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ADD-ON CIEP: 53487
MEMORANDUM

THE WHITE HOUSE

WASHINGTON

April 11, 1974

MEMORANDUM FOR: SECRETARY OF STATE
SECRETARY OF THE TREASURY
SECRETARY OF COMMERCE
CHAIRMAN, COUNCIL OF ECONOMIC ADVISORS
SPECIAL REPRESENTATIVE FOR TRADE NEGOTITATIONS
PRESIDENT, EXPORT-IMPORT BANK
CHAIRMAN, FEDERAL RESERVE SYSTEM

FROM: Randy Jayne
Assistant to Peter M. Flanigan

SUBJECT: Meeting of the Executive Committee of the Council on International Economic Policy, Friday, April 12, 1974, 10:00 a.m., Roosevelt Room, The White House; possible additional agenda item

The attached Treasury paper is for consideration at the meeting Friday morning.

cc: Governor Mitchell

Attachment

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ECONOMIC ASSISTANCE PROBLEMS IN LIGHT OF OIL SITUATION

A reduction of prices is, of course, the first answer to the problems facing the LDC's. However, we cannot expect oil prices to be reduced to the levels prevailing before last September. Thus, some LDC's will still have oil-induced (and food price-induced) balance of payments problems.

In approaching this problem, the U. S. Government needs a coherent, agreed view on 1) the magnitude of the problem; 2) how an understandable, workable, and comprehensive approach might be negotiated and organized; 3) what substantive international approaches seem promising, and 4) what, if any, new commitments or obligation the U.S. might be prepared to undertake.

1) Magnitude of the Problem --

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Annex A estimates only the impact of the increased oil prices on "hard hit" LDC's in 1974. More work (in process) needs to be done on the timing of these needs, and in evaluating the oil impact in the light of other commodity price impacts and overall trade trends for these countries. However, the table suggests relevant orders of magnitude.

2) Organization of International Discussion -- Annex B is a listing of possible forums for considering the assistance problem. The lack of a uniquely appropriate forum is contributing to the current sense of frustration, and this is an area in which our leadership could be effective; the choice will affect the substance.

3) Substantive Approaches -- Annex C summarizes the current state of play. The substance in some cases is dubious. Conflicts and overlaps are apparent.

4) U.S. Responses -- Annex D simply provides a checklist of theoretical possibilities for increased U.S. assistance as part of a multilateral effort. Obviously, the political possibilities here are extremely limited, and major substantive and tactical questions arise.

Attachments

Annex A

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The Impact of Increased Oil Prices on the LDCs

The increase in oil prices announced in October and December of 1973 will create severe balance of payments and economic growth problems for many LDC's. In order to finance the same volume of imports as in 1973, a much larger volume of capital flows will be required. Estimates of the increase of the oil import bill for the non-oil developing countries in 1974, for instance, are on the order of $9 billion at a $9-10 price (c.i.f.), while the projected current account deficit at this price is about $22 billion, compared with a $10.6 billion deficit in 1973.

The above figures overstate the magnitude of the "real" problem however, in that most of the increased capital requirement could be on commercial or near-commercial terms. The more difficult financing problem is that presented by many of the poorer LDC's who are hard hit and who do not have access to world capital markets. For most of the countries of South Asia, Africa, and scattered countries in Latin America such financing would only be meaningful on highly concessionary terms. (Specific countries that are hard hit and which would require concessionary assistance are listed in the attached). It is estimated that at current prices the amount of concessionary financing required in 1974 would be about $2-3 billion, and that at a $6 c.i.f. price the figure would be about $1 billion.

In addition to the impact of higher oil prices, many of the poorer developing countries are also affected by the reduced availability and higher costs of fertilizer and by higher grain prices in general. The World Bank has recently estimated that LDC imports of cereals increased from an average level of about $3 billion in 1970-72 to over $8 billion in 1973. (Part of this rise reflects an increase in import volumes due to poor harvests in many of the LDC's, although most of the increase is due to higher prices.)

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Estimated Increase in Oil Import Bill of Hard Hit LDC's Requiring Concessionary Assistance ($ millions)

	Oil Import Bill* — Sept. 73 Price & Alternative Price Assumptions ($ per barrel, CIF)				Increase in Import Bill		
	$3.40***	$6.00	$8.50	$10.50	$6.00	$8.50	$10.50
Bangladesh	37	65	92	114	28	55	77
Cambodia	4	8	11	14	4	7	10
Chile	145	256	362	447	111	217	302
Costa Rica	15	27	37	46	12	22	31
Dominican Rep.	29	52	73	90	23	44	61
Ethiopia	19	33	48	59	14	29	40
Guyana	12	21	30	37	9	18	25
Honduras	12	21	30	37	9	18	23
India	387	682	967	1194	295	590	807
Jamaica	45	79	112	138	34	67	93
Kenya	42	73	104	128	31	62	86
Pakistan	107	188	267	330	81	160	223
Philippines	208	367	520	642	157	312	431
Sahel**	10	17	24	30	7	14	20
Senegal	42	75	106	131	33	64	80
Sri Lanka	45	79	112	138	34	67	93
Sudan	39	68	96	119	29	57	80
Uruguay	46	81	115	142	35	69	96
Viet Nam	129	227	322	398	98	193	260
Total	$1373	$2419	$3423	$4234	$1046	$2055	$2861

* Assumes 1973 volume level.

** Chad, Mali, Niger, and Upper Volta.

*** Sept. 1973 price.

Annex B

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ORGANIZATIONAL ARRANGEMENTS FOR MOBILIZING
ASSISTANCE FOR HARDEST-HIT DEVELOPING COUNTRIES

Following is an annotated listing of possible organizational arrangements for mobilizing assistance for the LDC's hardest hit by the increases in oil prices.

1. ENERGY CONFERENCE: Participation of both oil producers and LDC's is uncertain. LDC's have been commending OPEC for its actions and focusing their effort to obtain aid on DC's. Europe and Japan are reluctant to oppose LDC demands. Such a conference might run wild like most UNCTACD and UN conferences. Nevertheless, such a conference probably could be limited to oil and permit a simultaneous negotiation on oil prices.

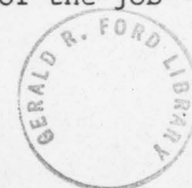
2. UNITED NATIONS GENERAL ASSEMBLY. There seems little prospect that any useful assistance could be negotiated in the UNGA: the organization is unwieldy and ineffective, and dominated by the smaller LDC's. Other DC's are unwilling to resist them for fear of political repercussions. The resolution which the Group of 77 have prepared for this meeting is a shopping list which commends the OPEC countries and makes extensive and extreme demands on the DC's.

3. INTERNATIONAL MONETARY FUND: The general framework and terms of the proposed oil facility are not appropriate for the hardest-hit LDC's except possibly for very short-term emergency financing. The Fund is, however, the logical body for extending balance-of-payments assistance (although this situation calls for "welfare aid" which is not the normal role of the Fund). It is relatively experienced in the field; it has the proper membership. The technical problems are minimal and the focus could more easily be kept on oil.

Use of the General Account for the hardest-hit LDC's would tend less to ratify the oil price increases and the interest rate would be lower than that proposed for the oil facility. However, the repayment period and the conditions normally attached would be inappropriate. Also the financing responsibility would fall primarily on the DC's (most importantly the U.S.) who supply the currency. The IMF might also end up with a substantial amount of bad debt.

4. COMMITTEE OF TWENTY: The time remaining for the C-20 is now probably too short to enable it to serve this purpose. It might still be possible to use Governors Council, although the Council may not have much freedom to propose actions by bodies other than the IMF.

5. INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT. IBRD membership is satisfactory and it is likely to focus on getting funds from OPEC. The Bank approach would, however, tend to ratify the oil price increases. Furthermore, it is oriented toward project lending, which is a slow, time-consuming process. The OPEC countries have shown little interest in IBRD (or IDA) approaches and there seems little possibility of getting them to provide funds in the amounts or on the terms which may be required. The Bank would have to be given strong public support for the job--a special mandate--before real progress could be expected.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6. COORDINATED APPROACH BY THE INTERNATIONAL FINANCIAL INSTITUTIONS: A coordinated approach by the IFI's would make a great deal of sense but whether the members of the regional institutions would be willing to endorse the action openly, especially to make demands on oil exporting countries, is dubious. The mandate could be limited to the oil problem and the burden focused on the oil exporters. A special approach to assist the hardest-hit LDC's would minimize the effect of ratifying the oil price increases. The IFI would in effect be developing a package for the oil exporters, who might react favorably.

7. OECD/OPEC CONFERENCE: This proposal seems a non-starter, despite the Shah's support. The oil price increases would be solidified. There would be no participation by the hardest-hit LDC's. The OECD unanimity rule and its tradition as a non-negotiating organization would make it a very poor advocate of U.S. views.

8. DEVELOPMENT ASSISTANCE COMMITTEE MINISTERIAL: As a DC forum, another non-starter, unlikely to produce anything but words. All it could do would be to appeal to the DC's to increase their aid.

9. INDEPENDENT COMMISSION TO PROPOSE ACTION: A small commission of world statesmen or wisemen could be appointed perhaps by the producer-consumer conference. If the group could be kept small (say 3 representing the oil producers, 3 the DC oil importers and 3 the LDC oil importers), if the terms of reference could be tightly drawn, and if the DC representatives were carefully chosen to ensure that they would not agree to recommendations which had no chance of gaining political support in the U.S. and the OPEC and LDC representatives were not demagogic, a useful dialogue might be developed. It would take time to organize such a group, however, and time for them to debate. Meantime financing would probably have to come through the IMF and debt rescheduling.

10. MULTIPLE CHANNELS APPROACH: Consideration of the problem in several channels simultaneously would keep matters uncertain, but eventually, enough might be done to take care of the hardest-hit LDC's. There is not too much likelihood of a package attractive enough to ratify the oil price increases. And the pressure might tend to stay on the oil exporters.

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VOLUME . . . . 2 pages

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MEMORANDUM FOR THE RECORD

SUBJECT: Minutes of CIEP Executive Committee Meeting, April 12, 1974 in the Roosevelt Room

ATTENDEES: List Attached

The meeting, chaired by Secretary Shultz and attended by the persons listed at Annex A considered issues relating to international investment, foreign banking activities in the U.S. and assistance to the LDCs to meet the balance of payments problems created by rising import costs for oil and other commodities. The item relating to DISC which was on the agenda was not considered.

1. International Investment

Mr. Flanigan opened the discussion by referring to the paper which had been distributed and indicated that a similar paper had been prepared with respect to overall policy in connection with trade and monetary matters. He pointed out that those aspects of our effort to reform the international economic system relating to investment were lagging. While there was work going on in the XCSS, he felt that the focus was not broad enough and that there was no broad U.S. policy to guide our overall actions. He pointed out that there was a possible hiatus in progress on international economic reform due to potential delays in the trade and monetary field and that it would be desirable to have investment as another area for continuing the discussion of an open world economy with our foreign partners.

He proposed that we use the OECD ministerial meeting to give new impetus to investment work in the XCSS, which in his opinion, had slowed down. Mr. Flanigan felt that if the paper under consideration correctly stated the Administration position he would suggest that it should serve as the basis of the statement at the May ministerial meeting to stepup the pace of investment activities in connection with reform of the international economic system which we had proposed. He suggested that the meeting consider (1) the substance of the paper and (2) the desirability and content of a U.S. statement at the OECD ministerial meeting.

a. Substance

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Mr. Burns asked whether the statement took account of Congressional concern over investment in strategic industries. Mr. Flanigan pointed out that the Administration had testified before committees in both houses and pointed out that there was adequate protection available under existing laws. In addition, the policy statement recognizes certain critical sectors as appropriate exceptions to the overall policy. Mr. Flanigan indicated that Chairman Burns was right in referring to Congressional concern (especially in light of recent bills that have been introduced by Representative Roe) but that he felt that the only serious bills were those designed to get more information about foreign investment and not to restrict it.

Mr. Burns asked if the CIEP had made a list of existing constraints on foreign investment. Mr. Flanigan indicated that such a list had been prepared and that it would be circulated to the Executive Committee members.

Mr. Rush indicated that the statement was a good one but expressed concern that the U.S. was one of the major culprits when it came to government interference. He referred to the Jackson/Vanik amendment with respect to MFN, the extraterritorial problem with respect to application of the Trading with the Enemy Act in Argentina and antitrust problems similar to those faced by ICI whose sales office in New York gave the Justice Department jurisdiction to seek data with respect to its worldwide operations. He said in his opinion our antitrust laws are the most flagrant example of the extraterritorial application of laws in the investment field.

Mr. Flanigan pointed out that while it was true that we sinned in the investment area most other nations (with the possible exception of the Federal Republic of Germany) were far worse sinners than the U.S. Chairman Shultz did note, however, that if we pushed the investment issue then we would be sure to get the areas where we were vulnerable raised by other nations. Mr. Flanigan noted that we must accept the fact that nations will be reluctant to accept the kind of policies we have outlined and that we may need to grandfather certain practices. What we are trying to do with the policy statement is to set forth a general framework and to begin work on removing the existing restrictions.

Mr. Eberle endorsed the principle of the grandfathering concept of extraterritorialling as expressed in Item III(2) and also endorsed the proposal in Item III(3) where we would seek to negotiate procedures for handling conflicts caused by extraterritorial application of laws. He also pointed out that Item I(3)(a) dealing with investment incentives that distort trade patterns could create a problem for the U.S. with respect to state laws and that we might need to grandfather some of our state practices.

In addition, he raised the question of whether it would be possible to totally eliminate or harmonize investment incentives, and suggested we revise our statement on the purpose of our work on incentives to bring it in line with what we are seeking in the OECD Trade Committee and GATT.

Mr. Volcker felt that the major issues with respect to the investment statement were those of tactics and priorities. He felt that it was a good statement of our position and that he had no problem with it as such except to note that it would be extremely difficult to negotiate and that some of its provisions would hit the U.S. as well as other nations.

After Messrs. Volcker, Rush and Tabor had agreed that the statement was a generally acceptable statement of our overall aims, Mr. Shultz suggested that the statement be reviewed in light of the previous discussion and that any specific comments be given promptly to Mr. Flanigan.

b. Tactics

The meeting then considered the question of tactics. Mr. Volcker expressed a strong view that it would not be useful to "throw a big stone" into the OECD Ministerial Meeting on the basis of the draft statement of policy. He believed that we should continue to proceed in those areas where progress seems most feasible and that the best course of action would be to proceed in the same manner as we had over the past year. He felt that any new statement from such a sweeping document could raise questions and could set the OECD work back by creating suspicions in the minds of other nations (e.g. that we were changing our mind by starting the investment exercise anew). In short, he felt that we should continue to push along in the XCSS and that no new initiative was required.

Mr. Casey felt that there should be a new thrust at the ministerial meeting but that we would need to be careful as to how we presented our position. He noted that there was not much enthusiasm in the OECD for the investment exercise and that it was only U.S. efforts which had kept it alive. Even now there were only two areas in which work is seriously proceeding-- national treatment and investment distortions -- and that all that was likely to result from the negotiations in these areas was some general principle with respect to consultation. He felt that the U.S. should continue to push to get something more favorable and suggested that there may be some pressures to this end from Congress resulting from the UN effort (in this regard he cited his recent letter from Rep. Gonzales with respect to a new investment forum and greater involvement of the LDCs). In short, Mr. Casey felt that a worthwhile initiative could be taken by the U.S. at the ministerial meeting.

Mr. Eberle supported Mr. Casey's view and indicated that we needed to move in a firm positive way in the OECD. If we didn't, OECD activities are apt to be concentrated on MNCs and results might be negative. He felt that we should take the initiative, that we could gain from such an initiative and that we would, at least, prevent any negative results.

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Mr. Rush agreed with Mr. Volcker and indicated that it was his impression that a number of matters in the investment field were moving well in the OECD. If we came forth now with broad proposals, we could be counter-productive by upsetting existing work and perhaps accelerating work on the MNC issue. While he felt it to be a good statement of our broad objectives, he felt that we should not toss out a big bomb at the ministerial meeting.

Mr. Flanigan pointed out that there was apparently a different perception as to how investment matters were moving in the OECD as some felt that the investment exercise needed a major infusion to keep it moving. He pointed out that he did not feel that a statement at this time would represent a new initiative or any change in U.S. position. He pointed out that we did not have to use this statement in its entirety but could refer to the work that was going on and then suggest areas for further work so that there would be no winding down of the current limited efforts in investment. Rather, we would attempt to broaden the OECD efforts with respect to investment to complement our reform movements in the trade and monetary field.

Mr. Volcker agreed that there was no major progress in the investment field in the OECD and there were real pockets of opposition and restraint. However, he pointed out that the XCSS was set up largely to handle investment matters and that it was in our interest to keep the investment exercise moving. He had no great disagreement in seeing something done at the ministerial meeting but pointed out that if we take a new hard approach we might force others to back off from their even limited cooperation. In short, he felt we should push only where progress seemed possible.

Mr. Rush added that if we were making a new initiative we should consult with our partners before hand.

Mr. Stein felt that this was not a major new initiative. In fact, it was a course of action which we had agreed upon two years ago and had dribbled along in a generally unproductive way since then.

Mr. Shultz then summarized the discussion on investment as follows:

1. There was general agreement on the policy paper which had been circulated but there were a few problems which had been raised which should be taken care of. Comments should be given to Mr. Flanigan and the CIEP staff, and the revised paper circulated for internal use as an internal policy guideline for administration officials;

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2. There was general agreement that the U.S. should keep the investment issue alive in the OECD and use the ministerial meeting, to the extent possible, to do so. The best way to provide continued emphasis was essentially tactical but the general consensus of the meeting was that the U.S. should not come on strong with a major new initiative. He felt that a group was needed to consider what our tactics should be for the ministerial meeting and what document we would need to do this. He suggested that the State Department take the lead and chair a small working group with representatives of CIEP, Treasury and other interested agencies, to decide on the best way to use the OECD, and in particular the ministerial meeting, to keep the investment issue moving.

3. It was agreed that we would need to consult with our major trading partners prior to the ministerial meeting.

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2. International Capital Markets

a. National Treatment for Foreign Banks

Mr. Flanigan began the discussion by saying that this issue had been discussed before at the January CIEP Executive Committee Meeting, and that in principle the Council had agreed that principle of non-discrimination should apply to foreign bank regulation in the United States. Because of disagreements among departments regarding the Federal Reserve's draft legislation designed to bring foreign bank regulation in line with the principle of national treatment, Mr. Flanigan felt that it was necessary to re-raise the issue before the Council.

Governor Mitchell then reviewed the status of the Fed's proposal. He indicated that the objectives of the legislation were to bring foreign bank regulations in line with the principle of national treatment, to subject foreign banks to controls for monetary policy purposes, and to provide a Federal option for U.S. entry by foreign banks. During the past year, Governor Mitchell had extensive discussions with foreign central bankers, and generally the principle of nondiscrimination was acceptable. Further discussions with foreign central banks are being carried on. Foreign commercial banks are concerned about what the reserve requirements of the Federal Reserve will cost them, and are concerned about their existing activities in the U.S. Governor Mitchell indicated that required Fed membership for foreign banks was technically not national treatment, but since major U.S. competitors of foreign banks are members of the Fed, in practice, it is nondiscriminatory treatment. He also indicated that all foreign banks derive some type of grandfathering procedure for multi-state activities as well as for their non-banking activities in the underwriting and brokerage areas. Governor Mitchell felt that it was important to move ahead quickly with legislation because of the rapid expansion of foreign bank activities in the United States. Postponement of action will make grandfathering more difficult. Since grandfathering is a way of reducing the likelihood of foreign retaliation, it is better to take action now when it is easier to grandfather the existing activities than to wait until the level of foreign bank activity is even greater. If U.S. banks want to continue to expand abroad in the future, it is important to get this issue settled now in a satisfactory way.

Governor Burns stated that if we wait, the problems will become more acute and we may get restrictive legislation in the future. He indicated that U.S. banks would prefer no action at the moment, because they fear retaliation. But if we proceed with generous grandfathering provisions, the fear of foreign bank retaliation will decline. He indicated that he would be opposed to permanent grandfathering even for branching. Practically, he did not think that there was a great difference between

15 year grandfathering and permanent grandfathering since many of the activities that would be grandfathered will probably be allowed to all U.S. banks, foreign and domestic-owned banks, sometime within the next 10 to 15 years.

Mr. Rush indicated that the State Department was studying our treaties to determine if there would be major problems with various grandfathering procedures. So far, none appear to have emerged.

Mr. Volcker indicated that there were contrasting views within the Treasury Department. For some, the present circumstances are not bad and put desirable pressure on the U.S. banking system, especially in the area of multi-state branching. Actions along the lines of the Fed bill would tend to freeze the U.S. banking system at its present form. Since there is no possibility that legislation could be passed this year, we should wait and see how things develop and possibly prepare legislation that would include changes in the U.S. banking system. He indicated that while grandfathering procedures may protect existing U.S. banks abroad, future American banking growth abroad may be subject to restrictions.

Chairman Burns stated that he did not think the Fed proposals would freeze the U.S. banking system since the Fed proposal simply brought the regulation of foreign banks in line with the regulations of U.S. banks, but did not prevent overall changes in the U.S. banking system.

Governor Mitchell indicated that if foreign countries did retaliate by restricting future American bank growth, we could vigorously protest such actions on the basis that such actions would be nondiscriminatory treatment.

Mr. Volcker indicated that national treatment can be subject to many interpretations. For example, if we override the principle of state's rights, which is an important principle in our banking system, we could be accused of not applying national treatment. Mr. Volcker felt that it was not undesirable to have some fluidity in the system. In addition, he was concerned that the legislation proposed by the Fed might come out of Congress even more restrictive because it will serve as a vehicle for discriminatory amendments.

Mr. Eberle felt that it was important to set a grandfathering date in some way as soon as possible.

Chairman Burns stated that Mr. Volcker was right that there would be no legislation this year, but that there is a process - a period of education - which will have to take place if concrete legislation is to be carried forward at some time. Proposing new legislation now would enable us to set a grandfathering date and would provide a specific concrete set of proposals for everyone to discuss.

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Secretary Shultz concluded the discussion by stating that he thought it was the consensus of the group that it was important to propose a piece of legislation to Congress and establish a grandfathering date. In addition, he stated that it was important to proceed with consultations with foreign governments and foreign banks so that it will be made clear that our intention is to avoid discriminatory treatment. Continued Administration support for the Federal Reserve draft legislation would be contingent on that legislation remaining consistent with the principle of nondiscrimination.

b. The Foreign Window Proposal

Chairman Burns stated that the Fed would have a paper on the foreign window proposal, but at the present time, thinking is running against the proposal.

Governor Mitchell indicated that the basic problem is how to build a fence around the foreign window in order to protect domestic monetary policy. Establishing the foreign windows would create channels for U.S. and domestic residents to avoid interest rates and reserve requirement restrictions. The foreign window raises other questions, of a more technical nature: for example, how deposits held in the foreign windows should be melded into U.S. domestic money supply. The work within the Fed today indicates that there is a hazard that there would be leakages from the foreign window or into the U.S. domestic monetary market. In addition, Governor Mitchell indicated that U.S. banks have not been that receptive to the proposal since U.S. banks believe that it is necessary to maintain a full service capability abroad in any case.

Chairman Burns also stated that he saw no serious interest on the part of American banks in having this foreign window and the existence of the foreign window would raise hazards for the credit and money policy. He indicated, however, that work within the Federal Reserve on the proposal would continue and that in addition the Fed will consider an option which would allow a U.S. bank to accept foreign currency deposits.

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3. U.S. Policy Towards Financial Proposals to Assist LDCs to meet oil and other import problems

Mr. Volcker lead off the discussion on the Treasury Department paper by pointing out that the only agreement so far was the universal recognition of the problem and many suggestions for its solution. With respect to procedural aspects of the problem, he raised the question of whether the U.S. could contribute anything by suggesting a forum for discussion to sort out the various proposals. With respect to our substantive position, he said we needed to decide what contribution the U.S. could make and what our overall attitude toward the effort will be. He concluded by noting that if we had no U.S. position then Secretary Kissinger should finesse the question during his upcoming UN speech.

Secretary Shultz indicated that we did have a position -- i.e. holding our level of support to the levels projected in the budget. He felt that we would be doing extremely well if we got the amounts for aid that we had requested and that we could not make further commitments because of the Congressional problem.

Mr. Cooper pointed out that it might be somewhat premature to discuss magnitudes of overall aid to the LDCs because of questions as to the magnitude of the impact of the oil price rise and also as to the precise timing of this impact. Mr. Flanigan noted that what was needed was careful country studies to assess the size and timing of the impact.

Mr. Volcker raised the question of whether the U.S. should accept a position of no additional aid. Mr. Eberle said in his opinion we should not lock the door on the possibility of additional aid but that we should not adopt a position that accepts the continuance of the current oil price. Mr. Flanigan noted that, on the basis of what was said so far, he would feel that it would be inappropriate to bring the issue forward in an international forum like the UN before we know our own position.

Mr. Cooper indicated that informal discussions were now underway and oil producers' indecision gave the U.S. some time to decide on its ultimate position. In his opinion what was needed was a better picture of the timing of the problem. Mr. Volcker expressed his uneasiness with respect to this kind of informal approach and Mr. Flanigan added that the U.S. would not exercise the appropriate leadership if it merely determined the parameters of the problem and waited for others to advance proposals or to take action.

The committee agreed to Mr. Flanigan's proposal that a working group under Mr. Cooper's chairmanship should be convened to examine the extent of the problem and timing issues and suggest options for U.S. policy.

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THE WHITE HOUSE

WASHINGTON

MAY 22 1974

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MEMORANDUM FOR: SECRETARY OF STATE
SECRETARY OF THE TREASURY
SECRETARY OF AGRICULTURE
SECRETARY OF COMMERCE
SECRETARY OF LABOR
DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET
CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISORS
THE SPECIAL REPRESENTATIVE FOR TRADE NEGOTIATIONS
ASSISTANT TO THE PRESIDENT FOR NATIONAL SECURITY AFFAIRS
ADMINISTRATOR AGENCY FOR INTERNATIONAL DEVELOPMENT

FROM: PETER M. FLANIGAN

SUBJECT: CIEP Executive Committee Decisions on World Food Conference, DISC and International Investment

At the CIEP Executive Committee meeting of May 17, the following decisions were taken:

I. Article XXIV (6)

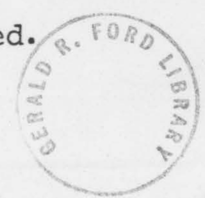
Ambassador Eberle's summary status report was noted and there was no objection to continuation of his current tactics.

II. Preparation for the World Food Conference (CIEPSM's 30 and 31).

The Committee agreed that the number of options in CIEPSM's 30 and 31 should be reduced and further work concentrated as follows:

CIEPSM 30 (Stocks Policy):

Options A, B and E in CIEPSM 30 would be dropped.



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E.O. 12958, SEC. 3.5
NSC MEMO, 11/24/98, STATE DEPT. GUIDELINES
BY wq, NARA DATE 9/6/05

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The two options remaining are: Option C, modified to read:

"U.S. Government policies which result in the creation and release of stocks in accordance with international guidelines sufficient for general food aid needs only",

and Option D:

"U.S. Government act to accumulate non-designated stocks according to international guidelines (should stocks held in the private sector be inadequate to meet guideline levels) for use in covering both commercial and food aid requirements".

CIEPSM 31 (Food Aid)

Options I and IV would be dropped. Further work would proceed on Options II and III.

A working group, chaired by Dennis Wood of the CIEP Staff and including representatives from USDA, OMB, AID, STATE, TREASURY, CEA and NSC, will review work of USDA in preparing estimates of the budgetary and economic costs of the remaining options cited above, including potential effects on domestic and world prices of each program in a range of stock and food aid levels which the group considers to be probable over the next 5 years. The group would also examine the techniques involved in the creation and release of the stocks involved for the purposes indicated in the stock policy options; assess the adequacy of these techniques in meeting the objectives and, if the group deems it useful, recommend alternative techniques for further policy-level review.

Representatives of other CIEP agencies may participate in the working group if they wish. Names of representatives should be submitted to Mr. Wood at the earliest opportunity.

In the meantime, without commitment, Ambassador Martin is authorized to proceed with informal consultations, at the World Food Conference Preparatory Committee meeting in June and bilaterally as he deems useful, on the basis of the following four points:

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1) The US would be prepared to participate in a more extensive exchange of information and consultation internationally as proposed by Boerma on food stocks, supply and demand and to cooperate in efforts to develop an improved analytical capability in these matters.

2) We would cooperate in developing a policy on food reserves within an international framework of agreed guidelines, and would discuss various techniques for participation in it, not excluding limited government held stocks for food aid or emergency needs, but not implying a return to the large US Government stocks of recent years.

3) We are prepared to consult internationally on future food aid requirements and to make purchases for them early in the crop year, but without multi-year commitments on volumes.

4) We want to examine with other countries better techniques for expanding food production in LDC's.

III. DISC

The Committee noted that discussions were proceeding both internationally and domestically in the context of possible tax reform legislation this year in which the removal or phase-out of the DISC law could become a key element. There was support for outright repeal coupled on the part of some members with a desire to get something for such repeal internationally or domestically or both. The Committee noted the strong objection of the Department of Commerce to removal and Secretary Dent's desire that any future decision on repeal of DISC would have to be taken by the President. In conclusion, it was agreed that no decision on removal would be taken at this time, but that a decision for or against removal may be necessary later in the light of the circumstances which may develop in the context of either the international or domestic discussions.

IV. International Investment

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A. Tactics in OECD

The Committee agreed:

a) That we would continue to press for expression in the OECD Ministerial Communique of Ministers' desire to move ahead with the OECD's work on investment reform.

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b) That the U.S. Delegate to the May 29-30 OECD Ministerial meeting would include in his remarks a statement which:

1) endorses rapid progress on the full range of issues in the investment exercise;

2) stresses its relevance to work on reform in the trade and monetary areas, and the contribution which clarification of rules, procedures and principles on investment can make to stabilize the international economy in a period of uncertainty arising in part out of the oil crisis;

3) expresses our desire to see the work deepened (by coming to grips with the difficult problems involved in such matters as treatment of established and new investors, and the variety of specific problems -- e.g., transfer pricing, accounting, tax matters, etc. -- being studied in the context of transnational investment and multinational enterprises) and broadened (by examining the usefulness and content of a set of principles concerning security of investment to balance work here and elsewhere on a code of conduct for MNC's).

In addition, he may, if he considers it desirable, include an expression of our desire to have the XCSS study improved OECD procedures or mechanisms that would permit periodic high-level review of progress on investment rules and consultation on problems which may arise.

B. Investment Policy Paper

The revised paper "U.S. Policy and Objectives on International Investment" has been approved and is attached. It will be used for internal U.S. Government guidance in the development of positions on investment issues and as an indication of future work needed on particular problems.

Attachment

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Mr Nielsen
Tab-E 3b

THE WHITE HOUSE

WASHINGTON

May 16, 1974

MEMORANDUM FOR: SECRETARY OF STATE
SECRETARY OF TREASURY
SECRETARY OF AGRICULTURE
SECRETARY OF COMMERCE
SECRETARY OF LABOR
DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET
CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS
THE SPECIAL REPRESENTATIVE FOR TRADE NEGOTIATIONS
ASSISTANT TO THE PRESIDENT FOR NATIONAL SECURITY AFFAIRS
ADMINISTRATOR, AGENCY FOR INTERNATIONAL DEVELOPMENT

FROM: DEANE R. HINTON

SUBJECT: SUPPLEMENTARY DISC PAPER FOR THE MEETING OF THE EXECUTIVE COMMITTEE OF THE COUNCIL ON INTERNATIONAL ECONOMIC POLICY - FRIDAY, MAY 17, 3 PM - ROOSEVELT ROOM, WHITE HOUSE

The attached Treasury staff paper is an attempt to provide some measure of impact of the DISC on domestic vs. foreign investment. The index system presented in Annex B and described in the paper is an attempt to summarize many complex features of the tax system with a single number so that comparisons could be made among countries. Simplifying and sometimes unrealistic assumptions had to be made in order to reach numerical estimates. Therefore, importance should not be attached to any single index value. However, with respect to investment, the following conclusions may be drawn:

The DISC makes it more favorable, from a tax standpoint, to manufacture in the U.S. and export than to produce abroad for local markets. Thus, the DISC may work as a small element in encouraging multinational firms to invest in the U.S. rather than in other industrial countries.

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DRAFT - May 16, 1974

3c

THE TAX COST OF CAPITAL

Explanation of the Data Presented in Annexes A and B of the Treasury Paper Entitled "DISC Review" Dated April 10, 1974

The Significance of the Data

The data in Annex A of the Treasury paper may be used to compare the tax burden on U.S. exports of manufactured goods under DISC with the tax burden on exports of manufactured goods from other countries. They were used in the paper to help evaluate the pro-DISC argument that, since other countries provide tax incentives for exports, we should too. The data generally show that DISC taxes are greater than the taxes which many other countries impose on their exports. However, it must be emphasized that the calculations rest on highly tentative assumptions about the shifting of profits to tax-haven sales subsidiaries.

The data in Annex B may be used to compare the tax burden on U. S. exports of manufactured goods under DISC with the tax burden on the production and sale of manufactured goods by U.S. subsidiaries in foreign countries for local consumption. They were used in the paper to help evaluate the pro-DISC argument that we should give tax incentives to exports to keep U. S. companies from locating production facilities abroad. The data generally show that the tax advantages of DISC are greater than the tax advantages of U. S. subsidiaries which produce abroad for local consumption abroad.

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Annexes A and B are attached to this explanation. The earlier data have been corrected and revised.

The Tax Cost of Capital Index

The data are presented in terms of a tax cost of capital index. The tax cost of capital concept is a tool used to measure the weight of the tax structure on the cost of capital assets. The cost of the capital is equal to the opportunity cost of capital (that is, the discount rate times the value of the asset), plus the economic depreciation of physical assets purchased with that capital, plus taxes on the return to capital. A reduction in taxes reduces the cost of capital.

The tax cost of capital index is equal to:

$$\frac{\text{the cost of capital including taxation}}{\text{the cost of capital in the absence of taxation}} \times 100$$

an index of 100 means that the effective tax on returns to capital is zero. An index less than 100 means that capital is being subsidized; the lower the index, the larger the subsidy.

Formula for Cost of Capital Index

Annexes A and B set forth the tax cost of capital indices as separately computed by Treasury for each country (including the United States). The simplified formula for the tax cost of capital index in a particular country for a particular asset category is:

$$\frac{1 - TB - C}{1 - A} \times 100$$

where T is the tax rate appropriate for the evaluation of depreciation allowances, B is the present value (at the time of purchase of a capital asset) of the prospective annual depreciation allowances, C is the percentage of the price of the asset which is subsidized through government grants or which may be credited against tax liability, and A is the tax rate applied to total export earnings. An explanation of this formula is given by Robert E. Hall and Dale W. Jorgenson in Fromm (ed.), Tax Incentives and Capital Spending (Washington, D. C. : Brookings Institution, 1971).

The Assumptions Used in Constructing the Capital Cost Index

The derivation of the formula for the capital cost index makes various assumptions. The principal assumptions are that:

(1) firms are profit maximizers;

(2) the rate of inflation is constant; and

(3) the discount rate is constant.

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The Underlying Data

The individual indices have been calculated by the Treasury Department from unpublished data in its files. Most of the data relates to 1972. Some of the underlying data are of questionable reliability, for example, the estimates of the present value of depreciation allowances and the assumed proportions of profits sheltered in export corporations. For

simplicity, the assumption is made that all capital outlays are depreciable. In reality, some kinds of capital outlay, for example, research and development expenditures, can be expensed in the year of purchase, whereas other kinds of capital outlay, for example, land costs, cannot be depreciated.

A Sample Calculation

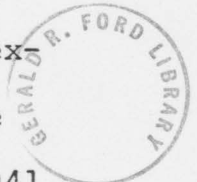
Annex A indicates that the tax cost of capital index for DISC is 119. This calculation was made in the following manner.

The formula for the capital cost index is:

$$\frac{1 - TB - C}{1 - AD} \times 100$$

The tax rate appropriate for the evaluation of depreciation allowances when a DISC is used (T) is about .36. This may be explained in the following way. In most cases, the DISC and its parent firm use the statutory rule that allows splitting of export profits. Thus, all costs of production such as labor, raw materials, and depreciation, can be said to reduce both the profits of the DISC and the profits of the parent. The two corporations are taxed at a .48 rate on three-quarters of the profits - one-half share of profits allocated to the parent and one-half of the one-half share allocated to the DISC. Thus, the overall tax rate on the DISC and its parent is about .36.

The value of the annual depreciation deductions (B) is about 0.547, assuming a 10% discount rate and calculating a rough weighted average between building and equipment expenditures. (The value for buildings is 0.379; the value for equipment is 0.603.) The investment credit (C) is .041. (Although the statutory rate of investment credit is 7%, the effective rate in manufacturing is about 5-1/2% of the cost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of equipment, because of various limits on using the credit; equipment accounts for about 75% of capital expenditures; thus, .055 x .75 equals .041.)

The tax rate applied to total export earnings when a DISC is used (A) is about .36. As explained above, the parent and the DISC are taxed at a .48 rate on about three-quarters of the profits. Thus, the tax rate applied to total export earnings is .36. In this example, T and A have the same value. However, in other fact situations not involving a DISC, T could be higher than A. For example, if the parent sells goods to a tax haven export subsidiary at a fixed price, then depreciation allowances will only affect the parent's profits, and not the subsidiary's profits. In that situation, T would be the tax rate applied to parent income.

Substituting the relevant DISC parameter values in the formula:

$$\frac{1 - (.36)\ (.547) - (.041)}{1 - (.36)} \times 100 = 119$$

Estimated Effective Current Tax Rate For U.S. Exports

Annexes A and B give separate figures for United States sales through tax-haven sales subsidiaries, Western Hemisphere Trade Corporations, DISCs alone, and DISCs in combination with tax-haven sales subsidiaries.

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In the absence of DISC, it is assumed that about 50% of profits can be allocated to the selling subsidiary. Thus, if the selling subsidiary is a tax-haven subsidiary paying <u>no</u> tax, the effective rate is about 48% of the 50% income attributed to the parent or 24%. (The tax-haven subsidiary might be able to avoid having deemed distributions under subpart F by making minimum distribution elections.) If the selling subsidiary is a Western Hemisphere Trade Corporation, the effective rate is about 41%.

If 50% of the profit is allocated to a tax-haven subsidiary paying no tax and 50% of the remaining profit is allocated to a DISC, the effective rate is about 18%. However, the use of both a tax-haven subsidiary and a DISC for the same transaction may not be widespread because of taxpayer fears that selling exports in this manner would trigger I.R.S. interest in the taxpayer's pricing methods.

Annex A shows the effective tax rate under the alternative assumptions that none of the selling subsidiary's profits are remitted, that 50% are remitted, and that 100% are remitted.

* * * *

Because of the seeming precision of the numbers given, it is easy to give excessive weight to the tax cost of capital data. Care should be taken to keep the data in proper perspective.

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Annex A

Tax Cost of Capital Engaged in Producing Manufactured Goods for Export

Country Type of export corporation	(1) Proportion of total profits assumed allocated to export corporation	(2) Tax Rate appropriate for evaluation of depreciation allowances a/	(3) Present value of depreciation allowances discounted at 10% per dollar of capital expenditure on: Buildings	(4) Equipment	(5) Cash grant or tax credit per dollar of capital expenditure	(6) Estimated tax rate on total export profits for different rates of distribution of export corporation profits to parent corporation: 0%	(7) 50%	(8) 100%	(9) Estimated index of tax cost of capital engaged in export production relative to zero tax case for different rates of distribution: 0%	(10) 50%	(11) 100%
United States											
Tax-haven sales subsidiary	0.500	0.480	0.379	0.603	0.041	0.240	0.360	0.480	92	109	134
Western Hemisphere Trade Corporation	0.500	0.480	0.379	0.603	0.041	0.410	0.410	0.410	118	118	118
Domestic International Sales Corporation b/	0.500	0.360	0.379	0.603	0.041	0.360 c/	0.360 c/	c/	119	119	c/
Domestic International Sales Corporation and tax-haven sales sub. b/	0.750	0.360	0.379	0.603	0.041	0.180 d/	0.300 d/	.420 d/	93	109	131
Australia											
Tax-haven sales subsidiary	0.750	0.475	0	0.550	0.020	0.119	0.297	0.475	89	112	149
Belgium											
Tax-haven sales subsidiary	0.750	0.420	0.426	0.700	0	0.145	0.151	0.157	86	87	87
Canada											
Tax-haven sales subsidiary	0.750	0.480	0.333	0.595	0	0.120	0.120	0.120	85	85	85
Denmark											
Tax-haven sales subsidiary; plant in non-development area	0.750	0.360	0.435	0.690	0	0.090	0.158	0.226	85	92	100

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Tax Cost of Capital Engaged in Producing Manufactured Goods for Export

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
Country Type of export corporation	Proportion of total profits assumed allocated to export corporation	Tax Rate appropriate for evaluation of depreciation allowances a/	Present value of depreciation allowances discounted at 10% per dollar of capital expenditure on:		Cash grant or tax credit per dollar of capital expenditure	Estimated tax rate on total export profits for different rates of distribution of export corporation profits to parent corporation:			Estimated index of tax cost of capital engaged in export production relative to zero tax case for different rates of distribution:		
			Buildings	Equipment		0%	50%	100%	0%.	50%	100%
Tax-haven sales subsidiary; plant in development area	0.750	0.360	0.326	0.518	0.250	0.090	0.158	0.226	64	69	75
ance											
Tax-haven sales subsidiary	0.750	0.500	0.406	0.729	0	0.125	0.134	0.144	77	78	79
rmany											
Tax-haven sales subsidiary; plant not in West Berlin	0.500	0.510 e/	0.189	0.651	0	0.255	0.318	0.380	98	107	117
Tax-haven sales subsidiary; plant in West Berlin	0.500	0.510 e/	0.189	0.651	0.169	0.255	0.318	0.380	75	82	90
eland											
Domestic export corporation in Dublin area	1.000	0	0	0	0	0	0	0	100	100	100
Domestic export corporation outside of Dublin area	1.000	0	0	0	0.400 f/	0	0	0	60	60	60
taly											
Tax-haven sales subsidiary	0.750	0.438	0.606	0.775	0	0.109	0.274	0.438	84	103	133
apan											
Tax-haven sales subsidiary	0.750	0.368 e/	0.319	0.715	0	0.092	0.230	0.368	85	100	122

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Tax Cost of Capital Engaged in Producing Manufactured Goods for Export

Country Type of export corporation	(1) Proportion of total profits assumed allocated to export corporation	(2) Tax Rate appropriate for evaluation of depreciation allowances a/	(3) Present value of depreciation allowances discounted at 10% per dollar of capital expenditure on: Buildings	(4) Equipment	(5) Cash grant or tax credit per dollar of capital expenditure	(6) Estimated tax rate on total export profits for different rates of distribution of export corporation profits to parent corporation: 0%	(7) 50%	(8) 100%	(9) Estimated index of tax cost of capital engaged in export production relative to zero tax case for different rates of distribution: 0%	(10) 50%	(11) 100%
Netherlands											
Tax-haven sales subsidiary; plant in non-development area	0.750	0.480	0.473	0.586	0	0.120	0.120	0.120	83	83	83
Tax-haven sales subsidiary; plant in development area	0.750	0.480	0.473	0.586	0.150 f/	0.120	0.120	0.120	66	66	66
Norway											
Tax-haven sales subsidiary	0.750	0.508	0.234	0.536	0	0.127	0.222	0.222	87	98	98
Spain											
Domestic corporation with export reserve; plant in non-development area	0.500	0.328	0.232	0.563	0	0.164	0.164	0.164	101	101	101
Domestic corporation with export reserve; plant in development area	0.500	0.328	0.232	0.563	0.150 f/	0.164	0.164	0.164	82	82	82
Sweden											
Tax-haven sales subsidiary	0.750	0.544	0.390	0.789	0 e/	0.136	0.136	0.136	72	72	72
Switzerland											
Tax-haven sales subsidiary	0.750	0.297	0.318	0.663	0	0.074	0.074	0.074	89	89	89

Annex A

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Tax Cost of Capital Engaged in Producing Manufactured Goods for Export

Country Type of export corporation	(1) Proportion of total profits assumed allocated to export corporation	(2) Tax Rate appropriate for evaluation of depreciation allowances a/	(3) Present value of depreciation allowances discounted at 10% per dollar of capital expenditure on: Buildings	(4) Equipment	(5) Cash grant or tax credit per dollar of capital expenditure	(6) Estimated tax rate on total export profits for different rates of distribution of export corporation profits to parent corporation: 0%	(7) 50%	(8) 100%	(9) Estimated index of tax cost of capital engaged in export production relative to zero tax case for different rates of distribution: 0%	(10) 50%	(11) 100%
United Kingdom											
Tax-haven sales subsidiary; plant in non-development area	0.500	0.500 e/	0.597	0.857	0	0.250	0.375	0.500	81	97	121
Tax-haven sales subsidiary; plant in development area	0.500	0.500 e/	0.597	0.857	0.200	0.250	0.375	0.500	54	65	81

Office of the Secretary of the Treasury
Office of Tax Analysis

a/ Generally, this is the regular corporate tax rate, since depreciation allowances are taken against domestic profits. However, in the case of DISC, there is a statutory allocation of profits, which means that expenses (including depreciation allowances) are partly charged against DISC profits. Likewise, an Irish export corporation cannot apply depreciation allowances against domestic profits.

b/ It is assumed that the parent corporation elects the statutory rule which allows it to allocate 50 percent of profits to the DISC (plus a portion of export promotion expenses, here neglected). In the case of a DISC selling to a tax-haven sales subsidiary, it is assumed that the tax-haven subsidiary earns 50 percent of profits, the DISC 25 percent, and the parent 25 percent.

c/ The DISC is deemed to distribute 50 percent of income to the parent, even if actual distributions are less. There is no point in having a DISC which distributes 100 percent of income, since the favorable tax rates are then lost.

d/ The distribution percentages here refer to distributions by the tax-haven sales subsidiary. The DISC is deemed to distribute 50 percent of its income.

e/ The German, Japanese, and United Kingdom tax rates are rates for retained earnings. Likewise, no account is taken of the French *avoir fiscale*.

f/ These figures represent averages of cash grants available for development areas.

g/ No allowance is made for the Swedish investment reserve system.

Annex B

Tax Cost of Capital Employed in Producing Manufactured Goods for Export by the U.S. or for Local Consumption Abroad

Country Type of Corporation	Tax Cost Of Capital Index
Mean value for all countries a/	134
United States	
Domestic corporation	134
Tax-haven sales subsidiary	
with 50 percent of income distributed to parent	109
Western Hemisphere Trade Corporation	118
Domestic International Sales Corporation	119
Australia	153
Belgium	126
Canada	143
Denmark	121 b/
France	135
Germany	148 b/
Ireland	138 b/
Italy	133
Japan	122
Netherlands	141 b/
Norway	125 b/
Spain	125 b/
Sweden	137
Switzerland	118
United Kingdom	121 b/

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Office of Tax Analysis

a/ The mean value includes the U.S. domestic corporation.

b/ The capital cost indices for investment in "development areas", which is encouraged by cash grants, are as follows: Denmark, 91; Germany (West Berlin), V114; Ireland, V58; Netherlands, V112; Spain, V102; United Kingdom, 81.

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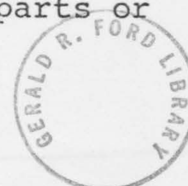
3d

DISC OPTIONS PAPER

The DISC legislation, which became effective January 1972, permits tax deferral of one half of the taxable income of a DISC, which is a U.S. corporation engaged exclusively in exporting and reinvesting its accumulated income in export related assets. The program was intended to stimulate export performance by U.S. corporations at a time when the U.S. was running a serious trade deficit under a system of fixed exchange rates, and to meet the objection that our tax structure and foreign tax laws favored foreign investment and the movement of production abroad by U.S. companies.

A review of the Administration's policy with respect to DISC is in order because of two important developments. Floating exchange rates, and the prospect of returning to stable but adjustable rates sometime in the future, may have made the DISC not only unnecessary, but in fact undesirable. At the same time, inflation and supply shortages have raised questions about the desirability for DISC export incentives where goods are in short supply.

Part I of this paper presents pro and con arguments on the issue of whether the DISC should be eliminated. If it is decided not to eliminate the DISC, the second order question is whether modifications in the DISC are necessary; Part II of this paper presents options for modifying the DISC. Part III presents approaches for terminating either parts or the whole of DISC.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Appendix A contains a STR paper which concludes that a decision to retain or eliminate the DISC can and should be made independently of negotiating considerations. There was no disagreement with this view at the work group level.

PART I

Option: Eliminate the DISC

PRO

1. With floating rates, the DISC incentive is no longer necessary to bring about overall balance of payments equilibrium.

2. With floating rates, the DISC is undesirable in that it distorts the structure of the balance of payments as well as the composition of U.S. production. To the extent that exports are stimulated by DISC, the dollar will not depreciate as much as it would in the absence of the program. As a consequence, DISC redistributes production, employment, and income away from industries which produce import competing products towards export industries.

3. It is undesirable to retain the DISC if the international monetary system is expected to return to fixed rates in the future. If fixed rates are implemented when the U.S. balance of payments is in overall balance, the starting structure of exchange rates will have been distorted by the existence of the DISC. In addition, under fixed rates, the existence of the DISC will not prevent the U.S. balance of payments from moving into deficit. The DISC can reduce a deficit when it is implemented, but once in existence and taken into account by existing exchange rates, the DISC cannot prevent further increases in the deficit. While on the surface it may seem paradoxical, eliminating the

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DISC now would retain the DISC as a tool for reducing a deficit sometime in the future if the United States found itself unable to adjust through exchange rates.

4. The DISC is an expensive method of promoting increased export activity. The benefits do not justify the loss of tax revenues. In 1972, alone, foregone tax revenue is estimated at $250 million, while increased exports may have amounted to only $300 to $400 million.

5. The DISC mechanism is not consistent with the thrust of U.S. trade policy to eliminate trade subsidies and restrictions. DISC is objectionable to the EEC and Canada as an unjustified export incentive and sets an undesirable precedent.

CON

1. While overall balance of payments adjustment may be achieved under floating or adjustable exchange rates, our exports are below optimum and it is desirable to continue to provide support to exports per se.

2. The DISC does not distort the structure of exchange rates and the structure of our balance of payments, but reduces a distortion which occurs because of our tax laws on foreign source income. Allowing tax deferrals on export income earned on production facilities in the U.S. is consistent with tax

deferrals on income earned abroad. The DISC thus reduces the tax incentive for locating production facilities abroad vis-a-vis U.S. locations.

OECD work on tax havens may tend to reduce this.

3. Foreign competitors in all developed countries are free to establish intermediary sales companies in low tax countries to export to third countries. The U.S. has tax rules that generally prevent this, except for larger U.S. companies that have substantial manufacturing abroad. DISC tends to offset the advantage given foreign exporters.

4. The statistics covering the one year of operation of the program understate the potential export stimulus since changes in U.S. production and investment in response to the DISC incentive could not be expected to occur in such a short period. In addition, while the revenue costs are highly visible, it is difficult to measure precisely the secondary and tertiary impact of the DISC on U.S. export production.

5. Abrupt removal of the program after only one year would make DISC a bad investment for all those firms that participated (about 5,000), and cause U.S. firms to react much more cautiously to government export promotion schemes in the future, should these be required.

6. Given the amount of effort it took to get the DISC legislation passed, it is too soon to make a decision to eliminate it without having more experience with respect to its benefits and costs.

7. Elimination seems ill-timed when the full ramifications of a changing monetary structure have not been determined and other countries are seeking to expand their exports (and, in some instances, limit their imports).

PART II

POSSIBLE DISC MODIFICATIONS

If the DISC is to be retained, certain changes in the program might be considered once that decision has been taken.

Option I: Establish an effective Administration procedure so that commodities judged by the Administration or the Congress to be in short supply are not eligible for DISC treatment until the short supply deisgnation is removed.*

PRO

1. There was a great deal of critism in 1973 when products which were embargoed because of their limited availability for domestic use were still entitled to DISC treatment.

2. Products in short supply are not in need of export promotion Export promotion raises the price and reduces the availability of short supply goods for U.S. consumers.

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* Section 993(c) of the DISC provisions of the Code now provides that if the President determines that the supply of a commodity is insufficient to meet the requirements of the domestic economy, he may declare that it be in short supply and ineligible for DISC treatment. Despite criticism, this provision has never been exercised.

CON

1. It is difficult to obtain interagency agreement on a reccommendation that a particular commodity is in short supply. Without rapid determination on some commodities, primarily agricultural ones, such as an option may be worthless.

2. Declaring items in short supply for DISC will increase the pressure for embargoes.

Option II: Exclude non manufactured commodities from DISC treatment.

PRO

A major goal of the DISC is to help equalize tax treatment provided exporters with that provided U.S. foreign subsidiaries so that foreign subsidiary production is not encouraged over U.S. exports. As such, it should apply primarily to manufactured products for which foreign subsidiary production is unlikely.

CON

The exclusion of all non manufactured products is too imprecise. All those products which cannot be produced by subsidiary operations should be excluded from DISC benefits, regardless of whether they are manufactured or non manufactured items.

Option III: Increase DISC deferral from 50% of DISC income to 100% of DISC income for small firms.

PRO

1. Many smaller firms presently find the cost of DISC operations outweighs the potential benefit. A 100% deferral would increase the number of small firms willing to undertake export operations.

2. A 100% deferral would be more comparable to U.S. taxation of foreign subsidiaries.

CON

1. This alteration is unfair to large firms. All should have access to the same tax benefits of the program.

2. One hundred percent deferral was rejected by the Congress in the initial DISC proposals.

3. This option presupposes that there is a necessity for creating a greater incentive for small corporations to export. At present, this supposition has questionable empirial support, and would increase an already large revenue loss.

4. Most foreign subsidiaries pay some local taxes.

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PART III

TERMINATION OPTIONS

If it is decided to eliminate DISC entirely or to eliminate its application to certain products, there are two basic approaches to termination.

Option I: Terminate the program immediately taxing all income on a current basis

PRO

The program would be eliminated as swiftly as possible.

CON

Such a termination would be a hardship for former DISC operators, since investment plans may have been predicated on the use of the accumulated untaxed income generated by the DISC, which is now subject to immediate tax.

<u>Option II</u>: <u>Terminate the DISC benefits for future exports immediately, and set a later date as a termination of deferral. Prior to the deferral termination, previously accumulated DISC income would become taxable to shareholders over a period of years, thus providing a phase out of deferral</u>.

PRO

1. The impact of the program as a tool of export promotion would be ended immediately.

2. The termination procedure is less of a hardship on former DISC owners, since tax payments are spread over time.

CON

The maintenance of a deferral period leaves the lingering suspicion that the program may be reinstituted in the future.

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Option III: Terminate DISC benefits at some future date (say 5 years) and set a later date for termination of deferral.

PRO

1. This may be acceptable to the Congress. The Senate version of the DISC originally contained a 10 year termination date.

2. This modification would meet the objection to Option I that exporters who engaged in DISC operations would experience losses if the program were phased out immediately.

3. This technique is already being considered in other tax programs, for instance the phase out of percentage depletion for oil and in some recommendations for eliminating Western Hempsphere trade corporations.

CON

1. The impact of the program as a tool for export promotion would not be ended immediately.

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2. All those objections listed under Option I, Part I would apply until the program was actually ended.

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APPENDIX "A"

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ADD-ON 534707

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OFFICE OF THE SPECIAL REPRESENTATIVE
FOR TRADE NEGOTIATIONS

EXECUTIVE OFFICE OF THE PRESIDENT
WASHINGTON
20506

MEMORANDUM April 29, 1974

TO : Deane R. Hinton
Deputy Executive Director
Council on International Economic Policy

FROM : John H. Jackson
General Counsel

SUBJECT: Interagency Review of the DISC

In your memorandum of April 18th, you requested our views on the options paper concerning the DISC prepared by the Treasury, with particular reference to the relationship between DISC, the GATT panel and negotiations on tax subsidy rules in the MTN.

In general, it appears to me that the first obligation of the interagency review is to ascertain the advisability of the continuation of DISC, in light of the policies that relate to the national interests of the United States. Although there is a rather intricate relationship between the DISC and some of our international negotiations, I believe it is important that we not let the international context unnecessarily distort or obscure the results of the policy determination on the merits of the DISC. Nevertheless, once it has been decided on policy grounds whether the DISC should be continued (or in what form it should be continued), then it would be useful for consideration to be given to the relationship of the DISC to our international negotiations.

The international activity regarding the DISC includes the following:

A. Formation of four GATT panels, with identical membership, to consider (i) a complaint by the EC against DISC under the procedure set forth in article XXIII(2) of the GATT, and (ii) complaints by the U.S. against similar tax practices of France, Belgium and the Netherlands. The selection of panel members is not yet complete. The first meeting of the panels

probably will be held next September, but may be held as early as June.

B. Meeting of May 29-31 of GATT Trade Negotiations Committee (TNC) Working Group on subsidies and countervailing duties. The U.S. seeks to tighten the GATT rules on export subsidies and to list banned subsidy practices. We have previously tabled a list of 21 export subsidy measures as candidates for possible prohibition, and we are preparing a list of questions on subsidies for discussion at the May meeting. The U.S. contends that the question of subsidies is more fundamental than that of countervailing duties, since without subsidies there would be nothing to countervail against. Because it is charged that DISC and related European tax practices constitute tax subsidies, they may be discussed at the May 29-31 meeting, or in this context subsequently.

C. Meeting of June 25th of GATT TNC Working Group on non-tariff barriers. The meeting will discuss a list of NTB's notified to the GATT secretariat by the CP's before May 15th. It is likely that DISC will be listed by other countries (e.g. Canada, Japan). The U.S. plans to defend DISC in such a way that the tax subsidy practices of other countries are raised.

Clearly, as long as the DISC remains United States law and policy, the United States should defend it whenever it is challenged in an international forum. Such a defense is not inconsistent with our position that the GATT subsidy rules should be reformed and tightened: the issue of DISC's legality under present GATT rules is separate from, though related to, the future reform of those rules in light of all countries' subsidy practices. If there is a policy decision to retain the DISC, then such retention could give us some bargaining leverage in the MTN negotiations on subsidies. Our position would be to contend that DISC does not violate the present GATT rules, but that if others wanted to extend the GATT rules in order to prohibit DISC and the similar tax practices of other countries, then we would be happy to consider such an extension.

However, when and if there is a decision to seek the repeal of DISC, the GATT case against the DISC will be rendered moot. We will still then have our three counterclaim cases

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against France, Belgium and the Netherlands, and we would be faced with a decision as to whether to continue those cases or not. We could continue those cases, following through to an Article XXIII(1) finding, or attempt again to broaden the consideration of these matters into a working party on tax measures having the effect of export subsidies. There is a link between the current complaints and the eventual reform, regardless of whether DISC is retained or dropped.

If a decision were made to repeal the DISC, then there might be given some consideration to how this could be done in a way so as to further the work towards new rules on tax measures. Whether an offer to repeal the DISC as part of a negotiation with our trading partners would be useful in obtaining important concessions from them, is very difficult to measure. One would have to guard against a temptation to retain the DISC long enough for it to be a bargaining chip, if that resulted in further engraining the DISC in United States law and promoting additional vested interests favoring it, if the basic policy decision were that the DISC was inappropriate for the national interests of the United States.

II. With respect to the options paper entitled "DISC Review", dated April 10, 1974, we feel that the paper should be substantially shortened and restructured. One way to do this would be to eliminate the sub-headings now contained in Part I and to list the main arguments, in greatly abbreviated form, under the principal question of whether DISC should be retained. An indication of this approach is set forth below:

I. Should DISC be retained?

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A. NO.

(1) Unnecessary: BOP adjusted automatically through floating exchange rates.

(2) Inequitable:
(a) favors higher profit exports;
(b) discriminates against export-competing industries;
(c) favors capital-intensive over labor-intensive exports.

(3) Disproportionate loss of revenue in relation to export increases.

B. <u>YES</u>

(1) World may return to fixed exchange rates.

[and so on]