

VALUING (US) GLOBAL INVESTMENT:
A Framework Discussion for FDI Policies from
BITS to Taxes

Remarks of
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Candidate Obama re-kindled an old argument that was much more in evidence in the 1970s -- the notion of the “runaway plant”. Management, it is held, feeling almost entirely responsible to its shareholders (and of course to its own compensation), and not much at all about its employees, moves jobs wherever the most profit can be made. So the answer now-President Obama provides is to attack tax deferral on foreign operations and thereby end the tax incentive for moving jobs overseas.

It is the job of political leaders, of presidents, to simplify a problem and get the people, or at least their elected representatives, to provide a solution. The Administration clearly senses that a problem exists which is very real, and then seemingly falls short in its analysis of its causes and therefore does not provide adequate solutions.

There are two forces that shape investment flows – market forces and the rule of law. This theorem works in reverse too, so I will re-state it in the negative: There are two forces that shape investment flows – the distortion of market forces and the absence of the rule of law. Both propositions are equally true, and can be proved.

Ever since Adam Smith² came along, there has been a growing belief in the good that the free play of market forces can do in terms of delivering economic efficiency. This belief is central to the organization of the American economy. Market forces are extremely harsh, however. It is futile to try to resist them fully. The story of Malden Mills is a case in point. The inventor of polartec and owner of a plant that made the material for fleece jackets, when his plant burnt down, kept paying his workers, and went bankrupt. He could not save jobs in the face of the absence of revenues. Acting contrary to market forces has its costs.

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² Adam Smith believed as much in moral philosophy, what is right and wrong, economic historians tell us, as he did in what his empirical observations told him led to the wealth of nations. So too an inquiry into the role U.S. foreign investment plays as an economic matter must be tempered by an inquiry into what role we would have it play if we were designing an acceptable domestic and international regime to govern investment in the name of fairness.

Now take the example of any good 19th century plant New England plant that made textiles and apparel. It would not last through the 20th century, first losing jobs to lower wage states in the South and then to offshore locations. Neither availability of capital nor innovation could halt the general outward movement of those plants and jobs for most of this industry. There may have been market distortions as well as market forces involved, some locations no doubt more tolerant of unions than others. But my guess is that that was not the only factor – a greater supply of less expensive labor would have won out eventually and determined where those plants and jobs went.

We are more tolerant of competition among the American states than we are of competition among nations. If Texas is blessed with oil revenues and invests in a great university system, it attracts a lot of high tech plants. A pool of engineering talent is created. Texas may also have granted locational subsidies. We tolerate the range of incentives granted as among the states, because they are not limitless, and because the states share a common national framework of laws and to a large extent social regulation. There are also some limits on what states think is appropriate to require of an investor. I have not heard of an instance in which the State of New Jersey gave a tax holiday to an investor conditioned on the new plant exporting 95% of its production to the other 49 States. It would be illegal for a State to condition an investment on a high degree of local (meaning State) content. And, the Obama tax officials would point out that there is generally current liability for federal taxation for all plants within the United States. To a large extent the system of laws governing the plants regardless of their location within the 50 states is within a tolerable range of equivalency.

When it comes to international trade and investment, there are sharp differences among countries and in how these differences should be dealt with. In 1965, the United States through its State Department entered into an Auto Agreement with Canada. The border was opened. Free trade prevailed – at least in terms of tariffs. But there were side letters negotiated allowing the Canadian government to impose local content requirements. Jobs were created in Canada that market forces probably would not have as pointedly dictated. The car companies profited. I believe that the union was at the time the same one on both sides of the border. Congress approved the auto pact, but shortly before doing so, stripped the State Department of further authority to negotiate trade agreements for the United States, not perhaps because of the auto pact, but because there was a feeling in Congress that the State Department would generally be too sensitive to the points of view of the folks on the other side of the negotiating table.

The foreign investments driven by the auto pact also did not raise objections within the U.S. because Canada and the United States possessed relatively similar economic environments, compared with the range of economies around the world.

Staying with autos for a moment -- in the 1970s and 1980s, there was a sharp conflict with Japan. Its market was closed to foreign cars in a whole variety of ways, too numerous to list here. The Japanese market was also closed to U.S. car company investment. The result was first the imposition of trade restrictions by the United States on imports of cars from Japan followed by Japanese car company investment in

transplants in this country. Today trade and investment between Japan and the United States is far more open. Market forces have are allowed to have greater, if not perfect play. U.S. taxation of foreign source income played no role in this story, nor in the Canadian case. Government regulation, tariffs, taxes geared to engine size, did have a strong part.

All this is preamble to a discussion of at least a few aspects of today's assigned topic – the appropriate shaping of taxation and the provisions of bilateral investment treaties as they affect flows of international trade and investment.

U.S. Taxation of Foreign Investment

One part of taxation that distorts international trade and investment to the disadvantage of the United States is very easy to identify with precision, and it is not deferral of foreign source income, it is the fact that the United States does not have a VAT and most other countries do.

If Jane Austen could propound a sentiment to which all her readers could agree, namely

It is a truth universally acknowledged, that a single man in possession of a good fortune, must be in want of a wife.

then I will venture a less elegant but equally universal American truth:

It is politically far easier to stigmatize multinational companies than it is to propose a new national tax on all purchases of goods and services.

But until we do adopt a VAT, which I think is inevitable to remedy the fiscal deficit, American exports will always bear the part of the social costs of our trading partners and foreign exports to the U.S. market will bear neither a full share of foreign social costs nor our own. It is a recipe for causing plants to move abroad – as profound in effect as a foreign currency pegged at an undervalued level.

As for the tax issue that has been put on the table, that is, the continuation of deferral of foreign source income, the problem is more complex and requires arthroscopic surgery not amputation. Where there is manipulation in the allocation of too much expense to the United States and too much profit to foreign countries in order to evade current U.S. taxation, the hole in the fisc should be plugged. In all respects, U.S. foreign investment should be given a level playing field -- that is U.S. headquartered companies having operations abroad should not be disadvantaged insofar as their international competitiveness is concerned by reason of U.S. tax law (putting aside the question of whether the concept of nationality still has meaning.).

The Rule of Law

This brings us to the role that the rule of law should play. For this inquiry, we have primarily a scant (4-pages including annex) multilateral agreement called TRIMS (the WTO Agreement On Trade-Related Investment Measures) and our bilateral investment treaties, referred to without intended irony as BITS. Our nation's model BIT is largely embodied in our bilateral agreement on investment with Rwanda. Today, by far the most important in economic terms BIT under negotiation is that with the Peoples Republic of China. Some relentless empiricists have pointed to some differences in the nature of U.S. interests as between Rwanda and China.

Without pointing a finger at any particular foreign country, it should be acknowledged that in some if not many respects, another country's economy will differ from our own, often not least in terms of the degree and nature of government intervention with respect to foreign investment.

With this in mind, a number of concrete suggestions are in order as to how the effectiveness of a new Model BIT might be framed in the context of some of the current realities U.S. investors face:

- The core commitment of any BIT is the grant of national treatment. This concept needs to be strengthened in all U.S bilateral investment treaties:
 - The term “national treatment” should be clarified to provide explicitly that it means treatment no less than that accorded the most-favored domestic enterprise, whether the latter is state-owned, state-invested, or wholly private.
 - National treatment should explicitly include the right of foreign investors to utilize without any adverse consequences intellectual property to which they have a right, whether it originates in the host state or not. Specifically, Article 8, Performance Requirements, in the 2004 Model BIT should be amended with the following prohibitions as follows³:

Article 8.1. (h) to require, by law, regulation, administrative guidance or in any other formal or informal manner, that a given level of research, development, testing, innovation, systems integration or other activity aimed at generating intellectual property be performed in the territory of that Party or that technology developed in the host country be required to be used as a condition for any investment, investment approval, receipt of any

³ The text was originally a U.S. Chamber of Commerce suggestion. The added underlined language is my own.

advantage, or procurement by any government entity or government-invested entity. .

Article 8.1.(i) to require, by law, regulation, administrative guidance or in any other formal or informal manner, that a foreign investor hold any given level or type of technology or other intellectual property as a precondition of investment approval

- The concept of "fair and equitable treatment", if included, should not be circumscribed by a narrowing reference to "international standards." The objective sought is adoption of a standard proscribing conduct far short of that which would amount to a "gross denial of justice." Simply the frustration (nullification or impairment) of receipt of the intended benefits of the BIT would suffice as the basis for a claim.
- Acts, policies, measures, formal or informal, that frustrate the enjoyment by an investor of the benefits of national treatment shall be actionable.
- Currently, domestic subsidies are largely exempt from national treatment obligations. This huge hole in the national treatment obligation at least needs to be re-examined.
- An act to be complained should not have to be "egregious or shocking", be carried out "in bad faith", or even be "arbitrary and capricious", etc. It should be recognized that acts, policies and measures that deny national treatment are often put into place to serve what are seen in the host country as valid purposes – such as to aid in development of a domestic industry, enhance its international competitiveness, provide it with a preference to increase domestic employment, etc. These may or may not shock the conscience but are nevertheless harmful to investors.
- Forced technology transfer should be more clearly prohibited, whether the measures employed are *de jure* or *de facto*. Policies that "encourage" technology transfer should, whenever employed, including when an advantage is conditioned on transfer of technology, be presumed to be placing the investor under duress, in violation of BIT obligations. In any dispute settlement proceeding the burden of proof that the technology transfer was not a requirement, where there is evidence of official policy statements of the host government favoring requirements or inducements for technology transfer, would shift to the host state.
- State toleration of anticompetitive practices which deprive an investor of intended benefits of the BIT should be actionable.
- A requirement of affording competitive equality should be added with respect to favorable treatment of state-owned, state-invested or state-controlled enterprises. In this regard the US Australia FTA is one model:

U.S.-Australia FTA, Article 14.4(3): *Australia shall take reasonable measures, including through its policy of competitive neutrality, to ensure that its governments at all levels do not provide any competitive advantage to any government business simply because they are government-owned. This paragraph applies to the business activities of government businesses and not to their non-business, noncommercial activities. . . . See also the U.S. BITs with Bangladesh, Egypt and Panama.*

- Care must be taken to avoid inclusion of limiting phrases such as prohibiting discrimination among investors *in like circumstances*" without further clarification. The inclusion of the term "in like circumstances" is likely to prove a means to avoid enforcement of commitments.
- A claim against a state should be allowed with respect to actions by an entity that is state-owned, in whole or in part, or state-controlled, when that entity is operating pursuant to guidance of the state, whether the guidance is by policy pronouncement or measure, whether formal or informal.
 - Evidence in the form of public statements by officials that indicate a policy that would lead to denial of national treatment should be sufficient to shift the burden of proof to the host state, for example, to show that its state-owned enterprises (SOEs) are not acting in furtherance of that government policy (as agents of the government) where the actions of the SOEs impair the enjoyment of a foreign investor of the benefits of the BIT.
 - Violations which result from actions of state-owned or controlled enterprises should explicitly be subject to state-to-state dispute settlement with the full participation in all respects of the private investor, the ultimate party at interest.⁴
- An investor (and its government) should be able to rely upon the publicly known or knowable condition of the market when the investment takes place, and need not show a specific commitment to it that the conditions it understood to be in effect would not change. .
- The draft Model BIT should be tested against all known measures that favor domestic enterprises over foreign firms. The following should reviewed carefully with respect to negotiation of any prospective bilateral investment treaty:
 - Discriminatory availability of capital and loans.
 - Discriminatory treatment rendered by local governments.

⁴ China's Protocol of WTO Accession requires state-owned enterprises to purchase solely on commercial considerations. This commitment should be added to a Model BIT

- Discriminatory exemptions from regulatory requirements, whether *de factor* or *de jure*.
- Discriminatory standards and exclusion from standards setting.
- Discriminatory procurement by state-invested or controlled enterprises. .
- Discriminatory taxation in terms of effects, not just facially. .
- Discriminatory land allocations.
- The requirement of full transparency of host government measures, policies and other actions that may adversely affect foreign investors should be improved to the point where the requirement is actually enforceable by either an investor or the investor's government.
- More difficult to define and regulate, to be sure, but international discussions must include addressing the problem of discriminatory actions taken by a host government in the name of "national security".

Conclusion

Foreign investment is vital to the United States, and that includes not only U.S. investment abroad driven by market forces and not government intervention, but inward foreign investment. America was built very largely with foreign capital. China's economic growth over the last few decades has been fueled by foreign capital, and America should welcome foreign investment today, including particularly from China. We need not only to double exports, we need to produce more in this country for all destinations, including those within the 50 states.

There is no empirical basis for the assumption that a primary determinant of job loss (to the extent that it exists) ascribed to U.S. corporate investment patterns is caused by the IRS Code provisions allowing deferral of foreign source income. There are so many more obvious distortions of market forces: – currencies pegged at undervalued rates, the gross imbalance in how the U.S and other countries raise tax revenues (non-VAT v. VAT); and the dramatic effects of host-government regulation, both direct and indirect, of U.S. foreign investment and the competitive conditions that they face. To focus on tax deferral is to miss the far larger problems and a gross disservice to the economy and the President's goal of doubling U.S. exports in the next five years as well as dealing with the phenomenally large level of U.S. foreign indebtedness stretching out farther than the eye can see.

Britain liquidated much of its overseas investments to finance two 20th Century wars. Any measures that result in a diminution of U.S. foreign investment will only weaken the U.S. economy and America's standing as a world power.