

**OVERVIEW OF PRESENT-LAW RULES
AND ECONOMIC ISSUES IN INTERNATIONAL TAXATION**

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 11, 1999, on issues relating to international tax reform. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides an overview of certain aspects of present law and economic issues relating to international taxation.

Part I of this document is a summary of the discussions contained in the remainder of the pamphlet. Part II provides an overview of certain present-law income tax rules that apply to U.S. persons doing business abroad and foreign persons doing business in the United States. Part III contains background and data relating to international trade and investment. Part IV discusses economic issues relating to international transactions. The Appendix presents data used in Figures 1-7 and 10.

¹ This document may be cited as follows: Joint Committee on Taxation, *Overview of Present-Law Rules and Economic Issues in International Taxation* (JCX-13-99), March 9, 1999.

I. SUMMARY

Present law

Under the present-law Federal income tax system, U.S. persons are subject to U.S. income tax on all income, whether derived in the United States or abroad. However, the United States generally allows a credit against the U.S. tax imposed on income derived from foreign sources for foreign income taxes imposed on such income. Foreign persons are subject to U.S. tax only on income that has a sufficient connection to the United States.

Within this basic framework, there are a variety of rules that affect the U.S. taxation of international transactions. Detailed rules govern the determination of the source of income and the allocation and apportionment of expenses between foreign-source and U.S.-source income. Such rules are relevant not only for purposes of determining the U.S. taxation of foreign persons (because foreign persons are subject to U.S. tax only on income that is from U.S. sources or otherwise has sufficient U.S. nexus), but also for purposes of determining the U.S. taxation of U.S. persons (because the U.S. tax on a U.S. person's foreign-source income may be reduced or eliminated by foreign tax credits). Authority is provided for the reallocation of items of income and deduction between related persons in order to ensure the clear reflection of the income of each person and to prevent the evasion of tax. Although U.S. tax generally is not imposed on a foreign corporation that operates abroad, several anti-deferral regimes apply to impose current U.S. tax on certain income from foreign operations of a U.S.-owned foreign corporation.

An international transaction potentially gives rise to tax consequences in two (or more) countries. The tax treatment in each country generally is determined under the tax laws of the respective country. However, an income tax treaty between the two countries may operate to coordinate the two tax regimes and minimize the double taxation of the transaction. In this regard, the United States' network of bilateral income tax treaties includes provisions affecting both U.S. and foreign taxation of both U.S. persons with foreign income and foreign persons with U.S. income.

Trends in U.S. international trade and investment

Foreign trade has become increasingly important to the United States economy. Exports and imports each have risen from less than six percent of GDP in 1962 to more than 14 percent in 1997. The United States generally was a net exporter of goods and services prior to 1982. Since that time, the United States has been a net importer of goods and services.

Trade deficits, capital inflows, investment, savings, and income are all connected in the economy. The value of an economy's total output must be either consumed domestically (by private individuals and government), invested domestically, or exported abroad. If an economy consumes and invests more than it produces, it must be a net importer of goods and services. If the imports were all consumption goods, in order to pay for those imports, the country must

either sell some of its assets or borrow from foreigners. If the imports were investment goods, foreign persons would own the investments. Thus, an economy that runs a trade deficit will also experience foreign capital inflows as foreign persons purchase domestic assets, make equity investments or lend funds (purchase debt instruments).

Net foreign investment has become a larger proportion of the economy and a more significant proportion of total domestic investment than in the past. In 1982, the United States changed from being a modest exporter of capital in relation to GDP to being a large importer of capital. In 1997, gross investment in the United States was \$1,351 billion and net foreign investment was \$141 billion, or 10.4 percent of gross domestic investment. The value of foreign assets owned by private U.S. persons has grown from \$295.1 billion in 1980 to \$3,477 billion in 1996. This growth in value has not been as rapid as the growth in the value of assets in the United States owned by foreign persons.

Economic issues in the taxation of international transactions

In general.--International investment plays an important role in determining the total amount of worldwide income as well as the distribution of income across nations. In addition, international investment flows can substantially influence the distribution of capital and labor income within nations. Because each government levies taxes by its own method and at its own rates, the resulting system of international taxation can distort investment and contribute to reductions in worldwide economic welfare.

The nature of these distortions depends on the method of taxing income from international investment. If investment income is taxed only at the source, substantial amounts of capital could be diverted to jurisdictions with the lowest tax rates instead of flowing to investment projects with the highest pre-tax rate of return. If a system of residence taxation is the worldwide norm, enterprises resident in low-tax countries might be able to attract more investment capital or perhaps increase their market share through lower prices to the detriment of enterprises resident in high-tax jurisdictions, even though the latter are more efficient. In either case, capital is diverted from its more productive uses, and worldwide income and efficiency suffer. The most straightforward solution to this problem is equalization of effective tax rates, but this may not be a practical solution given differences in national preferences for the amount and method of taxation. There is no consensus on what method of taxing international investment income minimizes distortions in the allocation of capital when nations tax income at different effective rates, but the alternatives of capital export neutrality and capital import neutrality are the most cited guiding principles. These two standards are each desirable goals of international tax policy. The problem is that, with unequal tax rates, these two goals are not mutually attainable.

Capital export neutrality.--Capital export neutrality refers to a system where an investor residing in a particular locality can locate investment anywhere in the world and pay the same tax. Under capital export neutrality, decisions on the location of investment are not distorted by

taxes. Capital export neutrality is a principle describing how investors pay tax, not to whom they pay. Capital export neutrality primarily is a framework for discussing the efficiency and incentives faced by private investors, and not the distribution of the revenues and benefits of international investment.

Capital import neutrality.--Capital import neutrality refers to a system of international taxation where income from investment located in each country is taxed at the same rate regardless of the residence of the investor. Some commentators refer to the principle of capital import neutrality as promoting "competitiveness." Under capital import neutrality, capital income from all businesses operating in any one locality is subject to uniform taxation. The nationality of investors in a particular locality will not affect the rate of tax.

Although they have important implications for national welfare as well as the distribution of income between capital and labor, the debate on the relative merits of capital export neutrality and capital import neutrality centers on which of these more efficiently allocates capital around the world and therefore on which better promotes worldwide economic welfare.

II. PRESENT LAW

A. U.S. Taxation of U.S. Persons with Foreign Income

1. Overview

The United States taxes U.S. citizens, residents, and corporations (collectively, U.S. persons) on all income, whether derived in the United States or elsewhere. By contrast, the United States taxes nonresident alien individuals and foreign corporations only on income with a sufficient nexus to the United States.

The United States generally cedes the primary right to tax income derived from sources outside the United States to the foreign country where such income is derived. Thus, a credit against the U.S. income tax imposed on foreign-source taxable income is provided for foreign taxes paid on that income. In order to implement the rules for computing the foreign tax credit, the Code and the regulations thereunder set forth an extensive set of rules governing the determination of the source, either U.S. or foreign, of items of income and the allocation and apportionment of items of expense against such categories of income.

The tax rules of foreign countries that apply to foreign income of U.S. persons vary widely. For example, some foreign countries impose income tax at higher effective rates than the United States. In such cases, the foreign tax credit allowed by the United States is likely to eliminate any U.S. tax on income from a U.S. person's operations in the foreign country. On the other hand, operations in countries that have low statutory tax rates or generous deduction allowances or that offer tax incentives (e.g., tax holidays) to foreign investors are apt to be taxed at effective tax rates lower than the U.S. rates. In such cases, after application of the foreign tax credit, a residual U.S. tax generally is imposed on income from a U.S. person's operations in the foreign country.

Under income tax treaties, the tax that otherwise would be imposed under applicable foreign law on certain foreign-source income earned by U.S. persons may be reduced or eliminated. Moreover, U.S. tax on foreign-source income may be reduced or eliminated by treaty provisions that treat certain foreign taxes as creditable for purposes of computing U.S. tax liability.

2. Foreign operations conducted directly

The tax rules applicable to U.S. persons that control business operations in foreign countries depend on whether the business operations are conducted directly (through a foreign branch, for example) or indirectly (through a separate foreign corporation). A U.S. person that conducts foreign operations directly includes the income and losses from such operations on such person's U.S. tax return for the year the income is earned or the loss is incurred. Detailed rules are provided for the translation into U.S. currency of amounts with respect to such foreign

operations. Thus, the income from the U.S. person's foreign operations is subject to current U.S. tax. However, a foreign tax credit may reduce or eliminate the U.S. tax on such income.

3. Foreign operations conducted through a foreign corporation

In general.--Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from those operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. A foreign tax credit may reduce the U.S. tax imposed on such income.

A variety of complex anti-deferral regimes impose current U.S. tax on income earned by a U.S. person through a foreign corporation. The main anti-deferral regimes set forth in the Code (in order of enactment) are the foreign personal holding company rules (secs. 551-558), the controlled foreign corporation rules of subpart F (secs. 951-964), and the passive foreign investment company rules (secs. 1291-1298). Additional anti-deferral regimes set forth in the Code are the personal holding company rules (secs. 541-547), the accumulated earnings tax (secs. 531-537), and the foreign investment company and electing foreign investment company rules (secs. 1246 and 1247).

Foreign personal holding companies.--The Revenue Act of 1937 established an anti-deferral regime for foreign personal holding companies ("FPHCs"). A FPHC generally is defined as any foreign corporation if five or fewer U.S. individual citizens or residents own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), and at least 60 percent of the corporation's gross income consists of certain types of passive income (such as dividends, interest, certain royalties and certain rents).² If a foreign corporation is a FPHC, all the U.S. shareholders of the corporation are subject to U.S. tax currently on their pro rata share of the corporation's undistributed foreign personal holding company income.

Controlled foreign corporations.--The Revenue Act of 1962 established an anti-deferral regime for controlled foreign corporations ("CFCs") under subpart F of the Code. A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only). Under the subpart F rules, the United States generally taxes the U.S. 10-percent

² Once the corporation qualifies as a FPHC, the gross income threshold for each subsequent year generally is 50 percent.

shareholders of a CFC on their pro rata shares of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders. Subpart F income typically is passive income or income that is relatively movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income (defined in sec. 954), insurance income (defined in sec. 953), and certain income relating to international boycotts and other violations of public policy (defined in sec. 952(a)(3)-(5)). Foreign base company income, in turn, includes foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income and foreign base company oil-related income. For example, foreign personal holding company income includes, among other items, dividends, interest, rents and royalties (subject to certain exceptions). In effect, the United States treats the U.S. 10-percent shareholders of a CFC as having received a current distribution out of the CFC's subpart F income. In addition, the U.S. 10-percent shareholders of a CFC are required to include currently in income for U.S. tax purposes their pro rata shares of the CFC's earnings invested in U.S. property. The U.S. tax on such amounts may be reduced through foreign tax credits.

Passive foreign investment companies.--The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies ("PFICs"). A PFIC generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.³ Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC, regardless of their percentage ownership in the PFIC. One set of rules applies to PFICs that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the PFIC's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. A second set of rules applies to PFICs that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the PFIC, plus an interest charge that is attributable to the value of deferral. A third set of rules applies to PFIC stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of their PFIC stock as of the close of the taxable year over their adjusted basis in such stock (subject to certain limitations).

Detailed rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, the PFIC rules generally do not apply to U.S. shareholders that are subject to the subpart F rules.

³ For purposes of applying the PFIC asset test, a foreign corporation that is publicly traded measures its assets using fair market value, a CFC that is not publicly traded measures its assets using adjusted basis, and any other foreign corporation that is not publicly traded measures its assets using fair market value unless the corporation elects to use adjusted basis.

4. Transfer pricing rules

In the case of a multinational enterprise that includes at least one U.S. corporation and at least one foreign corporation, the United States taxes all of the income of the U.S. corporation, but only so much of the income of the foreign corporation as is determined to have sufficient nexus to the United States. The determination of the amount that properly is the income of the U.S. member of a multinational enterprise and the amount that properly is the income of a foreign member of the same multinational enterprise thus is critical to determining the amount of income the United States may tax (as well as the amount of income other countries may tax).

Due to the variance in tax rates and tax systems among countries, a multinational enterprise may have a strong incentive to shift income, deductions, or tax credits among commonly controlled entities in order to arrive at a reduced overall tax burden. Such a shifting of items between commonly controlled entities could be accomplished by establishing artificial transfer prices for transactions between group members.

Under section 482, the Secretary of the Treasury is authorized to redetermine the income of an entity subject to U.S. taxation, when it appears that an improper shifting of income between that entity and a commonly controlled entity has occurred. This authority is not limited to reallocations of income between different countries; it permits reallocations in any common control situation, including reallocations between two U.S. entities. However, it has significant application to multinational enterprises due to the incentives for taxpayers to shift income to obtain the benefits of significantly different effective tax rates.

Section 482 grants the Secretary of the Treasury broad authority to allocate income, deductions, credits or allowances between any commonly controlled organizations, trades, or businesses in order to prevent evasion of taxes or to clearly reflect income. The statute generally does not prescribe any specific reallocation rules that must be followed, other than establishing the general standards of preventing tax evasion and clearly reflecting income. Treasury regulations adopt the concept of an arm's-length standard as the method for determining whether reallocations are appropriate. Thus, the regulations attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length. The regulations contain extremely complex rules governing the determination of an arm's-length charge for various types of transactions. The regulations generally attempt to prescribe methods for identifying a relevant comparable unrelated party transaction and for providing adjustments for differences between such transactions and the related party transactions in question. In some instances, the regulations also provide safe harbors.

Determinations under section 482 that result in the allocation of additional income to the United States theoretically might subject a taxpayer to double taxation if, for example, both the United States and another country imposed tax on the same income and the other country did not agree that the income should be reallocated to the United States. Tax treaties generally provide

mechanisms that attempt to resolve such disputes in a manner that may avoid double taxation if both countries agree. Such mechanisms include the designation of a "competent authority" by each country to act as that country's representative in the negotiation attempting to resolve such disputes. Such competent authority procedures, however, do not guarantee that double tax will not be imposed in a particular case.

One method for addressing the issue of double taxation is through the recently-developed advance pricing agreement ("APA") procedures. An APA is an advance agreement establishing an approved transfer pricing methodology entered into between the taxpayer, the Internal Revenue Service ("IRS"), and a foreign tax authority. The taxpayer generally is required to use the approved transfer pricing methodology for the duration of the APA. The IRS and the foreign tax authority generally agree to accept the results of such approved methodology. An APA also may be negotiated between only the taxpayer and the IRS; such an APA establishes an approved transfer pricing methodology for U.S. tax purposes. The APA process may prove to be particularly useful in cases involving industries such as financial products and services for which transfer pricing determinations are especially difficult.⁴

5. Foreign tax credit rules

Because the United States taxes U.S. persons on their worldwide income, Congress enacted the foreign tax credit in 1918 to prevent U.S. taxpayers from being taxed twice on their foreign-source income: once by the foreign country where the income is earned and again by the United States. The foreign tax credit generally allows U.S. taxpayers to reduce the U.S. income tax on their foreign-source income by the foreign income taxes they pay on that income. The foreign tax credit, however, does not operate to offset U.S. income tax on U.S.-source income.

A credit against U.S. tax on foreign-source income is allowed for foreign taxes directly paid or accrued by a U.S. person (the "direct" foreign tax credit). In addition, a credit is allowed to a U.S. corporation for foreign taxes paid by certain foreign subsidiary corporations and deemed paid by the U.S. corporation upon a dividend received by, or certain other income inclusions of, the U.S. corporation with respect to earnings of the foreign subsidiary (the "deemed-paid" or "indirect" foreign tax credit).

The foreign tax credit provisions are elective on a year-by-year basis. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes. For purposes

⁴ There is ongoing litigation in the U.S. District Court between the Bureau of National Affairs, Inc. ("BNA"), a tax publisher, and the IRS involving the public release of APAs. The IRS announced on January 11, 1999, that it was conceding that APAs are subject to disclosure under section 6110. (See IR-1999-05). The continuing issues are, among other things, the process of redacting confidential information from the APAs and the schedule under which such APAs will be released.

of the alternative minimum tax, foreign tax credits generally cannot be used to offset more than 90 percent of the U.S. person's pre-foreign tax credit tentative minimum tax.

A foreign tax credit limitation, which is calculated separately for various categories of income, is imposed to prevent the use of foreign tax credits to offset U.S. tax on U.S.-source income. Under this limitation, the credit for foreign taxes on income in a particular category may not exceed the same proportion of the taxpayer's U.S. tax liability which the taxpayer's foreign-source taxable income in that category bears to the taxpayer's worldwide taxable income for the taxable year. Detailed rules are provided for the allocation of expenses against foreign-source income. Special rules apply to require the recharacterization of foreign-source income for a year subsequent to a foreign loss year as U.S.-source income.

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back to the two immediately preceding taxable years and carried forward to the first five succeeding taxable years, and credited in such years to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years. For purposes of determining excess foreign tax credit limitation amounts, the foreign tax credit separate limitation rules apply.

6. Foreign sales corporations

A foreign sales corporation ("FSC") typically is owned by a U.S. corporation that produces goods in the United States. The U.S. corporation either supplies goods to the FSC for resale abroad to unrelated persons or pays the FSC a commission in connection with its sales to unrelated persons. Under special tax provisions, a portion of the export income of an eligible FSC is exempt from U.S. income tax (secs. 921-927). In addition, a U.S. corporation is not subject to U.S. tax on dividends distributed from the FSC out of earnings attributable to certain export income. Thus, there generally is no corporate level tax imposed on a portion of the income from exports of a FSC.⁵

⁵ Two export-related provisions preceded the enactment of the FSC provisions. Under provisions enacted in 1962, CFCs that qualified as export trade corporations were permitted to reduce their subpart F income by the amount of certain export trade income (secs. 970 and 971). No CFC may qualify as an export trade corporation unless it so qualified as of 1971. Under provisions enacted in 1971, domestic international sales corporations ("DISCs") were permitted to defer U.S. tax on certain export receipts (secs. 991-997). The FSC rules generally were enacted to replace the DISC rules to address concerns with General Agreement on Tariffs and Trade subsidy rules. Upon enactment of the FSC provisions in 1984, a special rule permitted any DISC to transfer its deferred earnings to a FSC. An interest charge is now imposed on the deferral of tax on the earnings of any remaining DISC. In July 1998, the European Union requested that a World Trade Organization ("WTO") dispute panel investigate the FSC regime and its compliance with WTO rules including the Agreement on Subsidies and Countervailing

B. U.S. Taxation of Foreign Persons with U.S. Income

1. Overview

The United States imposes tax on nonresident alien individuals and foreign corporations (collectively, foreign persons) only on income that has a sufficient nexus to the United States. In contrast, the United States imposes tax on U.S. persons on all income, whether derived in the United States or in a foreign country.

Foreign persons are subject to U.S. tax on income that is "effectively connected" with the conduct of a trade or business in the United States, without regard to whether such income is derived from U.S. sources or foreign sources. Such income generally is taxed in the same manner and at the same rates as income of a U.S. person. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign person to cases where the business is conducted through a permanent establishment in the United States.

In addition, foreign persons generally are subject to U.S. tax at a 30-percent rate on certain gross income derived from U.S. sources. Pursuant to an applicable tax treaty, the 30-percent gross-basis tax imposed on foreign persons may be reduced or eliminated.

The source of income for U.S. tax purposes is determined based on various factors, including the location or nationality of the payor, the location or nationality of the recipient, the location of the activities that generate the income, and the location of the assets that generate the income. For example, income from the sale or exchange of inventory property that is produced (in whole or in part) within the United States and sold or exchanged outside the United States, or produced (in whole or in part) outside the United States and sold or exchanged within the United States, is treated as partly from U.S. sources and partly from foreign sources. In general, 50 percent of such income is treated as attributable to production activities and is sourced based on the location of the production assets; the other 50 percent of such income is treated as attributable to sales activities and generally is sourced where the sale occurs.

2. Net-basis taxation

The United States taxes on a net basis and at the generally applicable U.S. tax rates the income of foreign persons that is "effectively connected" with the conduct of a trade or business in the United States. Any gross income earned by the foreign person that is not effectively connected with the person's U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person's income from such business.

Measures. A WTO dispute panel was established in September 1998 to address these issues.

The determination of whether a foreign person is engaged in a U.S. trade or business is based on the facts and circumstances. Basic issues involved in the determination include whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States with respect to the business is sufficient to attribute those functions to the foreign person.

The factors taken into account in determining whether income, gain or loss is effectively connected with a U.S. trade or business include, for example, in the case of U.S.-source capital gains and certain U.S.-source passive income, whether the amount is derived from assets used or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a material factor in the realization of such amount. In the case of any other U.S.-source income, gain, or loss, such amounts are all treated as effectively connected with the conduct of the trade or business in the United States. Only specific types of foreign-source income are considered to be effectively connected with a U.S. trade or business (sec. 864(c)(4)). Foreign-source income of a type not specified generally is exempt from U.S. tax.

3. Gross-basis taxation

In the case of U.S.-source interest, dividends, rents, royalties, or other similar types of income (known as fixed or determinable, annual or periodical gains, profits and income), the United States generally imposes a flat 30-percent tax on the gross amount paid to a foreign person if such income or gain is not effectively connected with the conduct of a U.S. trade or business. This tax generally is collected by means of withholding by the person making the payment to the foreign person receiving the income. Accordingly, the 30-percent gross-basis tax is generally referred to as a withholding tax. In most instances, the amount withheld by the U.S. payor is the final tax liability of the foreign recipient and, thus, the foreign recipient files no U.S. tax return with respect to this income.

Certain exclusions or exceptions from the withholding tax apply. For example, the United States generally does not tax capital gains of a foreign corporation that are not connected with a U.S. trade or business. Capital gains of a nonresident alien individual that are not connected with a U.S. business generally are subject to the 30-percent gross-basis tax only if the individual was present in the United States for 183 days or more during the year (sec. 871(a)(2)). In addition, certain types of interest (for example, interest from certain bank deposits and from certain portfolio obligations) are not subject to the withholding tax.

C. Income Tax Treaties

In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or exempt withholding taxes imposed by a treaty country on certain types of income (e.g., dividends, interest and royalties) paid to residents of the other treaty country. Treaties also contain provisions governing the creditability of taxes imposed by

the treaty country in which income was earned in computing the amount of tax owed to the other country by its residents with respect to such income. Treaties further provide procedures under which inconsistent positions taken by the treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries.

III. BACKGROUND AND DATA RELATING TO INTERNATIONAL TRADE AND INVESTMENT

This part presents background data relating to the scope of the international trade sector in the United States economy. This part discusses the economic relationship between trade deficits, capital inflows, investment, and savings in the economy. It briefly reviews trends in both the current account (the trade surplus or deficit) and the capital account (U.S. investment abroad and foreign investment in the United States).

A. Trade Deficits and Cross Border Capital Flows

National income accounting

In popular discussion of trade issues, much attention is given to the trade deficit or surplus, that is, the difference between the exports and imports of the economy. In the late 1980s, there was also attention given to inflows of capital from abroad. Capital inflows can take the form of foreign purchases of domestic physical assets, of equity interests, or of debt instruments. These two phenomena, trade balances and capital inflows, are not independent, but are related to each other. Trade deficits, capital inflows, investment, savings, and income are all connected in the economy. The connection among these economic variables can be examined through the national income and product accounts, which measure the flow of goods and services and income in the economy.⁶

⁶ The national income and product accounts measure the flow of goods and services (product) and income in the economy. The most commonly reported measure of national economic income is gross domestic product (GDP). Related to GDP is gross national product (GNP). GNP is GDP plus the net factor income received by residents of United States from abroad. Thus, wages earned by a U.S. resident from temporary work abroad constitutes part of GNP but not GDP. Similarly, the returns from investment abroad constitute part of GNP but not GDP. To help understand the connection between trade deficits and cross border capital flows, in the following it is useful to use GNP, which includes cross border returns to investment, rather than the more commonly reported GDP concept. The GNP of the economy is the total annual value of goods and services produced by the economy and may be measured in several ways. One way to measure GNP is by expenditures on final product. By this measure,

$$(1) \text{ GNP} = C + I + G + (X-M) + \text{NI}.$$

Equation (1) is an accounting identity which states that gross national product equals the sum of private consumption expenditures (C), private investment expenditures on plant, equipment, inventory, and residential construction (I), government purchases of goods and services (G), net exports (exports less imports of goods and services and net interest payments to foreigners, or X-M), plus net investment income (the excess of investment income received from

The value of an economy's total output must be either consumed domestically (by private individuals and government), invested domestically, or exported abroad. If an economy consumes and invests more than it produces, it must be a net importer of goods and services. If the imports were all consumption goods, in order to pay for those imports, the country must either sell some of its assets or borrow from foreigners. If the imports were investment goods, foreign persons would own the investments. Thus, an economy that runs a trade deficit will also experience foreign capital inflows as foreign persons purchase domestic assets, make equity investments or lend funds (purchase debt instruments).

For example, when the United States imports more than it exports, the United States pays for the imports with dollars. If foreigners are not buying goods with the dollars, then they will use the dollars to purchase U.S. assets. (An alternate way of viewing these relationships is that dollars flowing out of the U.S. economy in order to purchase goods or to service foreign debt must ultimately return to the economy as payment for exports or as capital inflows.)

The previous discussion focuses on the disposition of the economy's output. If the economy is a net importer, it must attract capital inflows to pay for those imports. If the economy is a net exporter, it must have capital outflows to dispose of the payments it receives for its exports. Another way of looking at the connection between capital flows and the goods and services in the economy is to concentrate on the sources of funds for investment. Because

abroad over investment income sent abroad or NI).

An alternative is to measure GNP by the manner in which income is spent. By this measure,

$$(2) \text{ GNP} = C + S + T.$$

Equation (2) is another accounting identity which states that gross national product equals the sum of private consumption expenditures (C), saving by consumers and businesses (S), and net tax payments to the government (T) (net tax payments are total tax receipts less transfer, interest, and subsidy payments made by all levels of government).

Because both measures of GNP are simple accounting identities, the right hand side of equation (1) must equal the right hand side of equation (2). From this observation can be derived an additional national income accounting identity:

$$(3) I = S + (T - G) + (M - X) - NI$$

Equation (3) states that private investment equals private saving (S), plus public saving (T-G) and net imports (M - X), less net investment income.

domestic investment must be financed either through saving or foreign borrowing, net capital inflows must also equal the difference between domestic investment and saving.

These relationships can be summarized as follows (the equation ignores relatively small unilateral transfers such as foreign aid and assumes, without loss of generality, that the government budget is balanced):

$$\begin{aligned}\text{Net Foreign Borrowing} &= \text{Investment} - \text{Saving} \\ &= (\text{Imports} - \text{Exports}) - \text{Net Investment Income}\end{aligned}$$

For this purpose, imports and exports include both goods and services, and net investment income is equal to the excess of investment income received from abroad over investment income sent abroad.⁷ The excess of imports over exports is called the trade deficit in goods and services. Net investment income can be viewed as payments received on previously-acquired foreign assets (foreign investments) less payments made to service foreign debt.

If the investment in an economy is larger than that country's saving, the country must either be running a trade deficit or the economy is increasing its foreign borrowing. Similarly, a country cannot run a trade surplus without also exporting capital, either by increasing its foreign investments, or by servicing previously-acquired foreign debt. Because the level of net investment income in any year is fixed by the level of previous foreign investment (except for changes in interest rates), changes in investment or saving that are associated with capital inflows will have a negative impact on a country's trade balance.

Economic implications of trade deficits

A trade deficit is not necessarily undesirable. What is important is the present and future consumption possibilities of the economy. That will depend in part on whether the trade deficit is financing consumption or investment. For example, if a country uncovers profitable investment opportunities, then it will be in that country's interest to obtain funds from abroad to invest in these profitable projects.⁸ If the economy currently does not have enough domestic savings to invest in these projects, it could reduce its consumption (generating more domestic saving) or look to foreign sources of funds (thus allowing investment without reducing current

⁷ This equation in the text can be seen from equation (3) in footnote 6 above if the government budget is assumed to be balanced, that is, if $G = T$. It follows that if the government runs a deficit, that is, if $G > T$, for a given level of investment, saving, and net investment income, net foreign borrowing must be greater.

⁸ This scenario describes the experience of the United States in the mid to late 1800s, when foreign capital inflows financed much of the investment in railroads and other assets.

consumption). For example, suppose new oil reserves that could be profitably recovered through increased investment are discovered in the United States. The investment may be financed by foreigners. In order to invest in U.S. assets, foreigners will have to buy dollars, thus increasing the value of the dollar. This dollar appreciation makes U.S. goods more expensive to foreigners, thereby reducing their demand for U.S. exports. At the same time, the dollar appreciation makes foreign goods cheaper for U.S. residents, increasing the demand for imports and resulting in a trade deficit. Eventually, the flow of capital will be reversed, as the U.S. demand for new investment falls, and foreigners receive interest and dividend payments on their previous investments.

The foreign borrowing in the above example was used to finance investment. This borrowing did not reduce the living standards of current or future U.S. residents, because the interest and dividends that were paid to foreigners came from the return from the new investment. If foreign borrowing finances consumption instead of investment, there are no new assets created to generate a return that can support the borrowing. When the debt eventually is repaid, the repayments will come at the expense of future consumption. For instance, consider a situation in which the domestic supply of funds for investment decreases because domestic saving rates fall. Foreign borrowing in this case is not associated with increased investment, but instead is devoted to investment that was previously financed with domestic savings. Because the foreign borrowing is not associated with increased investment, future output does not increase, and interest and dividends on the investment will be paid to foreign persons at the expense of future domestic consumption. In this case, there may be an increase in the standard of living for current U.S. residents at the expense of a decrease in the standard of living of future residents.

During the period that foreign borrowing finances U.S. consumption, the United States runs a trade deficit. Although the United States could service its growing foreign debt by increased borrowing, and hence larger trade deficits, in the long run trade deficits cannot keep growing. In fact, the United States must eventually run a trade surplus. If the United States imported more goods than it exported every year, there also would be an inflow of foreign capital every year. This capital inflow would be growing with the increasing costs of servicing the foreign debt. Eventually, foreigners would be unwilling to continue lending to the United States, and the value of the dollar would fall. The fall in the dollar would eliminate the trade deficit, and the United States would eventually run a trade surplus, so that the current account deficit (the sum of the trade deficit in goods and services and the net interest on foreign obligations) would be small enough for foreigners to be willing to lend again to the United States.

Even when foreign investment finances domestic consumption, trade deficits and capital inflows themselves should not necessarily be viewed as undesirable, because the foreign capital inflows help to keep domestic investment, and hence labor productivity, from falling. For instance, the large inflow of foreign capital to the United States in the 1980s is widely viewed to be a result of low U.S. saving rates. If the mobility of foreign capital had been restricted (through capital or import controls, for example), then the low saving rate could have led to higher domestic interest rates and lower rates of investment. That decreased investment would have led

to decreases in future living standards because the lower growth rate of the capital stock would have resulted in lower growth rates of U.S. labor productivity. The fact that foreign capital was not restricted and did finance U.S. investment helped mitigate the negative effects on economic growth of low domestic saving.

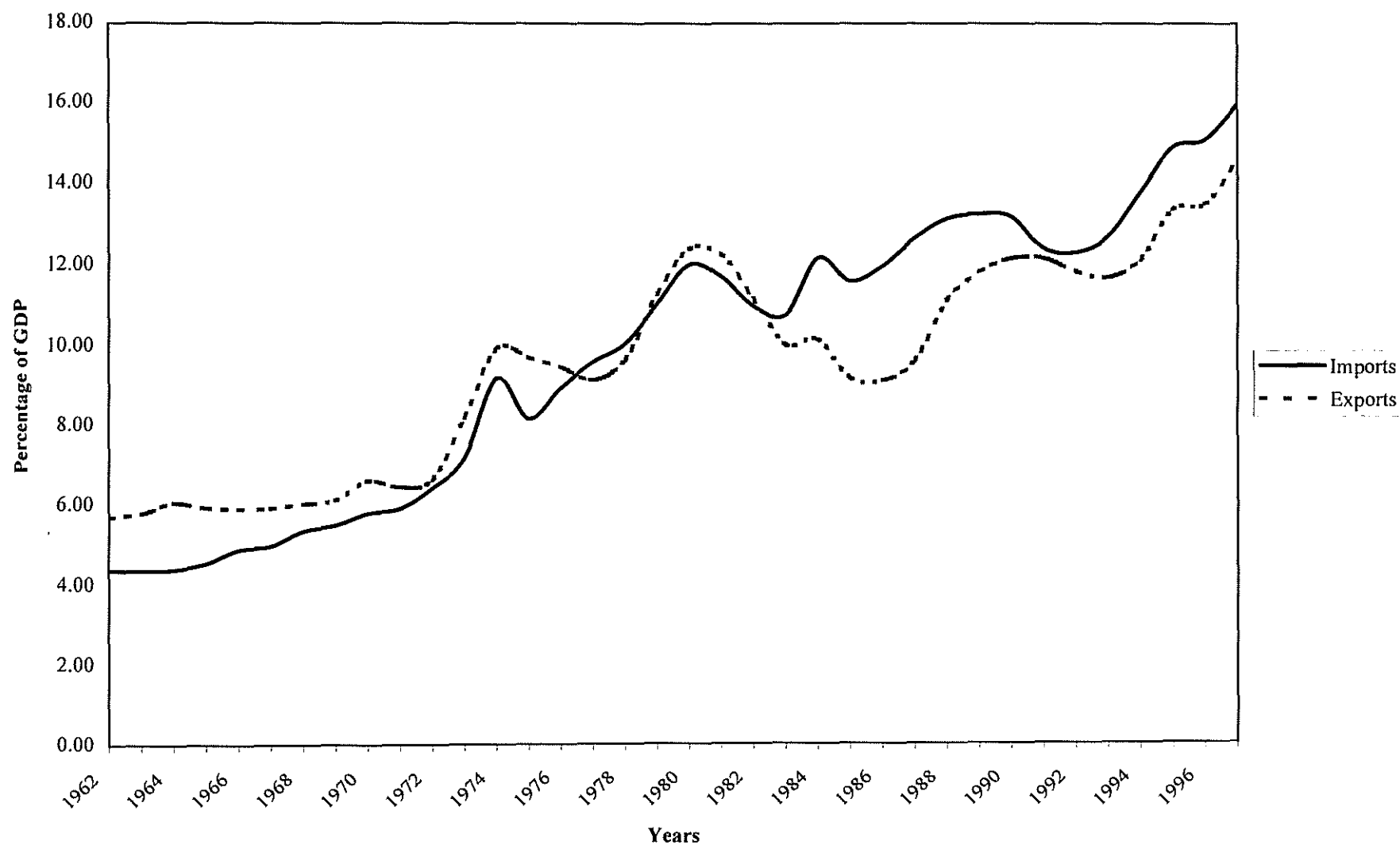
The above observations support the argument that the trade deficit does not in itself provide a useful measure of international competitiveness, since trade deficits and trade surpluses can be either good or bad for the United States. The example of oil discovery discussed above shows that even increases in a country's stock of exportable goods can have ambiguous effects on the trade deficit. If the discovery of oil also increases the demand for investment, then the trade deficit may actually increase in the short run. Increases in natural resources, advances in technology, increases in worker efficiency, and other wealth-enhancing innovations have ambiguous effects on the trade deficit in the short and medium run. Because these innovations increase the productivity of U.S. workers and lower production costs, they increase the attractiveness of U.S. goods, and may result in increased exports. To the extent these innovations increase the demand for investment, however, they can have the opposite effect on the trade deficit. Nonetheless, each of these innovations increases the output of the economy, and hence the incomes of U.S. residents.

B. Trends in the United States' Balance of Payments

Foreign trade has become increasingly important to the United States economy. Figure 1 presents the value of exports from the United States and imports into the United States as a percentage of GDP for the period 1962-1997.⁹ As depicted in Figure 1, exports and imports each have risen from less than six percent of GDP in 1962 to more than 14 percent in 1997. Figure 1 also shows that the United States generally was a net exporter of goods and services prior to 1982. Since that time, the United States has been a net importer of goods and services.

⁹ Data for Figure 1 are from the U.S. Commerce Department, Bureau of Economic Analysis and are reprinted in Appendix Tables A.1. and A.2.

Figure 1.-- Exports and Imports as a Percentage of United States GDP , 1962-1997



The net trade position of a country is commonly summarized by its current account. The U.S. current account as a whole, which compares exports of goods and services and income earned by U.S. persons on foreign investments to imports of goods and services and income earned by foreign persons on their investments in the United States (plus unilateral remittances), was positive as recently as 1981, but generally has been in deficit by over \$90 billion per year nine times since 1984. Figure 2 reports the current account balance of the United States for the period 1963 through 1997 in nominal (non-inflation-adjusted) dollars.¹⁰ Figure 2, like Figure 1, shows the United States' change in status from net exporter to net importer since the early 1980s. Figure 2 reflects a substantial reduction in the current account deficit for 1992. In that year, the United States received substantial payments from abroad related to the Persian Gulf war.

¹⁰ Data for Figure 2 are from the U.S. Commerce Department, Bureau of Economic Analysis and are reprinted in Appendix Table A.1.

Figure 2.--United States Current Account Balance, 1963-1997
[millions nominal dollars]



The aggregate data reported in Figures 1 and 2 mask differences in the trade position of various sectors of the economy. As explained above, the current account compares exports of goods and services and payments of income earned by U.S. persons on foreign investments to imports of goods and services and payments of income earned by foreign persons on their investments in the United States. Figures 3, 4, and 5 separately chart the nominal dollar value of exported and imported goods (Figure 3), exported and imported services (Figure 4), and investment income earned by U.S. and foreign persons (Figure 5).¹¹ The sum of the export curves in Figures 3, 4, and 5 less the sum of the import curves (plus unilateral remittances) equals the current account balance curve of Figure 2.

Figures 3, 4, and 5 reveal different trends. As has been widely reported, the merchandise (goods only) trade deficit has been over \$100 billion per year since 1984. On the other hand, the United States has been a net exporter of services since the mid-1970s (Figure 4). Only since 1994 have payments of income to foreign persons on their U.S. investments exceeded U.S. receipts of income on investments abroad (Figure 5).

¹¹ Data for Figures 3, 4, and 5 are from the U.S. Commerce Department, Bureau of Economic Analysis and are reprinted in Appendix Table A.1.

Figure 3.--U.S. Merchandise Trade, 1962-1997
[millions nominal dollars]

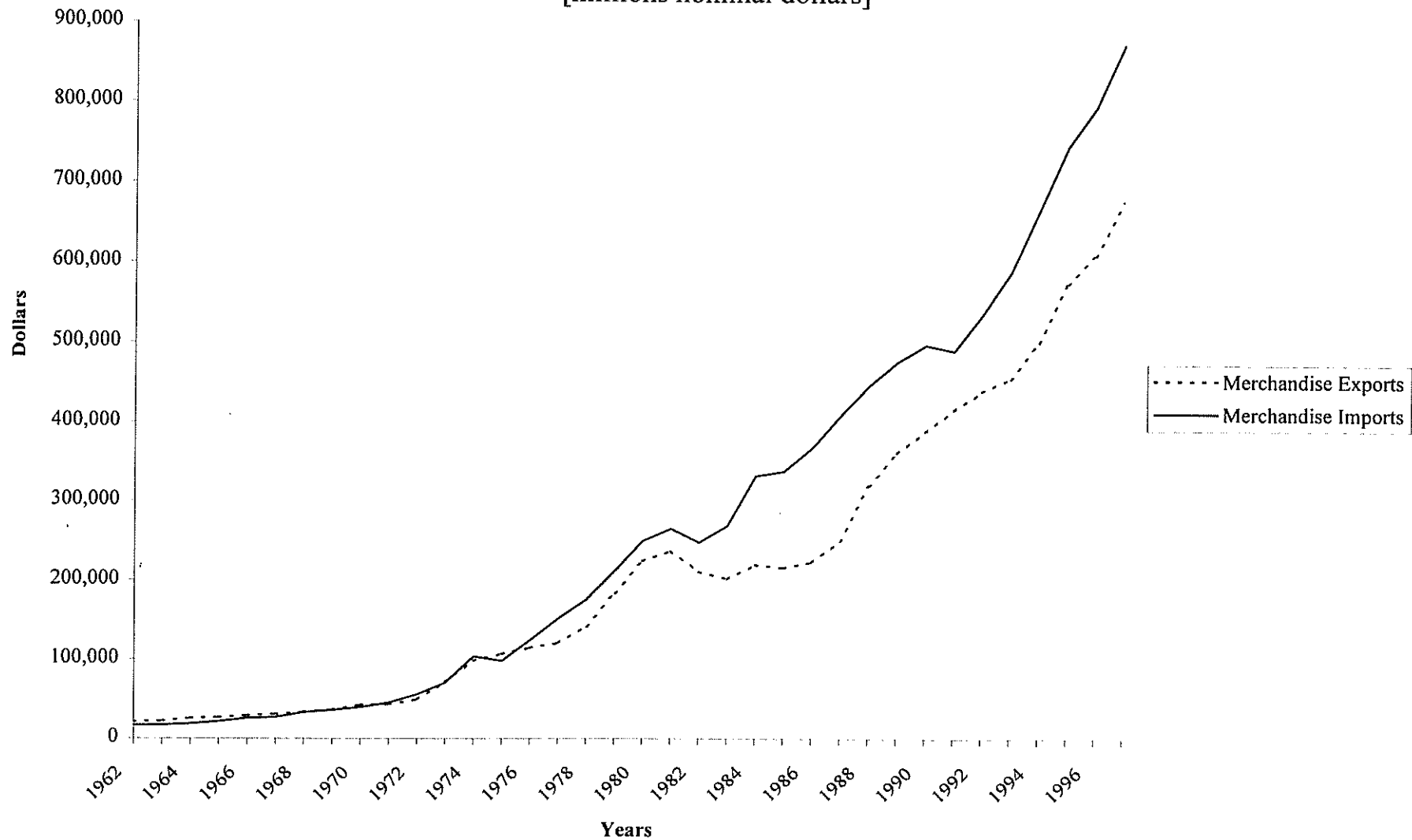
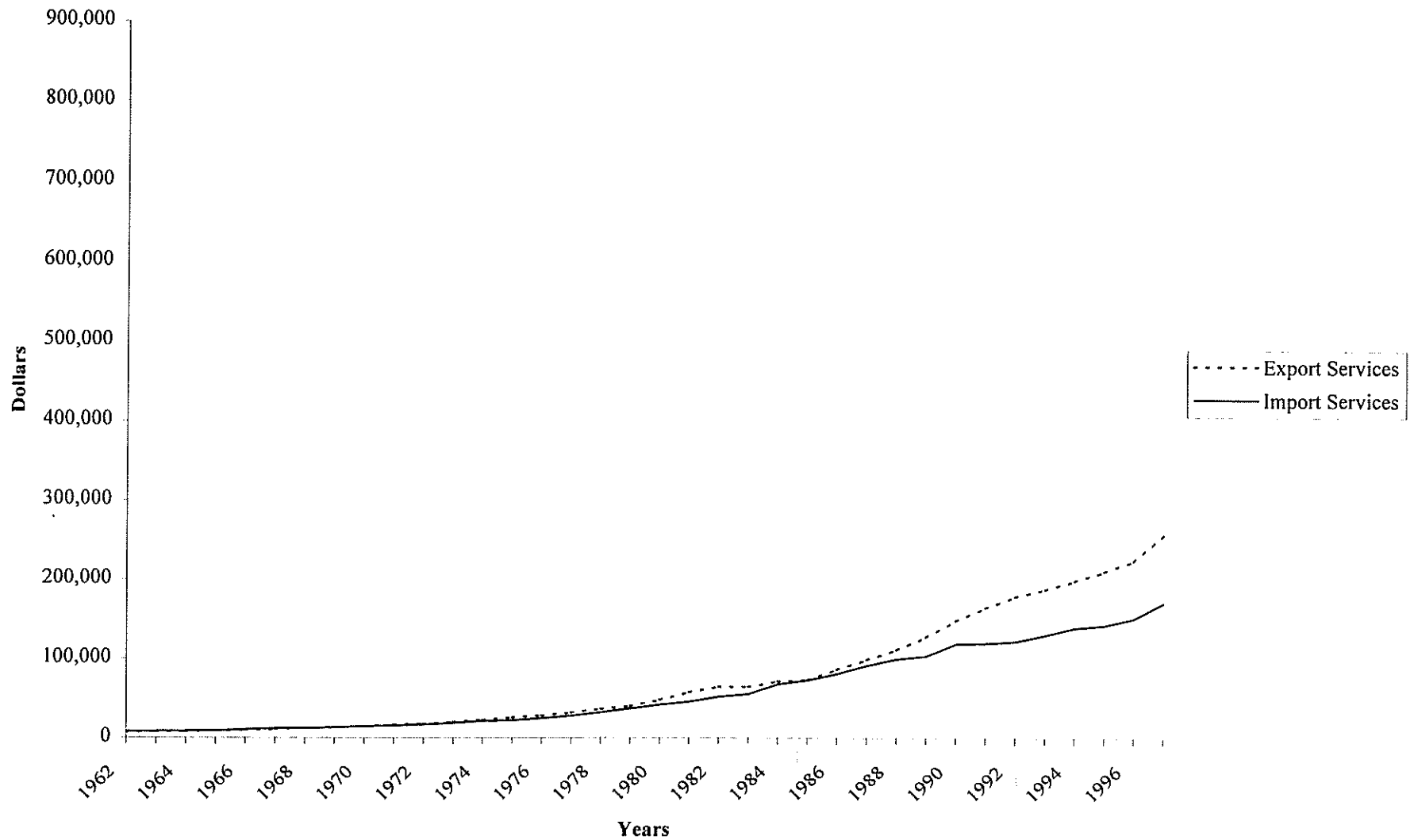
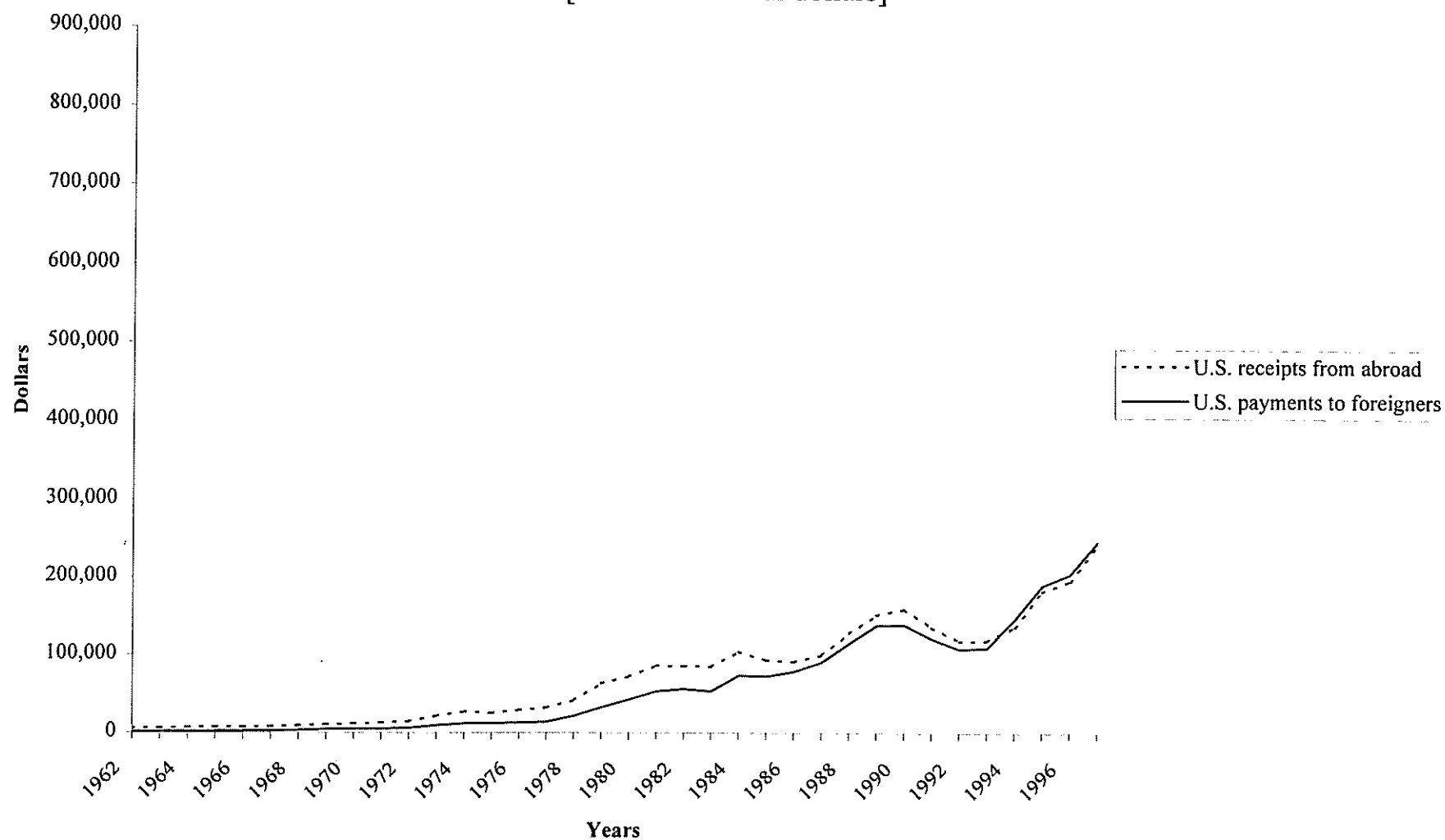


Figure 4.--Trade in Services, 1962-1997
[millions nominal dollars]



**Figure 5.--U.S. Receipts of Income from Abroad and U.S. Payments
to Foreign Persons, 1962-1997**
[millions nominal dollars]



These aggregate data also do not reveal the extent to which growing trade flows result from trade between related parties. For example, a domestic company might ship components manufactured in the United States to its foreign subsidiary for final assembly and sale. Such shipments would be counted as exports from the United States. A domestic company might produce components abroad and ship them to the United States for final assembly and sale. Such shipments would be counted as imports to the United States. Likewise, a foreign parent company might ship components from abroad to its U.S. affiliate for final assembly and sale in the United States. Such shipments would be counted as imports into the United States. The foreign affiliate might ship components to another country for assembly and sale. Such shipments would be counted as exports from the United States.

The preceding paragraph suggests that intra-firm trade involves the shipment of components across borders. Other intra-firm trade may involve the shipment of raw materials abroad for manufacture abroad or shipment of finished goods to a foreign sales affiliate. The data do not permit such distinctions to be drawn. Nevertheless, the extent of this intra-firm cross-border trade is large and growing. In 1994, large foreign-owned domestic corporations reported sales of tangible goods to related foreign persons (exports) of \$70.5 billion, a figure representing 14 percent of total U.S. merchandise exports in 1994. Large foreign-owned domestic corporations reported purchases of tangible goods from related foreign persons (imports) of \$180.6 billion, a figure representing 27 percent of total U.S. merchandise imports in 1994.¹² Similarly, in 1994, U.S. multinational enterprises shipped \$136.1 billion of goods to their foreign affiliates, a figure representing 26 percent of U.S. merchandise exports in 1994. Foreign affiliates of U.S. multinational enterprises shipped \$113.4 billion of goods to their U.S. parent enterprise, a figure representing 17 percent of U.S. merchandise imports in 1994.¹³ Thus, in total, in 1994 intra-firm trade accounted for at least 40 percent of U.S. merchandise exports and 44 percent of U.S. merchandise imports.

The balance of payments accounts, presented in Table 1, are analogous to a sources and uses of funds statement of the United States with the rest of the world. As demonstrated in Part III.A. above, the current account balance, which consists primarily of the trade balance, should be exactly offset by the capital account balance, which measures the net inflow or outflow of capital to or from the United States. The difference between the current account surplus or deficit

¹² Michael G. Seiders, "Transactions Between Large Foreign-Owned Domestic Corporations and Related-Foreign Persons, 1994," *SOI Bulletin*, 17, Winter 1997-1998, pp. 123-140. The figures reported in the text are the sum of reported "sales of stock in trade" and "sales of other tangible property." See Figure B. In 1991, such inter-affiliate trade by large foreign-owned domestic corporations represented 11 percent of merchandise exports and 24 percent of merchandise imports.

¹³ Raymond J. Mataloni, Jr., "U.S. Multinational Companies: Operations in 1995," *Survey of Current Business*, 77, October 1997, p. 50.

and the capital account deficit or surplus is recorded as a statistical discrepancy. Serious problems of measurement cause the accounts to be somewhat mismatched in practice, but basic patterns are unlikely to be significantly distorted by these problems.

Table 1.--International Transactions of the United States, Selected Years, 1975-1997
(\$ Billions nominal)

	<u>1975</u>	<u>1980</u>	<u>1985</u>	<u>1990</u>	<u>1997</u>
Current Account Balance	18.1	2.3	-124.2	-92.7	-166.4
Exports of Goods and Services	<u>157.9</u>	<u>344.4</u>	<u>382.7</u>	<u>697.4</u>	<u>1,167.6</u>
Merchandise	107.1	244.3	215.9	389.3	678.3
Services	25.5	47.6	73.2	147.8	253.2
Receipts from U.S. assets abroad	25.4	72.6	93.7	160.3	236.0
Imports of Goods and Services	<u>132.7</u>	<u>333.8</u>	<u>484.0</u>	<u>756.7</u>	<u>1,295.5</u>
Merchandise	98.2	249.8	338.1	498.3	877.3
Services	22.0	41.5	72.9	118.8	167.9
Payments on foreign-owned U.S. assets	12.6	42.5	73.1	139.6	250.3
Unilateral Transfers	<u>7.1</u>	<u>8.3</u>	<u>23.0</u>	<u>33.4</u>	<u>38.5</u>
Capital Account Balance	-24.0	-27.7	101.3	48.2	263.6
Foreign Investment in the United States	<u>15.7</u>	<u>58.1</u>	<u>141.2</u>	<u>122.2</u>	<u>690.5</u>
Direct Investment	2.6	16.9	20.0	47.9	107.9
Private non-direct investment	6.0	25.7	122.3	40.4	564.4
Official	7.0	15.5	-1.1	33.9	18.2
U.S. Investment Abroad	<u>39.7</u>	<u>87.0</u>	<u>39.9</u>	<u>74.0</u>	<u>426.9</u>
Direct investment	14.2	19.2	14.1	30.0	119.4
Private non-direct investment	21.1	54.4	19.1	44.2	306.7
Increase in government assets	4.3	13.3	6.7	-0.1	1.0
Allocation of Special Drawing Rights	----	<u>1.2</u>	----	----	----
Statistical Discrepancy	5.9	25.4	23.0	44.5	-97.1

Source: Douglas B. Weinberg, "U.S. International Transactions, First Quarter 1995," *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, June 1995, pp. 76-117, and Christopher L. Bach, "U.S. International Transactions, Fourth Quarter and Year 1997," *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, April 1998, pp. 51-97.

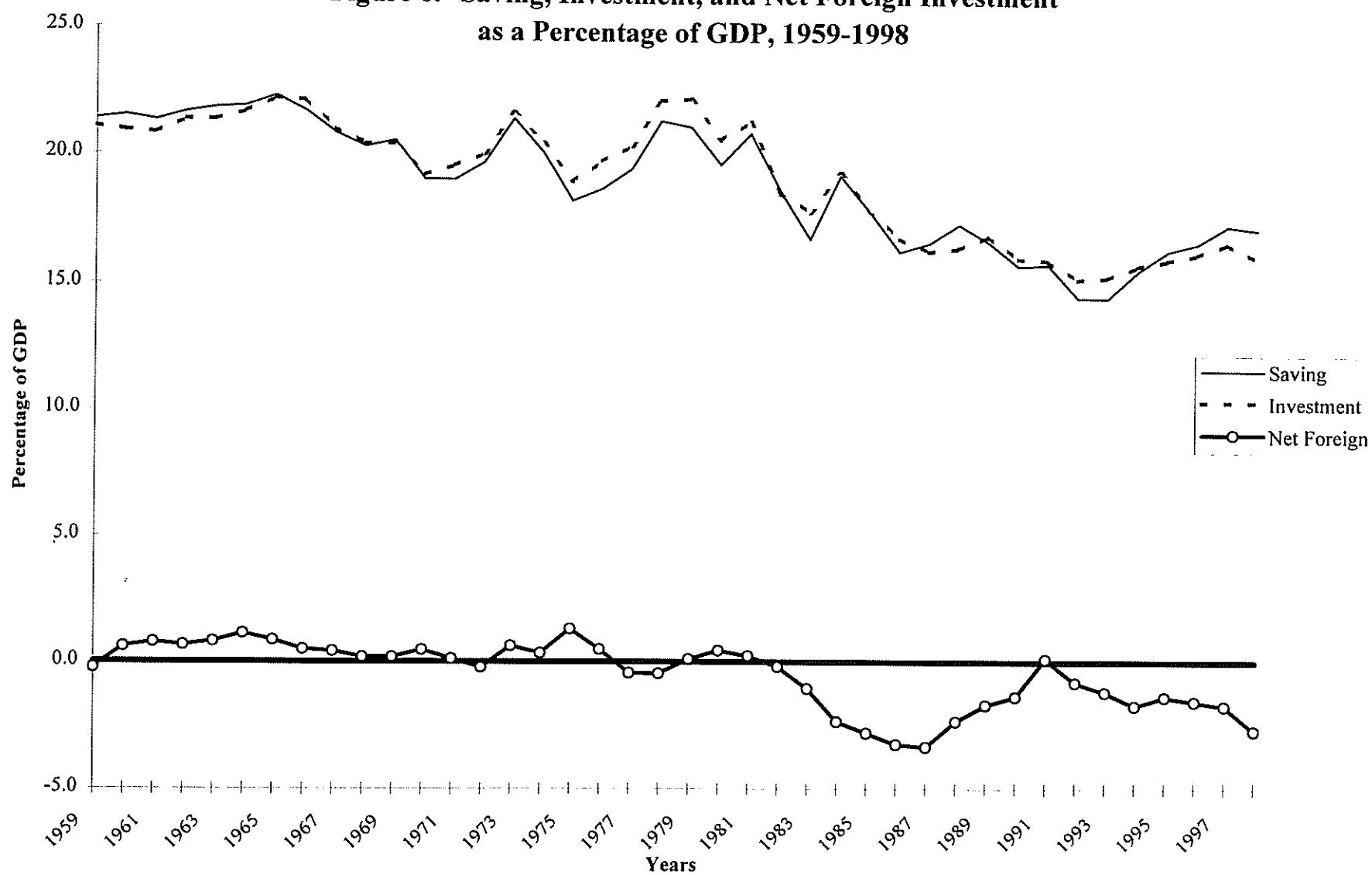
C. Trends in the United States' Capital Account

Overview of the United States' capital account

As explained in Part III.A., above, when the United States imports more than it exports, the dollars the United States uses to buy the imports must ultimately return to the United States as payment for U.S. exports or to purchase U.S. assets. As Figure 2 and Table 1 document the United States' current account has been in deficit since the early 1980s. Figure 6 plots gross (before depreciation) U.S. investment and gross U.S. saving as a percentage of GDP for the period 1959-1998.¹⁴ Figure 6 also plots net foreign investment as a percentage of GDP. In Figure 6, when the United States is a net exporter of capital, net foreign investment is measured as a positive number and when the United States is a net importer of foreign capital net foreign investment is measured as a negative number. Net foreign investment became a larger proportion of the economy since 1982. At the same time, the United States changed from being a modest exporter of capital in relation to GDP to being a large importer of capital. Net foreign investment has become a larger proportion of the economy and a more significant proportion of total domestic investment than in the past. In 1997, gross investment in the United States was \$1,351 billion and net foreign investment was \$141 billion, or 10.4 percent of gross domestic investment. In 1993, net foreign investment comprised 8.9 percent of gross domestic investment.

¹⁴ Data for Figure 6 are from the U.S. Department of Commerce, Bureau of Economic Analysis and are reprinted in Appendix Table A.2.

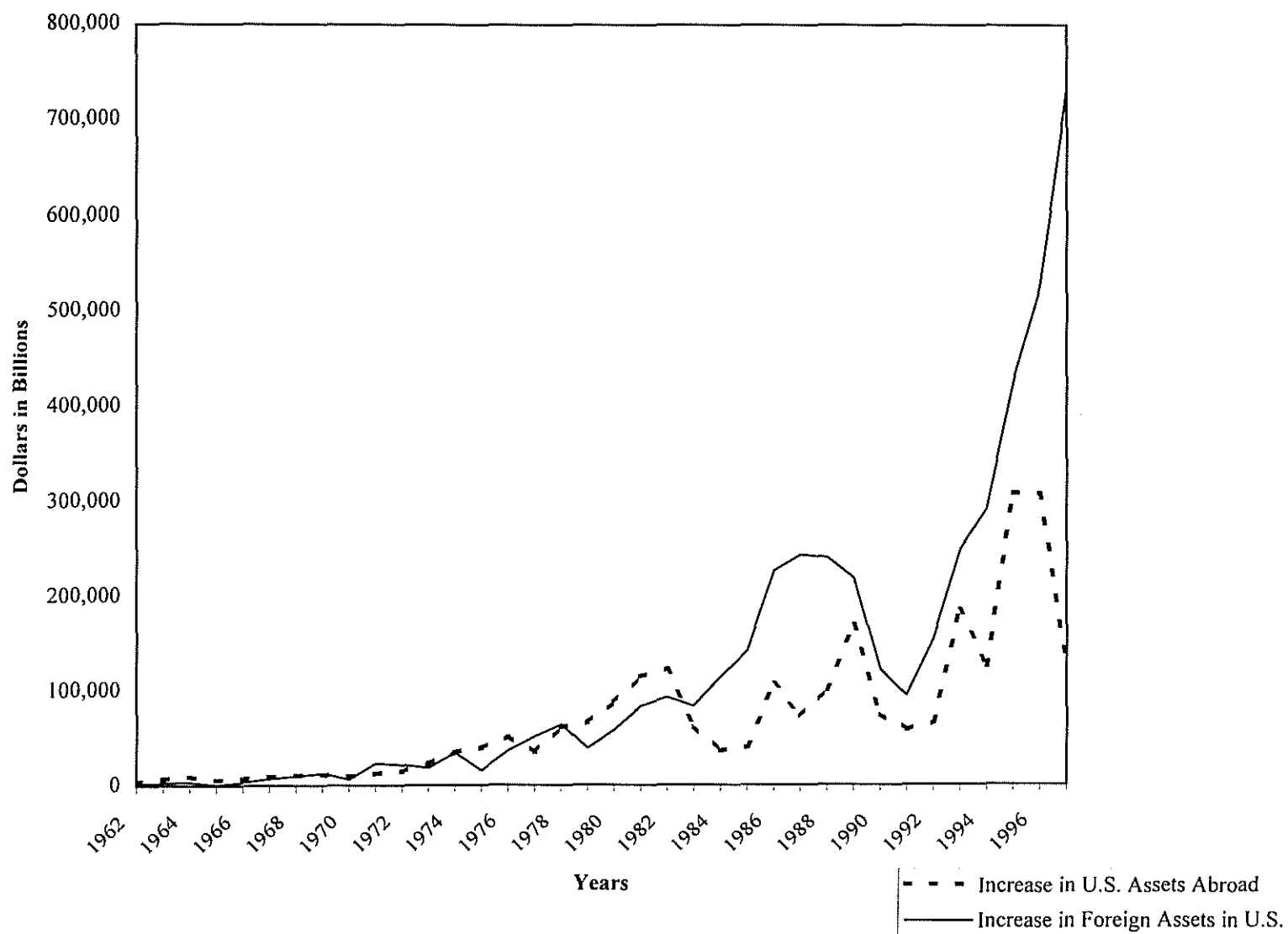
**Figure 6.--Saving, Investment, and Net Foreign Investment
as a Percentage of GDP, 1959-1998**



The net foreign investment in the United States is measured by the United States' capital account. The capital account measures the increase in U.S. assets abroad compared to the increase in foreign assets in the United States. Figure 7 plots the annual increase of U.S. assets abroad and of foreign assets in the United States in nominal dollars for the period 1962-1997.¹⁵

¹⁵ Data for Figure 7 are from the U.S. Department of Commerce, Bureau of Economic Analysis and are reprinted in Appendix Table A.3.

Figure 7.--Annual Increases in U.S. Assets Abroad and in Foreign Assets in U.S., 1962-1997



Growth in foreign-owned assets in the United States¹⁶

The amount of foreign-owned assets in the United States grew more than 700 percent between 1975 and 1988 and more than 300 percent between 1980 and 1988.¹⁷ The total amount of foreign-owned assets in the United States exceeded \$4.5 trillion by the end of 1996.¹⁸ The recorded value of U.S.-owned assets abroad grew less rapidly during the same period. The Department of Commerce reports that in 1975 the amount of U.S.-owned assets abroad exceeded foreign-owned assets in the United States by \$74 billion. By the end of 1988, however, the situation had reversed, so that the amount of foreign-owned assets in the United States exceeded U.S.-owned assets abroad by \$162 billion. By 1996, the amount of foreign-owned assets in the United States exceeded U.S.-owned assets abroad by \$871 billion.¹⁹ These investments are measured by their book value. Some argue that the market value of U.S.-owned assets abroad is similar to, or greater than, the market value of foreign-owned assets in the United States, if market values were measured accurately.²⁰ Figures 8 and 9 display the value of U.S.-owned assets abroad and foreign-owned assets in the United States for selected years measured under both current (or book) cost and based on estimates of current market values. Whether this argument is correct with respect to the current net investment position, it is clear that foreign-owned U.S. assets are growing more rapidly than U.S.-owned assets abroad as depicted in Figure 7.

¹⁶ For a more complete discussion of issues relating to foreign investment in the United States, see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990.

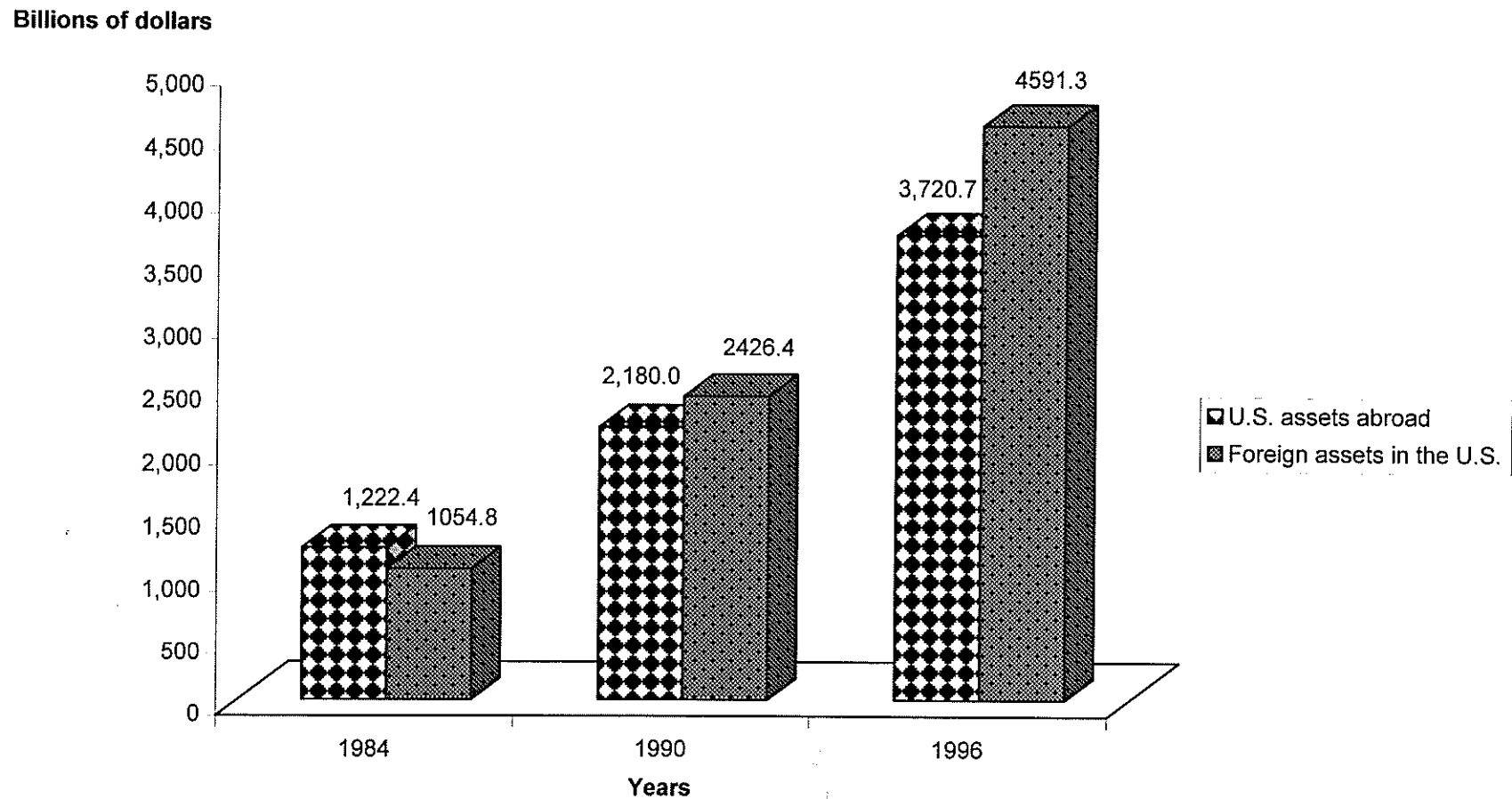
¹⁷ Russell B. Scholl, "The International Investment Position of the United States in 1988," *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, June 1989, p. 43.

¹⁸ Russell B. Scholl, "The International Investment Position of the United States in 1996," *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, June 1997 pp. 22-33.

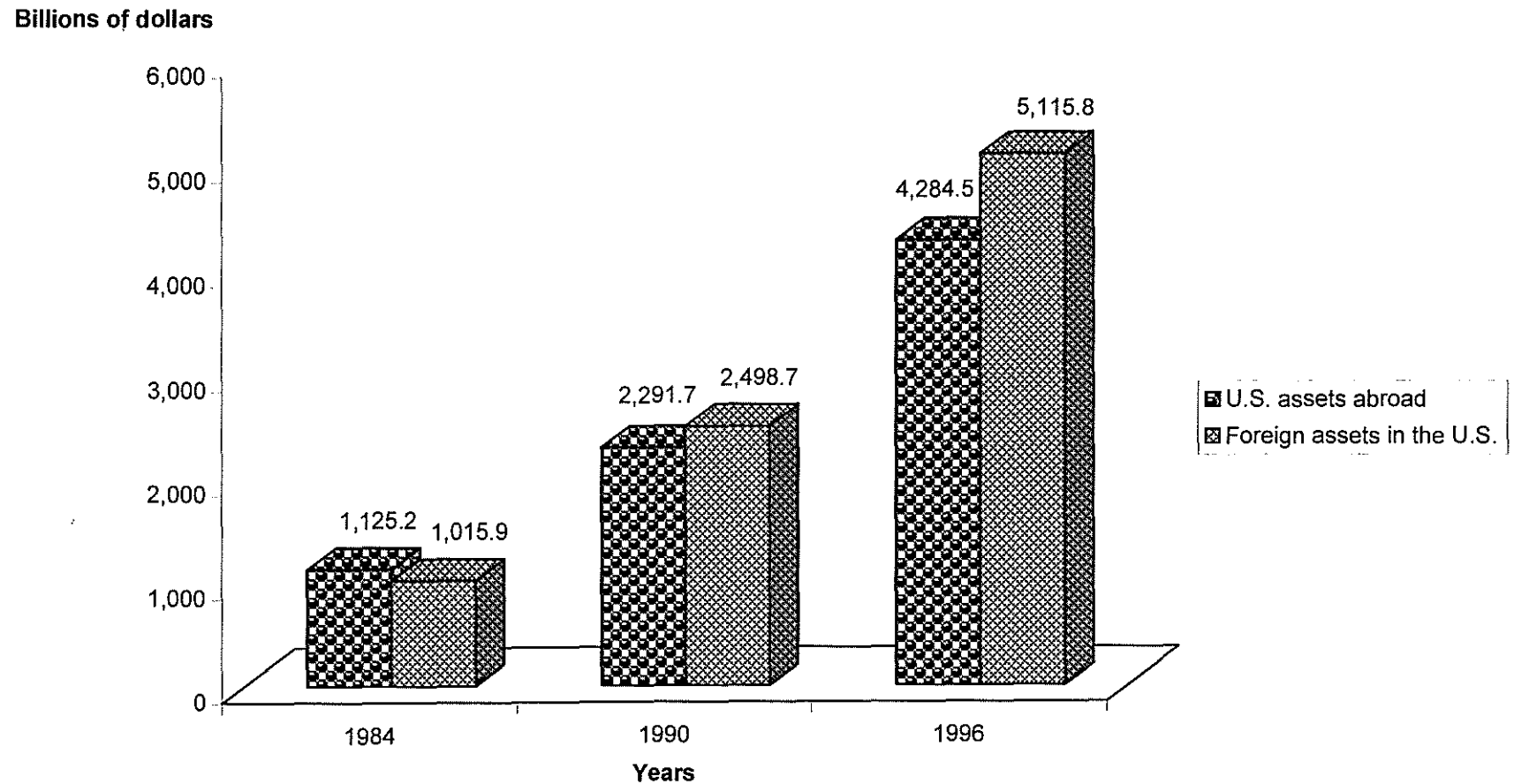
¹⁹ *Ibid.*

²⁰ Some commentators also have observed that the statistical discrepancies in the trade data are becoming large enough to question any conclusions which might be drawn from such data. See "Statistical Discrepancy" in Table 1 above. The distinction between book valuation and market valuation is only relevant for the category of investment labeled "direct investment," not for "portfolio investment." The distinction between direct and portfolio investment is explained in the text below.

**Figure 8.--International Investment Position of the United States,
1984, 1990, and 1996
(direct investment at current cost)**



**Figure 9.--International Investment Position of the United States,
1984, 1990, 1996
(direct investment at market value)**



Foreign assets in the United States (and U.S. assets abroad) can be categorized as direct investment, non-direct investment, and official assets. Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interests in an unincorporated business. Foreign persons held direct investments of \$729 billion in the United States in 1996, having grown from \$83 billion in 1980.²¹

The largest category of investment is non-direct investment held by private (non-governmental) foreign investors, commonly referred to as portfolio investment. This category consists mostly of holdings of corporate equities, corporate and government bonds, and bank deposits. The portfolio investor generally does not have control over the assets that underlie the financial claims. In 1996, portfolio assets of foreign persons in the United States were more than triple the recorded value of direct investment, \$2,576 billion compared to \$729 billion, respectively.²² Bank deposits account for approximately one-third of this total, and reflect, in part, the increasingly global nature of banking activities. Figure 10 reports the dollar value of foreign holdings of selected U.S. assets, both portfolio investment and direct investment, for 1984, 1990, and 1996. Foreign investment in bonds, corporate equities, and bank deposits, like other types of financial investment, provide a source of funds for investment in the United States but also represent a claim on future U.S. resources.

The final category of foreign-owned U.S. assets is official assets: U.S. assets held by governments, central banking systems, and certain international organizations. The foreign currency reserves of other governments and banking systems, for example, are treated as official assets. Levels of foreign-held official assets have grown more slowly than foreign-held direct and portfolio investment of private investors.

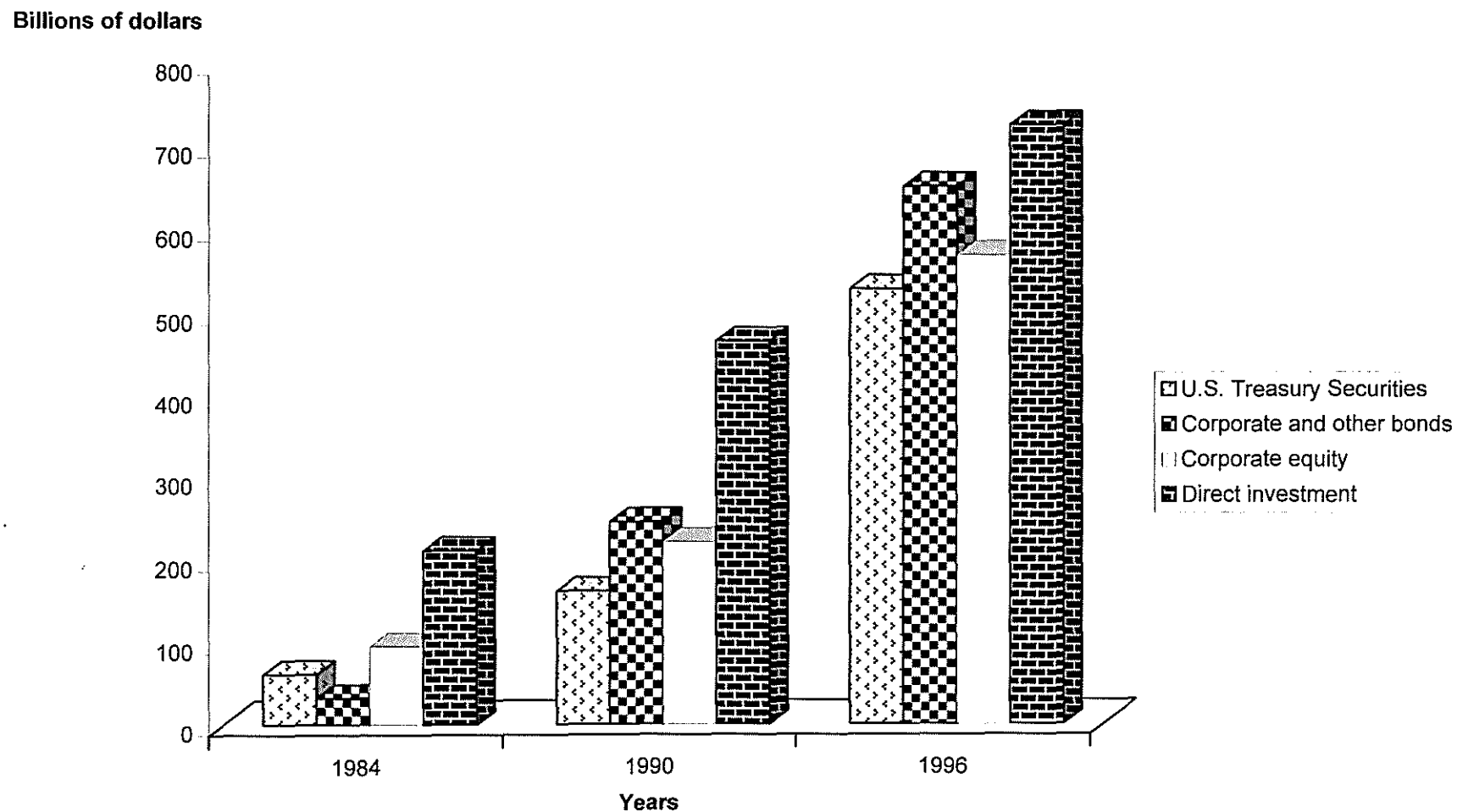
The value of investments by private U.S. persons abroad has grown from \$295.1 billion in 1980 to \$3,477 billion in 1996.²³ This growth has not been as rapid as the growth in the value of investments by foreign persons in the United States.

²¹ Russell B. Scholl, "The International Investment Position of the United States in 1994," *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, June 1995, pp. 52-60, and Scholl, "The International Investment Position of the United States in 1996."

²² Scholl, "The International Investment Position of the United States in 1996."

²³ Scholl, "The International Investment Position of the United States in 1994," and Scholl, "The International Investment Position of the United States in 1996."

**Figure 10.--Selected Nongovernmental Foreign Holdings of United States' Assets, Both Portfolio and Direct Investments, 1984, 1990, 1996
(direct investment at current cost)**



IV. ECONOMIC ISSUES IN THE TAXATION OF INTERNATIONAL TRANSACTIONS

A. Overview

As the previous section documents, cross border trade and investment has grown substantially over the past decade. International investment plays an important role in determining the total amount of worldwide income as well as the distribution of income across nations. In addition, international investment flows can substantially influence the distribution of capital and labor income within nations. Because each government levies taxes by its own method and at its own rates, the resulting system of international taxation can distort investment and contribute to reductions in worldwide economic welfare. A government's tax policies affect the distribution of income directly, by collecting tax from foreigners earning income within its borders and from residents earning income overseas, and indirectly by inducing capital movements across national borders.²⁴

Analysts usually assess any system of taxation in terms of four general principles.

1. Efficiency. Does the tax system minimize economic distortions or are tax considerations important to investment and employment decisions? Generally, neutrality promotes economic efficiency.
2. Equity. Does the tax system meet the revenue needs determined by the Congress in a fair manner? "Fairness," of course, is a subjective criteria. In the international context, one might ask whether domestic businesses are treated fairly *vis-à-vis* foreign-based businesses. Ultimately, the burden of taxes are borne by individuals, either as investors, workers, or consumers.
3. Growth. Does the tax system promote economic growth? A growing economy creates economic opportunities and increases real income for U. S. persons.
4. Simplicity. Does the tax system economize on compliance and administrative burdens? Complexity increases the burden of the tax on the taxpayer and administrative burdens reduce the net revenue available to the government for other purposes.

²⁴ For a discussion of the economic effects of U.S. taxation with particular focus on the rules affecting inbound investment, see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990.

In the international context, some have offered an additional principle.

5. Harmonization. To what extent does the tax system conform with international norms? Does the tax system help promote other policy goals in the United States' dealings with foreign countries?

Policymakers cannot apply these principles in a mutually exclusive fashion. Decisions regarding fairness or growth may affect efficiency or harmonization. Decisions regarding efficiency and harmonization may create complexity. Tradeoffs among these principles are inevitable. The discussion in the remainder of this pamphlet will relate only to the principle of efficiency.

The next three sections (B., C., and D.) discuss in sequence the economic and distributional effects of international investment flows in a world with no taxes, in a world with equal taxes, and finally in a world with unequal taxes. Section B examines the relatively simple case of international investment in a world without taxation. In this case, each government (independent of the actions of other governments) can pursue both worldwide interests and national interests simultaneously. To maximize economic welfare, no government would restrict or subsidize the free flow of capital. Besides increasing wealth, the free flow of capital can also result in a redistribution of income between capital and labor. In particular, labor in the capital-importing countries benefits at the expense of labor in the capital-exporting countries.

Section C begins by examining the economics of capital flows when income taxes are imposed at equal rates on all income no matter the source. With taxation, it is not necessarily the case that each government can pursue maximum national economic welfare and maximum worldwide economic welfare simultaneously. With these goals now potentially inconsistent, a country undertaking policies consistent with worldwide economic welfare may not be promoting its own national interest. Although detrimental to worldwide economic welfare, the national interest could in some degree be furthered by subsidizing domestic investment and discouraging outbound investment. It is in this context that section C introduces the concept known as national neutrality. Under a system of national neutrality, a government taxes outbound investment by its residents more heavily than domestic investment, in order to redirect capital investment to domestic locations, and therefore maximize domestic economic income. This concept is inappropriately labeled "neutrality" since it is deliberately non-neutral in its disincentives for outbound investment, which are intended to maximize domestic income.²⁵

Section D further relaxes the assumption that taxes are imposed at the same rate on all income. With unequal taxation, it is much more difficult to determine the design of a tax system that best promotes worldwide economic welfare. At this juncture, the concepts of capital export neutrality and capital import neutrality are introduced. Sometimes the concept of capital import

²⁵ This nonneutrality is only the case, however, if revenue from taxation is not used for the direct benefit of the taxpayer (i.e., it is not a fee for government services rendered).

neutrality is referred to as the goal of "competitiveness." As a whole, the U.S. system of taxation is a hybrid containing elements consistent with both capital import neutrality and capital export neutrality.

B. The Location of Investment Without Taxation

Maximizing income

Just as free international markets for goods and services result in beneficial "gains from trade," the free flow of funds in capital markets also promotes worldwide economic welfare. U.S. citizens and corporations may invest directly in overseas operations over which they exercise substantial control, or they may invest indirectly in securities and other financial instruments in which they generally are passive investors. Similarly, foreign residents and corporations invest directly in U.S. operations or indirectly by purchase of a wide variety of U.S. financial instruments, such as bank deposits, government bonds, and securities of private corporations.

In general, investors seek to place their funds in projects with the highest risk-adjusted rate of return, regardless of location. If this were not the case, capital markets would inefficiently allocate capital by not matching savings with the most productive investment opportunities, and economic welfare would suffer. Any impediments to the free flow of capital generally reduce worldwide economic welfare. For example, if there were no international capital flows, and the U.S. rate of return were 10 percent while the rate of return in the rest of the world were 8 percent, the opening of international capital markets would reallocate capital from abroad to the United States, and the United States would become a net capital importer. Worldwide welfare would improve because foreign investors would now export funds in order to reallocate capital from lower-return foreign investment projects to more productive investment opportunities in the United States.

To maximize worldwide economic welfare, government policies should not interfere with the free flow of traded goods or of traded capital.²⁶ For this reason, tariffs on imported goods and restrictions on inflows of capital are widely recognized as policies reducing worldwide economic welfare, although they can certainly increase the income of particular domestic producers or particular domestic investors. However, it is not the case that all policies that increase international trade and capital flows increase economic welfare. Export subsidies may increase

²⁶ When conditions approximating "perfect competition" are not present, it may be advantageous for a particular country to distort free trade. For example, the government of a nation with a competitive domestic sector and dominant in a particular natural resource can nationalize its resources and raise the worldwide price to monopoly levels. Alternatively, the government can leave the industry competitive, and extract monopoly profits by raising taxes on the natural resource. Under certain conditions, "strategic trade policy" (described below) could increase national welfare by distorting free trade.

international trade, and they may indeed produce economic benefits for the favored industries and their consumers, but they are also likely to reduce worldwide economic welfare. Similarly, policies to promote outbound investment in excess of free-market levels result in a misallocation of capital that reduces worldwide output and income. If capital is perfectly mobile, investors will equalize rates of return for all investments worldwide. If the United States subsidized outbound investment by its residents and corporations, the underlying (before-subsidy) rate of return on outbound investment would fall below that on investment in the United States. In this case, from the standpoint of promoting worldwide efficiency, too much capital would be located outside the United States.

The distribution of income between capital and labor

The location of investment has important implications for the distribution of income. In general, increased capital formation increases the productivity of labor. With more output per worker, labor income (including wages and other forms of compensation) increases. Any reallocation of investment from the United States to foreign localities, for whatever reason, will reduce the productivity of U.S. workers and therefore their compensation. The remaining smaller pool of capital in the United States will receive a higher rate of return as investors drop the least profitable domestic investment projects in favor of investment opportunities abroad.

It is important to note that despite the decline in wages resulting from the reallocation of capital, an increase in overall income may nonetheless occur. As noted above returns on domestic investments rise and, presumably, the U.S. investors who funded offshore investments did so because such investments would generate a greater return than domestic investments. A situation of unrestricted capital flows is considered optimal because it maximizes total income. If total national income increases due to the freedom of capital flows, and an outflow of capital reduces domestic wages, then the increase in capital income necessarily exceeds the decline in wages.²⁷

Similarly, any increase in inbound investment into the United States increases the productivity of U.S. workers and their income.²⁸ Increased investment by foreign persons in the

²⁷ Because the investors who earn the capital income may be different from the workers whose wages decline, the distribution of income across households may change.

²⁸ The Council of Economic Advisors emphasized this point in reviewing the net inflow of foreign investment in the United States that began in the 1980s as documented in Figure 6.

The unhindered flow of foreign direct investment leads to additional productive resources in the United States and facilitates the realization of cost efficient scales of business by consolidating under one corporate roof separate, but related, operations. These boost the productivity and international competitiveness of the

United States also reduces the return on capital in the United States. If capital inflows are the result of free-market policies, they increase national welfare. However, as in the case of outbound investment, not all sectors of the economy will necessarily be better off.

The effect of outbound investment on domestic investment

A critical factor in determining the effects of international capital flows on the distribution of income is whether domestic saving increases in response to the availability of outbound investment opportunities. If outbound investment does not reduce domestic investment, then outbound investment will not reduce labor income (although by increasing returns on capital it may reduce labor's share of income). However, if outbound investment results in a reduction of the U.S. capital stock, labor income will also decline. The importance of one's assumption about the effect of outbound investment on domestic savings can hardly be overemphasized. Many conclusions and policy prescriptions derived from the theory of international taxation depend on this assumption.²⁹ Unfortunately, little empirical research has been undertaken to determine the direct effect of investment overseas by U.S. investors on U.S. savings and on investment in the United States.³⁰

United States, create jobs, and promote innovation and productivity. The inflow of capital helps to sustain U.S. investment despite the current low U.S. national saving rate, and thus contributes to economic growth.

When U.S. multinational firms first set up in Europe during the 1950s and 1960s, many Europeans feared that Europe was being bought out by Americans and that their economies were being Americanized. U.S. direct investment has benefitted the European economy. The recent increase in foreign direct investment in the United States will similarly benefit the U.S. economy.

Council of Economic Advisors, *Economic Report of the President*, (Washington: U.S. Government Printing Office), 1991, p. 258.

²⁹ As explained in more detail below, if domestic investment does not decline as a result of increased outbound investment, then the relevance of national neutrality is greatly diminished, and capital import neutrality becomes a more attractive policy goal relative to capital export neutrality.

³⁰ Some studies have looked at changes in investment in particular industries which have made foreign investments. That is not relevant to this discussion as in a vibrant market economy, reduced investment in one sector may be offset by increased investment in another sector. One study that has attempted to measure the effect on gross domestic investment from changes in foreign direct investment is Martin Feldstein, "The Effects of Outbound Foreign Direct Investment on the Domestic Capital Stock," in Martin Feldstein, James R. Hines, Jr., and

One way that outbound investment can affect domestic investment is illustrated by the case of a so-called "runaway plant." The term "runaway plant" usually refers to the relocation to a foreign country of a U.S. production facility owned by U.S. persons. Even if this phenomenon is observed, it does not necessarily lead to the conclusion that U.S. investors collectively reduce investment in the United States by the amount of the outbound investment or by any other amount. Facilities that had been located in the United States may have been substantially funded by domestic debt and now could be funded by foreign debt. If this were the case, outbound investment may make available domestic debt capital for other investments in the United States. Similarly, unemployed workers and other resources made available as a result of the plant relocation may provide new investment opportunities for other domestic investors. Therefore, if a U.S. plant does relocate, it is uncertain how much (or, strictly speaking, whether) U.S. investment has declined by virtue of that fact. If lower rate financing and inexpensive labor become available as a result of outbound investment, runaway plants conceivably might not reduce U.S. domestic investment. However, it is unclear to what extent these newly available resources might increase domestic investment.

An indication of the effect of outbound investment on domestic investment may be available in the evidence of the responsiveness of domestic saving to changes in domestic rates of return. For example, if domestic saving is not responsive to changes in domestic rates of return, then domestic saving may be similarly unresponsive to changes in rates of return on outbound investment. However, there is no conclusive evidence on the responsiveness of saving to changes in rates of return.³¹

R. Glenn Hubbard (eds.), *The Effects of Taxation on Multinational Corporations*, (Chicago: University of Chicago Press), 1995. Using data on OECD countries from the 1970s and 1980s, Feldstein finds that, on average, one dollar of foreign direct investment by residents of OECD countries reduces gross domestic investment in OECD countries by approximately one dollar. Feldstein uses this estimate, along with the observation that the aggregate capital stock of U.S. foreign affiliates is financed by foreign borrowing in addition to direct investment, to estimate that each dollar of assets in U.S. foreign affiliates reduces the U.S. domestic capital stock by between 20 and 40 cents. These estimates should be considered tenuous. Kenneth A. Froot, "Comment," in Martin Feldstein, James R. Hines, Jr., and R. Glenn Hubbard (eds.), *The Effects of Taxation on Multinational Corporations*, (Chicago: University of Chicago Press), 1995, argues that measurement problems with the available data create a bias such that a one dollar increase in foreign direct investment results in a less than one dollar decrease in domestic gross investment, albeit still a decrease.

³¹ Substantial disagreement exists among economists as to whether taxpayers will respond to increases in net return on savings by increasing or reducing their saving. Some studies have argued that theoretically one should expect substantial increases in saving from increases in the net return. Other studies have argued that, theoretically, large behavioral responses to changes in the after-tax rate of return need not occur. Empirical investigation of the

C. The Location of Investment with Equal Tax Rates

If all investors face the same overall rate of tax on capital income, regardless of their residence or the source of their income, the allocation of capital across national borders generally will not be distorted. Although investors receive lower returns as a result of taxation, the rates of return on investments across countries relative to each other are not affected. As in the case of free trade and no taxes, worldwide economic welfare is promoted by international investment. However, unlike the case of a world with no taxes, despite the worldwide increase in welfare, one country may be worse off as the result of international capital movements.

The wedge between promotion of worldwide welfare and national economic welfare occurs because taxation of international investment redistributes income across national jurisdictions. The net benefit to each country depends on whether tax is collected by the country where the investment is located ("source taxation") or the country of residence of the investor ("residence taxation").

The upper panel of Chart 1 displays a system of international taxation in which tax rates on income earned by all capital--of residents of all countries no matter where their investment is located--is taxed at the same rate. In this situation, total neutrality prevails in the capital markets. Capital flows freely to its most efficient uses, and investors from different countries with businesses located in and competing in the same market pay the same rate of tax. This system allows capital to flow freely and maximizes worldwide income.

responsiveness of personal saving to after-tax returns provides no conclusive results. Some studies find personal saving responds strongly to increase in the net return, while others find little or a negative response. For a discussion of the determinants of the rate of saving, see Joint Committee on Taxation, *Present Law and Background Relating to Tax Incentives for Savings* (JCX-7-99), February 24, 1999.

Chart 1.--Total Neutrality and National Neutrality

A. Total Neutrality

Domestic and foreign investor face same tax rate no matter where investment is located.

		LOCATION OF INVESTMENT	
		Domestic	Foreign
RESIDENCE OF INVESTOR	Domestic	Tax Income at Uniform Rate	Tax Income at Uniform Rate
	Foreign	Tax Income at Uniform Rate	Tax Income at Uniform Rate

B. National Neutrality (With No Retaliation)

Domestic investor is subject to the domestic tax rate on domestic investment. Domestic investor is subject to foreign tax equal to tax on domestic investment plus an extra layer of domestic tax. Foreign investment income is subject to foreign tax rate regardless of the residence of the taxpayer.

		LOCATION OF INVESTMENT	
		Domestic	Foreign
RESIDENCE OF INVESTOR	Domestic	Tax Income at Uniform Rate	Tax Income at Uniform Rate Plus Extra Domestic Tax
	Foreign	Tax Income at Uniform Rate	Tax Income at Uniform Rate

Panel A of Chart 1 provides a taxonomy of the tax that would apply to income from an investment by location of the investment and by residence of the investor in a world with identical tax rates. If taxes are the same around the world, total neutrality may result from several different international tax arrangements. First, total neutrality will result if each country imposes a purely residence-based tax (arrangement 1). In that case, each country taxes all income of its residents no matter where earned, but does not tax income of foreigners earned within its borders. Alternatively, total neutrality will result under an exemption system where each country taxes all income earned within its borders regardless of the residence of the investor earning that income, and no country taxes income from outbound investment of its residents (arrangement 2a). Finally, total neutrality will result if each country imposes tax on the worldwide income of its residents but allows credits for taxes paid to foreign governments, and each country also imposes tax on all income earned by foreigners within its borders (arrangement 2b).

Although all of these systems maximize worldwide income through total neutrality, and each of these systems collect the same amount of total tax, the choice among these systems greatly affects the distribution of tax revenue across countries. Under a purely residence-based system (arrangement 1 above), governments collect tax revenue on income from outbound investment and collect no tax on income on inbound investment. Under a territorial system (arrangement 2a above) or a worldwide/source system with credits (arrangement 2b above), governments collect tax on income from inbound investment and no tax on income from outbound investment. Thus, both from the perspective of the government's treasury and from the perspective of national income, a capital exporting country may find a residence system more beneficial, while a capital importing country may find a territorial or a worldwide/source system with credits more beneficial.

Since nations usually reserve to themselves primary taxing jurisdiction over income from investments located within their borders, it is important to focus on the welfare implications of taxation by nations in which the investment is located. If countries generally impose tax on income arising from within their borders (without regard to the residence of the recipient), the movement of investment--whether foreign or domestically owned--from a foreign to a domestic location, can increase national income by the amount of tax collected. However, with equal rates of tax worldwide, the taxpayer is indifferent as to which country collects the tax.

These principles can be illustrated by a simple example. Assume the rate of return is 10 percent in the United States and 12 percent in France. With no taxes, worldwide economic welfare, as well as the economic welfare of each nation, is promoted by the United States exporting some capital to France. By relocating a \$100 investment, U.S. investors receive \$12 where they had previously received \$10. Suppose, in addition, that each nation imposes a 30-percent income tax. It is still in a U.S. investor's interest to seek the relatively more profitable investment opportunities in France, and worldwide efficiency is still promoted by free flows of international capital. Furthermore, if effective tax rates are equal around the world, the U.S. investor is indifferent to whether governments impose source or residence taxation. However, those governments are not indifferent. Whether source or residence taxation prevails is of major

importance to the distribution of income across nations. In this example, even though the French rate of return is higher, if France taxes income at the source, U.S. national income is reduced by investment in France. For the relocation of \$100 of investment abroad, the United States as a whole now only receives \$8.40 of income (after a 30-percent French tax amounting to \$3.60) while the U.S. would have received \$10 (\$7 of after-tax return plus \$3 of U.S. tax) for investment located in the United States. National income of the United States is reduced by \$1.60 as a result of the relocation of \$100 of investment.³²

National neutrality through deductions instead of credits for foreign taxes

As just explained, because countries typically tax income arising within their borders, a nation can increase its income through policies that reduce outbound investment by its residents and encourage inbound investment by foreigners. This is the case even if net outbound investment is driven below the level that would prevail in a free and efficient international capital market. In contrast to the case of a world with no taxes, promoting national economic interest does not coincide with promoting worldwide economic income. Furthermore, in a world of source taxation, the national interest and the interests of outbound investors do not coincide.

To further its national interest, a government can reduce outbound investment by reducing the after-tax rate of return on outbound investment and driving its before-tax return above that on domestic investment. It can penalize outbound investment by imposing a layer of taxation in addition to foreign taxation at source. Panel B of Chart 1 provides the taxonomy of the tax that would apply to income from an investment by location of the investment and by residence of the investor under such a tax system.

³² Many authors have discussed these types of welfare effects on taxation. See, for example, Michael J. Boskin, "Tax Policy and the International Location of Investment," in Martin Feldstein (ed.) *Taxes and Capital Formation*, Chicago: University of Chicago Press, 1987, p. 79:

[D]omestic welfare falls when U.S. firms substitute [outbound investment] for investment at home, because the nation receives only the net-of-foreign-tax return (and only when it is repatriated) rather than the gross return. These welfare effects are augmented by the beneficial effects on labor productivity of greater foreign or direct investment in the United States. Thus, a reduction in taxation of new corporate investment improves welfare through three channels: the standard mechanism, through which the lowering of the marginal tax rate generates new domestic investment opportunities for U.S. firms; a reallocation of the location of investment by U.S. firms toward home and away from abroad; and an increase in [inbound investment by foreign investors.]

Outbound investment is only in the national interest if the return after foreign tax (but before domestic tax) equals or exceeds the before-tax return on domestic investment. This condition is achieved when a capital exporting nation, in response to foreign source taxation, does not cede taxing jurisdiction over foreign source income (for example, through a foreign tax credit) and allows only a deduction for foreign taxes.³³

The policy of allowing only deductions for foreign taxes is sometimes known as "national neutrality." A deduction penalizes outbound investment and aligns the interests of the taxpayer with the interests of its home country--but only at the expense of reduced worldwide economic welfare. Despite the potential to maximize national welfare, self-interested nations generally do not adopt tax systems designed to achieve national neutrality. There are at least three possible explanations for this. First, there is reason to expect that one nation's unilateral attempt to improve its own welfare through a policy of national neutrality would meet with retaliation by other nations with similar policies. Such tax competition would reduce worldwide income even further.³⁴ If, on the other hand nations can coordinate their tax policies, a tax system can be designed to increase worldwide income above the inefficient level produced by national neutrality. With international coordination, there is potential for adopting a system in which worldwide income could be maximized (and, if necessary, redistributed) so all nations could be better off.

Second, the disincentives to outbound investment embodied in the concept of national neutrality only increase national welfare if outbound investment increases at the expense of domestic investment. If the economy responds to increased outbound investment with increased domestic saving instead of reduced domestic investment, policies to discourage outbound investment may have little positive effect on domestic labor and, furthermore, may reduce national welfare in addition to worldwide welfare.

Third, even if the first two rebuttals to national neutrality do not hold, there is some evidence that outbound investment increases exports by more than it increases imports. This increase in net exports may provide benefits to domestic labor and increase overall domestic

³³ Several authors provide a description of how deductions for foreign taxes maximize domestic welfare of a capital-exporting country. See Richard E. Caves, *Multinational Enterprises and Economic Analysis*, Cambridge, England: Cambridge University Press, 1982, pp. 229-231; and Peggy B. Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments*, Cambridge, Massachusetts: International Tax Program, Harvard Law School, 1969, p. 134.

³⁴ In the context of international trade, policies that attempt to promote domestic economic welfare at the expense of the rest of the world are referred to as "beggar-thy-neighbor" policies.

income. If this is the case, policies discouraging outbound investment could increase the merchandise trade deficit and reduce national output.³⁵

D. The Location of Investment with Unequal Tax Rates

If tax rates are not equal across national jurisdictions, taxes have the potential not only to redistribute income across nations, but also to distort investment decisions in a manner that reduces worldwide economic welfare. The nature of these distortions depends on the method of taxing income from international investment. If investment income is taxed only at the source, substantial amounts of capital could be diverted to jurisdictions with the lowest tax rates instead of flowing to investment projects with the highest pre-tax rate of return. If a system of residence taxation is the worldwide norm,³⁶ enterprises resident in low-tax countries might be able to attract more investment capital or perhaps increase their market share through lower prices to the detriment of enterprises resident in high-tax jurisdictions, even though the latter are more efficient. In either case, capital is diverted from its more productive uses, and worldwide income and efficiency suffer. The most straightforward solution to this problem is equalization of effective tax rates, but this may not be a practical solution given differences in national preferences for the amount and method of taxation. There is no consensus on what method of taxing international investment income minimizes distortions in the allocation of capital when nations tax income at different effective rates, but the alternatives of capital export neutrality and capital import neutrality are the most cited guiding principles. These two standards are each

³⁵ For a discussion of the positive effects of outbound U.S. investment, see Council of Economic Advisers, *Economic Report of the President*, Washington, D.C.: U.S. Government Printing Office, February 1991, pp. 258-261. The discussion on outbound investment concludes (p. 259): "On a net basis, it is highly doubtful that U.S. direct investment abroad reduces U.S. exports or displaces U.S. jobs." Empirical studies find either no effect or a positive effect of overseas production in a host-country market on home-country exports to that market. Robert E. Lipsey reports that, on average, studies find one dollar of overseas production by U.S. affiliates generates \$0.16 of exports from the United States. Robert E. Lipsey, "Outward Direct Investment the U.S. Economy," in Martin Feldstein, James R. Hines, Jr., and R. Glenn Hubbard (eds.), *The Effects of Taxation on Multinational Corporations*, (Chicago: University of Chicago Press), 1995. There is no definitive conclusion about the effect of outbound investment on U.S. employment. Lipsey concludes, "[T]he evidence suggests that the effect of overseas production on the home-country labor market involves the composition of a firm's home employment rather than the total amount. That change in composition is mainly a shift toward more managerial and technical employment...." *Ibid.* p. 31. However, most of the evidence Lipsey reviews examines individual industries rather than aggregate economic effects.

³⁶ The text envisions a system of residence taxation applied to enterprises. A pure residence system would fully integrate corporate and individual income taxes and tax individuals based upon their residence.

desirable goals of international tax policy. The problem is that, with unequal tax rates, these two goals are not mutually attainable. Satisfying both principles at the same time is possible only if effective tax rates on capital income are the same in all countries.

Capital export neutrality.--Capital export neutrality refers to a system where an investor residing in a particular locality can locate investment anywhere in the world and pay the same tax.

Capital import neutrality.--Capital import neutrality refers to a system of international taxation where income from investment located in each country is taxed at the same rate regardless of the residence of the investor.

Chart 2 below, compares capital import neutrality with capital export neutrality. The chart provides a taxonomy of the tax that would apply to income from an investment by location of the investment and by residence of the investor under the principle of capital export neutrality (panel A) and under capital import neutrality (panel B). Tax rates are always equal for investors residing in the same country under capital export neutrality. Tax rates are always equal for investments located in the same country under capital import neutrality.

Chart 2.—The Principles of Capital Export Neutrality and Capital Import Neutrality

A. Capital Export Neutrality

Domestic investor faces domestic tax rate no matter where investment is located. Foreign investor faces foreign tax rate no matter where investment is located. Foreign investment income is subject to foreign tax rate regardless of the residence of the taxpayer.

		LOCATION OF INVESTMENT	
		Domestic	Foreign
RESIDENCE OF INVESTOR	Domestic	Tax Income at Domestic Rate	Tax Income at Domestic Rate
	Foreign	Tax Income at Foreign Rate	Tax Income at Foreign Rate

B. Capital Import Neutrality

Domestic investment income subject to the domestic tax rate regardless of the residence of the taxpayer. Foreign investment income subject to foreign tax rate regardless of the residence of the taxpayer.

		LOCATION OF INVESTMENT	
		Domestic	Foreign
RESIDENCE OF INVESTOR	Domestic	Tax Income at Domestic Rate	Tax Income at Foreign Rate
	Foreign	Tax Income at Domestic Rate	Tax Income at Foreign Rate

Under capital export neutrality, decisions on the location of investment are not distorted by taxes. Capital export neutrality is a principle describing how investors pay tax, not to whom they pay. Unlike national neutrality (described above), capital export neutrality primarily is a framework for discussing the efficiency and incentives faced by private investors, and not the distribution of the revenues and benefits of international investment. Tax systems may adhere to the principle of capital export neutrality by taxing worldwide income and granting credits for income and profits taxes paid to foreign governments. As an alternative to the system of foreign tax credits, capital export neutrality could be achieved with the source country relinquishing its jurisdiction to tax income derived from investments within its borders and allowing the country of residence the exclusive right to tax this income.

Under capital import neutrality, capital income from all businesses operating in any one locality is subject to uniform taxation. The nationality of investors in a particular locality will not affect the rate of tax. Capital import neutrality may be achieved by the residence country exempting income earned from foreign jurisdictions entirely from tax and allowing the source country's taxation to be the only taxation on the income of international investors. This is commonly referred to as a "territorial" or an "exemption" system of international taxation.

Some commentators refer to the principle of capital import neutrality as promoting "competitiveness." This notion of competitiveness³⁷ refers to the ability of U.S. multinationals (firms headquartered in the United States that operate abroad) that locate production facilities overseas to compete in foreign markets. Overseas production facilities owned by U.S. interests may compete with firms owned by residents of the host country or with multinational firms based in other countries. The notion of capital import neutrality promoting the competitiveness of such businesses focuses on the after-tax returns to investments in production facilities abroad. As described above, under the principle of capital export neutrality, any business would see the return from its investment in any given foreign country taxed only by that foreign country. Under present law, residual U.S. taxation in the case of a U.S. multinational may apply differently than residual taxation by another capital-exporting country. The result may be that the after-tax return to an investment by a U.S. multinational in a given foreign country may be

³⁷ The term "competitiveness" encompasses different concepts. In the present context it might be better labeled "multinational competitiveness." Multinational competitiveness refers to the competitiveness of certain types of firms or industries relative to other types of firms or industries. The term "competitiveness" also is used in the context of measuring the ability of firms located in the United States to sell their output in foreign markets and to compete in domestic markets with output produced in foreign countries. In that context, competitiveness might be better labeled "trade competitiveness." Trade competitiveness often is measured by the U.S. trade deficit. Competitiveness also is used to describe comparisons of the current U.S. living standard and the prospects for future U.S. living standards with those of other countries. This notion of competitiveness focuses on the productivity growth of U.S. labor and the saving rate of the United States, because both of these factors affect future living standards.

less than the after-tax return earned by another investor, even if that investor makes an identical investment to that of the U.S. multinational. Some argue that this puts the U.S. multinational at a competitive disadvantage.

The distribution of income between capital and labor

Although they have important implications for national welfare as well as the distribution of income between capital and labor, the debate on the relative merits of capital export neutrality and capital import neutrality centers on which of these more efficiently allocates capital around the world and therefore on which better promotes worldwide economic welfare. Before exploring the relative efficiency of capital import and capital export neutrality, however, it is useful to examine the distributional effects of each, and in this context, to examine how the concepts of capital export neutrality and capital import neutrality compare with the principle of national neutrality.

One argument in favor of capital export neutrality is that it promotes horizontal equity. Under capital export neutrality, two investors with identical income would be taxed equally regardless of the location of their investment. Capital import neutrality may reduce income tax on income from outbound investment below the level of tax on domestic investment income, and, on average, capital income may be treated more favorably than income from other sources. National neutrality, on the other hand, would increase taxes on income from outbound investment. It would also reduce the pre-tax rate of return on saving by foreclosing investment opportunities abroad. However, horizontal equity may be a more important factor in the short run than in the long run. In the long run, under any tax system, financial markets should tend to value investments such that the after-tax return to investments is equalized.

Strategic trade policy and capital import neutrality

Another possible argument for capital import neutrality comes from recent literature on international trade. Strategic trade theory abandons the traditional assumption of perfect competition and provides a framework for maximizing national economic welfare in the presence of oligopolistic markets. According to strategic trade theory, and contrary to the traditional theory of free trade, it may be in the national interest to subsidize certain industries if firms in these industries inevitably will exercise considerable market power. For example, intangible capital such as developed through research and development expenditures or the creation of brand names may create monopolistic advantages in worldwide markets. In this case, subsidies can hasten the development of domestic industry which can prevent exploitation by foreign oligopolists. A capital import neutral tax policy is one method of providing such a subsidy to the outbound investing sector of the U.S. economy.³⁸

³⁸ Some analysts have questioned the empirical basis of claims that intangible capital create oligopolistic markets. See, Harry Grubert and John Mutti, "Taxing Multinationals in a

It is not clear that strategic trade policy would achieve greater national welfare than free trade policy.³⁹ Furthermore, even if a government chose to implement strategic trade policy, and it chose to implement this policy through the tax system, presumably it would not provide tax subsidies solely for outbound investing sectors of the U.S. economy. Instead, strategic trade policy implemented through the tax system would presumably provide tax incentives to all domestic import-competing sectors and domestic export sectors.

Which principle better promotes worldwide efficiency?

In a world of unequal taxes, where it is not possible to achieve both capital export neutrality and capital import neutrality, which is preferable from the perspective of worldwide efficiency? No consensus exists. The Treasury Department has been a proponent of capital export neutrality. In a study on tax reform issued at the outset of 1977, the Treasury Department favored the concept of capital export neutrality in the particular form of residence-based taxation:

A number of considerations point to the residence principle as the more desirable principle to establish. First, the concept of income as consumption plus change in net worth implies that attribution of income by source is inappropriate. Income, by this definition, is an attribute of individuals, not of places. Second, if owners of factor services are much less mobile internationally than the factor services they supply, variations among countries in taxes imposed by residence will have smaller allocation effects than tax variations among places of factor employment. Third, the income redistribution objective manifested by the use of progressive income taxes implies that a country should impose taxes on the entire income of residents.⁴⁰

Explicitly comparing it with capital import neutrality and national neutrality, the Administration reaffirmed its support of the principle of capital export neutrality in its 1985 Tax Reform proposals:

In reaching the decision to continue the worldwide taxation of U.S. taxpayers with allowance of foreign tax credits, the Administration considered and rejected the alternatives of exempting foreign source income from U.S. tax, or taxing foreign source income but only allowing a deduction for foreign taxes.

World with Portfolio Flows and R&D: Is Capital Export Neutrality Obsolete?" *International Tax and Public Finance*, 1995.

³⁹ See Daniel J. Frisch, "The Economics of International Tax Policy: Some Old and New Approaches," *Tax Notes*, April 30, 1990, p. 584.

⁴⁰ U.S. Treasury Department, *Blueprints for Basic Tax Reform* (January 17, 1977), p. 99.

While an exemption approach would in some circumstances facilitate overseas competition by U.S. business with competitors from countries that tax foreign income on a favored basis, such an approach also would favor foreign over U.S. investment in any case where the foreign country's effective tax rate was less than that of the United States. Moreover, there would be a strong incentive to engage in offshore tax haven activity. The long-standing position of the United States that, as the country of residence, it has the right to tax worldwide income is considered appropriate to promote tax neutrality in investment decisions. Exempting foreign income from tax would favor outbound investment at the expense of U.S. investment. The other alternative, to allow only a deduction for foreign taxes, would not satisfy the objective of avoiding double taxation. Nor would it promote tax neutrality; it would be a serious disincentive to make outbound investments in countries where there is any foreign income tax.⁴¹

The literature on the theory of international taxation provides no clear direction as to the better of the two principles. Although there are advocates for capital export neutrality and for capital import neutrality, it is sometimes unclear whether authors consider capital export neutrality superior to capital import neutrality since the two principles are frequently not explicitly compared. For example, authors usually agree that ideally both capital import neutrality and capital export neutrality are desirable, but then they must also acknowledge that when tax rates are not equal across national jurisdictions, these two principles are not mutually attainable. The authors then usually leave the reader with little guidance as to their preference. Richard Caves favors neither principle, but does point out that the superiority of one principle over the other depends on the responsiveness of saving.⁴² Joel Slemrod favors capital export neutrality as the better policy objective, but also notes that this conclusion does not take into account that capital export neutrality may distort business decisions on where to incorporate and investors' decisions on where to reside.⁴³

Peggy Musgrave and Thomas Horst were the first authors who explicitly attempted to ascertain the relative efficiency of capital export neutrality and capital import neutrality.⁴⁴ Horst's

⁴¹ *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*, (May 1985), p. 383.

⁴² Richard E. Caves, *Multinational Enterprise and Economic Analysis*, Chapter 8.

⁴³ Joel Slemrod, "Competitive Advantage and the Optimal Tax Treatment of the Foreign Source Income of Multinational: The Case of the U.S. and Japan," paper prepared for the Conference on International Tax Policy, sponsored by the American College of Tax Counsel and ALI-ABA, April 20-21, 1990, Washington D.C. p. 10.

⁴⁴ Peggy B. Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments*; and Thomas Horst, "A Note on the Optimal Taxation of International Investment

analysis explores the relative merits of capital import neutrality and capital export neutrality by focusing on the response of domestic savings to increased outbound investment opportunities. A central tenet of his analysis is that worldwide efficiency suffers under a system of capital export neutrality if domestic savings is responsive to changes in taxes, and that worldwide efficiency suffers under capital import neutrality if savings is fixed. However, as discussed below, the relative merits of capital export neutrality and capital import neutrality can be better understood in a framework broader than that of Horst's model.

The effect of alternative policies on the two distortions to saving and investment

It is perhaps easiest to understand the competing objectives of capital export neutrality and capital import neutrality by recognizing that there are two types of potential distortions to saving and investment. The first is a distortion in the level of overall saving. The second is a distortion in the allocation of saving among alternative investments. Capital export neutrality promotes the efficient allocation of savings by taxing all capital income at an equal rate regardless of the source. If the rate of domestic saving is inefficiently low, capital import neutrality promotes efficiency by reducing the tax burden on savings and thereby providing an incentive to increase the level of savings. However, since it provides incentive only for saving that produces foreign source income, capital import neutrality distorts the allocation of savings. Therefore, a tax rate on outbound investment lower than the tax rate on domestic investment can only increase economic welfare if the improvement in efficiency from the increase in saving is greater than the reduction in efficiency from the misallocation of savings.

On the other hand, capital export neutrality promotes worldwide efficiency in the allocation of savings. Thus, if there are costs resulting from an inefficient worldwide allocation of savings, capital export neutrality increases efficiency by providing an incentive to allocate capital to locations that promote the greatest pre-tax return to investment. However, given that the taxation of income from investments generally distorts the decision to save, capital export neutrality may provide for an overall increase in economic welfare only when the costs arising from an inefficient allocation of saving is large relative to the costs from an inefficient level of saving.⁴⁵

Income," *Quarterly Journal of Economics*, Vol. 93, June, 1980, pp. 793-798. Horst notes that his analysis is a mathematical formalization of Musgrave's earlier work.

⁴⁵ This discussion highlights the importance of empirical investigation of the costs arising from market distortions in the level and allocation of saving. For more discussion of this point see R. Glenn Hubbard, "U.S. Tax Policy and Foreign Direct Investment: Incentives, Problems, and Reform," in *Tax Policy and Economic Growth*, (Washington, D.C.: American Council for Capital Formation, Center for Policy Research), 1995, fn. 8.

A policy that reduces all tax rates (applied to domestic and foreign source income equally) is superior to a policy of equal revenue cost that reduces tax rates only on foreign source income. With a broad reduction in rates, there is a comparable increase in the rate of saving with no distortion of the allocation of capital. For example, a \$10 billion across-the-board reduction in tax rates on all capital income (i.e., income from both domestic and outbound investment) is more efficient than a \$10 billion reduction in tax rates only for outbound investment. However, if tax rates on domestic source capital income are for some reason fixed,⁴⁶ a policy of reducing taxes only on foreign source income would be the only method of increasing saving. While such a targeted rate reduction is clearly less desirable, it still might improve economic efficiency. However, even if it is desirable to reduce capital income taxes and the only way to do so is by reducing taxes on foreign source income, strong economic assumptions are required for capital import neutrality to be a desirable policy objective. If the foreign country in which domestic funds are invested taxes all income generated within its borders at the same rate, capital import neutrality would require a U.S. tax rate of zero on foreign source income. Only if the outbound investment encouraged by a reduction in taxes on foreign source income has no effect on domestic investment, and it is assumed that tax rates on domestic investment cannot be altered, will capital import neutrality maximize worldwide efficiency.⁴⁷

⁴⁶ This is implicitly assumed in Horst, "A Note on the Optimal Taxation of International Investment Income."

⁴⁷ *Ibid.*

Appendix Table A.1.--U.S. International Transactions, 1962-1997

(\$ millions)

Years	Exports of goods, services and income	Exports of merchandise adjusted (excluding military)	Exports of services	Income receipts on U.S. assets abroad	Imports of goods, services and income	Imports of merchandise adjusted (excluding military)	Imports of services	Income payments on foreign assets in the U.S.	Unilateral transfers (Net)
1962	33,340	20,781	6,941	5,618	25,676	16,260	8,092	1,324	4,277
1963	35,776	22,272	7,348	6,157	26,970	17,048	8,362	1,560	4,392
1964	40,165	25,501	7,840	6,824	29,102	18,700	8,619	1,783	4,240
1965	42,722	26,461	8,824	7,437	32,708	21,510	9,111	2,088	4,583
1966	46,454	29,310	9,616	7,528	38,468	25,493	10,494	2,481	4,955
1967	49,353	30,666	10,667	8,021	41,476	26,866	11,863	2,747	5,294
1968	54,911	33,626	11,917	9,367	48,671	32,991	12,302	3,378	5,629
1969	60,132	36,414	12,806	10,913	53,998	35,807	13,322	4,869	5,735
1970	68,387	42,469	14,171	11,748	59,901	39,866	14,520	5,515	6,156
1971	72,384	43,319	16,358	12,707	66,414	45,579	15,400	5,435	7,402
1972	81,986	49,381	17,841	14,765	79,237	55,797	16,868	6,572	8,544
1973	113,050	71,410	19,832	21,808	98,997	70,499	18,843	9,655	6,913
1974	148,484	98,306	22,591	27,587	137,274	103,811	21,379	12,084	9,249
1975	157,936	107,088	25,497	25,351	132,745	98,185	21,996	12,564	7,075
1976	172,090	114,745	27,971	29,375	162,109	124,228	24,570	13,311	5,686
1977	184,655	120,816	31,485	32,354	193,764	151,907	27,640	14,217	5,226
1978	220,516	142,075	36,353	42,088	229,870	176,002	32,189	21,680	5,788
1979	287,965	184,439	39,692	63,834	281,657	212,007	36,689	32,961	6,593
1980	344,440	224,250	47,584	72,606	333,774	249,750	41,491	42,532	8,349
1981	380,928	237,044	57,354	86,529	364,196	265,067	45,503	53,626	11,702
1982	361,436	211,157	64,079	86,200	355,804	247,642	51,749	56,412	17,075
1983	351,306	201,799	64,307	85,200	377,573	268,901	54,973	53,700	17,718
1984	395,850	219,926	71,168	104,756	474,203	332,418	67,748	74,036	20,598
1985	382,747	215,915	73,155	93,677	484,037	338,088	72,862	73,087	22,954
1986	401,843	223,344	86,523	91,976	528,513	368,425	80,992	79,095	24,189

<u>Years</u>	<u>Exports of goods, services and income</u>	<u>Exports of merchandise adjusted (excluding military)</u>	<u>Exports of services</u>	<u>Income receipts on U.S. assets abroad</u>	<u>Imports of goods, services and income</u>	<u>Imports of merchandise adjusted (excluding military)</u>	<u>Imports of services</u>	<u>Income payments on foreign assets in the U.S.</u>	<u>Unilateral transfers (Net)</u>
1987	449,514	250,208	98,539	100,767	592,745	409,765	91,678	91,302	23,107
1988	560,426	320,230	111,126	129,070	662,487	447,189	99,491	115,806	25,023
1989	642,025	362,120	127,387	152,517	719,758	477,365	103,535	138,858	26,106
1990	697,426	389,307	147,819	160,300	756,694	498,337	118,783	139,574	33,393
1991	718,194	416,913	164,278	137,003	732,486	490,981	119,614	121,892	6,869
1992	737,394	440,352	178,617	118,425	766,796	536,458	121,991	108,346	32,148
1993	763,826	456,823	187,755	119,248	829,668	589,441	129,979	110,248	34,084
1994	838,820	502,485	198,716	137,619	954,304	668,584	138,829	146,891	35,761
1995	969,189	575,940	210,590	182,659	1,082,268	749,364	142,230	190,674	35,075
1996	1,032,478	611,669	223,907	196,902	1,155,101	799,343	150,440	205,318	42,472
1997	1,179,380	679,325	258,268	241,787	1,294,904	877,279	170,520	247,105	39,691

Source: U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, June 1995, pp. 84-85; June 1997, p. D-58; and February 1999, p. D-52.

**Appendix Table A.2--U.S. Gross Domestic Product,
Gross Saving, Gross Investment, and Net Foreign
Investment, 1960-1994**
(\$ billions)

Year	GDP	Gross saving	Gross investment	Net Foreign investment
1959	507.2	108.5	106.9	-1.2
1960	526.6	113.9	110.2	3.2
1961	544.8	116.8	113.5	4.3
1962	585.2	127.4	125.0	3.9
1963	617.4	135.4	131.9	5.0
1964	663.0	145.8	143.8	7.5
1965	719.1	161.0	159.6	6.2
1966	787.8	171.7	174.4	3.9
1967	833.6	174.4	175.1	3.5
1968	910.6	185.8	186.0	1.7
1969	982.2	202.9	200.7	1.8
1970	1,035.6	198.2	199.1	4.9
1971	1,125.4	215.3	220.4	1.3
1972	1,237.3	244.9	248.1	-2.9
1973	1,382.6	297.5	299.9	8.7
1974	1,496.9	302.3	306.7	5.1
1975	1,630.6	298.3	309.5	21.4
1976	1,819.0	340.9	359.9	8.9
1977	2,026.9	395.5	413.0	-9.0
1978	2,231.4	477.4	494.9	-10.4
1979	2,557.5	540.9	568.7	2.6
1980	2,784.2	547.4	574.8	12.5
1981	3,115.9	651.1	665.7	7.4
1982	3,242.1	604.7	601.8	-6.1
1983	3,514.5	589.6	626.2	-37.3
1984	3,902.4	751.5	755.7	-91.5
1985	4,180.7	746.7	748.0	-116.9
1986	4,422.2	721.0	743.1	-142.9
1987	4,692.3	780.9	764.2	-156.4
1988	5,049.6	877.2	828.7	-118.1
1989	5,438.7	907.9	919.5	-92.4
1990	5,743.8	904.4	920.5	-78.6
1991	5,916.7	935.3	944.0	7.3
1992	6,244.4	905.4	949.1	-50.5
1993	6,550.2	938.4	993.5	-88.2
1994	6,931.4	1,055.9	1,087.2	-139.6
1995	7,269.6	1,187.4	1,160.9	-100.6
1996	7,661.6	1,274.5	1,242.3	-119.2
1997	8,110.9	1,406.3	1,350.5	-140.9
1998 1/	8,573.9	1,474.5	1,372.5	-231.6

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Note: 1-Seasonally adjusted annual rate of third quarter of 1998.

**Appendix Table A.3.--Increase in U.S. Assets Abroad
and Foreign Assets in the United States, 1962-1997**
(\$ billions)

<u>Years</u>	<u>Increase in U.S. assets abroad</u>	<u>Increase in foreign assets in U.S.</u>
1962	4,174	1,911
1963	7,270	3,217
1964	9,560	3,643
1965	5,716	742
1966	7,321	3,661
1967	9,757	7,379
1968	10,977	9,928
1969	11,585	12,702
1970	9,337	6,359
1971	12,475	22,970
1972	14,497	21,461
1973	22,874	18,388
1974	34,745	34,241
1975	39,703	15,670
1976	51,269	36,518
1977	34,785	51,319
1978	61,130	64,036
1979	66,054	38,752
1980	86,967	58,112
1981	114,147	83,032
1982	122,335	92,418
1983	61,573	83,380
1984	36,313	113,932
1985	39,889	141,183
1986	106,753	226,111
1987	72,617	242,983
1988	100,087	240,265
1989	168,744	218,490
1990	74,011	122,192
1991	57,881	94,241
1992	65,875	153,823
1993	184,589	248,529
1994	125,851	291,365
1995	307,856	424,462
1996	306,830	525,046
1997	478,502	733,441

Source: U.S. Department of Commerce, Bureau of Economic
Analysis, Survey of Current Business, June 1995, pp. 84-85;
June 1997, p. D-58; February 1999, p.

**Appendix Table A. 4--Selected Nongovernmental Foreign Holdings
of United States Assets, Both Portfolio
and Directed Investments, 1982-1996**

(\$ billions)

<u>Year</u>	<u>U.S. Treasury Securities</u>	<u>Corporate and other Bonds</u>	<u>Corporate Equity</u>	<u>Direct Investment</u>
1982	25.8	16.7	76.3	176.9
1984	62.1	32.4	96.1	211.2
1986	96.1	140.9	168.9	265.8
1988	100.1	191.3	201.0	375.2
1990	162.4	245.7	221.7	467.3
1992	225.1	319.8	300.4	500.5
1994	266.7	413.9	338.9	585.0
1996	530.6	654.1	571.3	729.1

Source: Russell B. Scholl, "The International Investment Position of the United States, in 1996,
Survey of Current Business, 77 July 1997, pp. 24-33.