net income is actually predicted because of greater operating efficiencies and lower expenses.

An analysis of the returns to the U.S. balance of payments from foreign direct investment outlays indicated that, on the average, there had been a prompt recoupment of dollar outflows through earnings, sales of capital equipment, and concomitant exports (11). If dollar outflows are recouped in a short time, every effort should be made by the control authorities not to reduce foreign investment but to substitute foreign borrowings for dollars 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 not be to interfere with private decision 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 payment situation adversely by reducing total returns and lengthening the recoupment period.

Many arguments had been put forth as to the effect--harmful or beneficial--of the OFDI program upon the United States economy. Among the most frequently heard was that restrictions on direct investment were, in fact, harmful to the U.S. balance of payments accounts (12). Investment outflow was returned almost twice over every year in earnings. Between 1950 and 1967, $69.5 billion flowed into the United States as earnings, as opposed to a total dollar outflow for investment of $33 billion. Thus, restriction of investment expansion, so the argument ran, would result in a reduction of U.S. future earnings capacity and, therefore, harm the U.S. future balance of payments position. Such control, it is said, hurt the U.S. competitive position in the world marketplace because investment opportunities are lost to other countries which are never regained or, if they are, only at substantial cost and difficulty. And lost to the DI as funds for further investment are foreign earnings repatriated to the United States because in excess of authorized allowables. In subtle as well as in obvious ways, then, the mandatory direct investment controls are seen as striking a hard blow to the most important plus factor in U.S. balance of payments accounts.
Moreover, by encouraging foreign financing of direct investment, it was also argued that the program created a considerable debt overhang which someday would have to be paid off at considerable cost to U.S. payments position (13). Furthermore, the necessity to obtain foreign financing forced many to borrow who had funds of their own available. Foreign financing sought in foreign capital markets often was not available to small and medium-sized investors or was more costly than funds obtained from United States sources.

4.3 Effects on Exports

Critics of the program argued that direct investment controls result in a reduction of U.S. exports. Since in the late 60s, 25 percent of U.S. exports were goods shipped to foreign subsidiaries and affiliates, direct investment abroad was obviously a major determinant of the level of U.S. exports (14). Moreover, U.S. traditional trade surplus plunged dramatically from $3.5 billion in 1967 to $100 million in 1968--a loss of $3.4 billion, and it has been suggested that the investment controls were responsible for that deterioration. It should also be noted that possible retaliations by foreign countries might have a further adverse effect upon American exports.

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 investment 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.

And, the control over intercompany financing of exports reduced 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 percent 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 contribution 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 (15).
4.4 Removing the Controls

In view of statutory authority, unlike most major monetary programs, the Foreign Direct Investment Program was a product solely of the Executive Branch. While Congressional concern over the advisability of the Program was expressed, Congress had no role in its promulgation and doubt has been expressed as to whether the Regulations were authorized by the trading with the Enemy Act of U.S. (16). This Act, passed by Congress in October 1917, originally delegated to the President broad discretionary authority under section 5(b) to regulate commercial transactions between United States nationals and the nationals of any foreign country, whether enemy, ally, or otherwise, while the United States was at war (17). So, the statutory authority for the imposition of direct investment controls must rest upon the declaration of a national emergency by the President (18). In fact, the President's executive order relied specifically for authority upon a statutory provision giving the President broad powers to regulate transactions in foreign exchange or property during any "period of national emergency declared by the President" (19). The most expansive aspect of the presidential power under this provision is the virtually unlimited authority to designate a period of national emergency. In promulgating the executive order which established the Foreign Direct Investment Program, President Johnson continued the national emergency proclaimed by President Truman and reaffirmed by Presidents Eisenhower and Kennedy. The determination of a national emergency is "so peculiarly within the
province of the chief executive" that it is not readily susceptible to judicial review (20). Although the Nixon Administration was committed to removal of the mandatory controls on foreign direct investment, it recognized that this removal must be accompanied by improvement in the fundamental economic problems which created a persistent imbalance in the nation's balance of payments and provoked the dollar confidence crisis late in 1967 which led to the institution of the controls (21).

The breadth of the President's authority stems not only from the patently broad language of the statute but also from the history of the statute's use under the past four presidents. Precedents involving its use fall into two distinct categories. Executive measures in the first category deal with the regulation of gold and silver in domestic financial crises, while the second category includes order prohibiting substantially all commercial transactions with enemy countries or territories during periods of war or diplomatic stress. When placed in this context, the order clearly represented an expansion of presidential power. While it was a domestic financial measure, designed to strengthen the dollar, it went far beyond the handling of currency. It restricted transfers of all kinds of property and required the repatriation of property located abroad.

The conclusion to be drawn from this analysis, however, is not that the order was ultra vires. Instead, it may be viewed as a hybrid of the two categories and a reasonable extension of each of them. The order was war-related because of the nature of the national emergency upon which the President founded his exercise of authority and because
of the close relationship between the current balance of payments problem and the Vietnam War. At the same time, the order was partly within the domestic monetary category because continued deficits would impair the stability of the dollar. Since the order was logically related to previous precedents and because of the expansive nature of the statutory authorization, it was unlikely that the Program could be judicially upset for lack of authority, particularly in view of congressional acquiescence (22).

On the other hand, the United States used restrictions on the outflow of capital for the purpose of correcting the deficit in the U.S. payments balance. Clearly such restrictions violate the principle of freedom for international commerce--including investment--on which U.S. international economic policies are generally based (23). Furthermore, the Regulations could be viewed as depriving a DR or AFN of property without due process of law or without just compensation in violation of the Fifth Amendment (24). A DR, for example, could incur considerable tax costs in repatriating money or property held in foreign countries, or be put to unnecessary expense in obtaining foreign financing for investments which could have been financed with the investor's own funds without the interest expense. More broadly, there is the possibility that foreign investment is such a primary activity that any serious curtailment of it deprives an investor of the use and enjoyment of his property. The Fifth Amendment, moreover, speaks in terms of "deprivation" which is a much broader category than that of a taking or confiscation. Where the delegation of authority to the president is questionable, or there
is potential abuse of that authority, this problem becomes especially acute. The Regulations however in permitting investment abroad according to historical base period levels of investment, merely regulated the rate of increase in an investor's overseas transfer of capital. A Dr was never denied the use of his money to make investments; indeed, the Regulations provided him with an array of options to maximize his opportunities to invest abroad while still furthering the balance of payments objectives of the OFDr program. And, compliance with the repatriation requirements, moreover, could bring the Dr into conflict with certain foreign corporation laws, especially in Europe where the heaviest concentration of United States foreign investment was located and where the Regulations were strictest in regard to increased investment. A decision by a Dr not to reinvest the earnings of its AFNs would raise the important issue of "whether and to what extent the DI, in complying with the Regulations, could cause the board or the shareholder's meeting of the European subsidiary to determine its reinvestment policy according to the DI's repatriation obligation rather than according to their best business judgment as required under European corporation law. One could argue that causing the payment of dividends by the AFN, where the reinvestment or retention of earnings would be a clearly appropriate internal business decision, violated the fiduciary obligation of the Dr as a member of management or as a controlling shareholder to act in the corporate interest and to protect the interest of minority shareholders (25).
Measures had to be developed for preventing a rush of U.S. dollars to payoff foreign borrowing before it became due and normally to prevent a flood of dollars eager to escape possible future controls (26). This was accomplished by phasing out the repayment of foreign borrowing according to a pre-arranged schedule or encouraging a roll-over of debt. In light of all of these infirmities, the Office of Foreign Direct Investments (OFDI) announced January 29, 1974, that the Secretary by Executive Order 11387 and otherwise by law, the Foreign Direct Investment Regulations contained in Title 15, Code of Federal Regulations, Chapter X, Part 1000, was revoked (27). Such revocation did not, however, affect their force or validity or the responsibilities of any person thereunder while in effect, or their continued enforcement (28).
Endnotes


(2) Young, Governmental Regulations of Foreign Investment, 47 Texas Law Review (1969), pp. 440-441.


(4) Behrman, supra note 1 at p. 86.


(6) Behrman, supra note 1 at p. 87.

(7) Id., p. 88.

(8) Id., p. 89.

(9) Id., p. 90.

(10) Young, supra note 2 at p. 441.

(11) Behrman, supra note 1 at pp. 84-86.

(12) McDermott, supra note 5 at pp. 556-557.

(13) American investors borrowed nearly $3.8 billion in 1968, and $2.2 billion of that figure represented international bond issues sold by American corporations, a rise of $1.6 billion from 1967. $1.6 billion of these international bond issues were Eurobonds (American accounted for 86 percent of Eurobonds sold.)

(14) McDermott, supra note 5 at p. 558.

(15) Behrman, supra note 1 at pp. 91-93.

(16) Echoing Mr. Nixon's campaign charged that the Regulations were "based on questionable legal authority."
(17) McDermott, supra note 5 at p. 529.

(18) Id., p. 532.


(22) Note, supra note 3 at pp. 166-167.

(23) Furth, Barriers to Investment Abroad As Tools of Payments Policy, 34 Law and Contemporary Problems (1969), p. 64.

(24) McDermott, supra note 5 at pp. 540-541.

(25) Id., p. 547.

(26) Behrman, supra note 1 at pp. 93-94.


CHAPTER V
CONCLUSION

This thesis has explored the importance of foreign direct investment; the support structure and impetus for United States foreign investment; the related involvement of the United States government and foreign governments; the impact of foreign direct investment on national balance of payments; and the foreign direct investment program of the United States. To summarize, U.S. foreign direct investment is a debit item in determining the balance of payments, but is also a major factor in the economic growth of the world. It has made available to other nations needed dollars, advanced technology and managerial skills. However, during the late 1960's U.S. foreign direct investment became a major national economic policy issue, not as a result of balancing welfare benefits and costs as it should have, but as the consequence of a narrower focus on the choice of particular means to reduce the deficit. The Foreign Direct Investment Regulations (FDIR) were designed to curtail the outflow of dollars from the United States and to encourage the repatriation of earnings from previous outflow. Viewed in the most favorable light, the FDIR resulted in an improvement in the United States balance of payments position. At worst, the Regulations led to a reduction of capital inflow to the extent that the payments deficit was corrected only by devaluing the dollar.
The history of U.S. Foreign Direct Investment Regulations suggests that the decision to control foreign direct investment should focus mainly on two issues. First, in light of the nation's political and commercial relations with other countries, what is the total welfare gain from foreign direct investment and its distribution between the home and host markets. Second, what imperatives for action are dictated by the country's balance of payments position.

Appropriate weighing of these issues necessitates sensitivity to both private sector and public sector realities. Companies invest abroad in the first place because the size of the market or source of supply indicates that an investment will be profitable. In considering the profitability, most companies do not require a larger profit than can be obtained through a similar investment in the United States. In a large number of instances, companies have invested in a foreign country initially as a result of steps taken by the foreign government making it difficult to serve the market any longer through export from the United States. Unless the market or source of supply is believed to be suitable for foreign investment, no action by foreign governments will induce United States companies to invest in a particular country. The equally important public sector reality is that responsible sharing of a country's progress and technical advances with other countries is a critical touchstone for promotion of human welfare and economic progress at home and abroad. Therefore, the decision to impose foreign direct investment controls should clearly delineate whether such controls are only temporary to handle
short-term balance of payments problems or are logical, long-term measures to achieve legitimate development objectives.
BIBLIOGRAPHY


