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DISC AFTER FOUR YEARS:

REASSESSMENT NEEDED

By Michael J. McIntyre

The time has now come to reassess the judgment made in 1971 when the original domestic international sales corporation (DISC) legislation was approved by Congress. At that time, the United States had an overvalued currency which was causing domestically produced goods to be overpriced abroad. Unwilling to formally devalue the dollar, we felt compelled to adopt a series of indirect measures to accomplish the same result. In the wake of the restructuring of the international financial system that has since taken place, most of these measures -- the interest equalization tax, the foreign direct investment controls, and the Federal Reserve Board's restrictions on foreign borrowing -- have now been repealed. The question for the Ways and Means Committee is whether DISC should go the same way.

When DISC was being debated in 1970 and 1971, allegations were made by supporters and opponents of the legislation, with no easy way of determining who was correct. After several years experience with DISC, however, the following statements can no longer be seriously disputed:

Cost Effectiveness Challenged

1. DISC provides no significant benefits to small business. At the time of its enactment, Treasury spokesmen asserted that DISC would make it possible for small businessmen to enjoy the benefits of tax deferral then available to multinational corporations through manipulation of the minimum distribution provisions of Subpart F of the Internal Revenue Code. Treasury data now show, however, that three-quarters of DISC benefits go to corporations with assets in excess of $250 million, and substantially all of the remaining beneficiaries have assets in excess of $100 million dollars. Tax reform advocates who predicted this result in 1971 have been proved correct.

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2. DISC is one of our most expensive tax expenditure items. In enacting the DISC legislation in 1971, Congress anticipated an annual revenue loss of less than $200 million. In fact, the definition of "producers loans" given in the statute was expected to reduce the tax loss substantially after the first 10 years of operation. Our experience with DISC has shown that these assumptions were in error. For 1975, the estimated revenue loss has been pegged at $1.6 billion and rising, putting DISC near the very top of the tax expenditures list.

3. DISC produces no measurable increase in exports. After two extensive studies of DISC by the Treasury Department and a careful study by the Office of Management and Budget, no evidence has been produced which demonstrates -- or even strongly suggests -- that DISC has been a significant factor in the volume of United States exports. Exports have increased dramatically since the enactment of DISC in 1971, but this increase is explained almost entirely by the devaluation of the dollar and the shift for most important world currencies to a system of floating exchange rates. Further study of DISC is unlikely to produce important new information, for the effects of DISC are virtually impossible to isolate. We know for certain that whatever the role of DISC, its impact on exports is minor and the cost is very high. Congress rarely has had so much data on any tax provision. (For story on Treasury study, see Tax Notes, April 21, page 3. For stories on the OMB report, see Tax Notes, May 14, pages 3 and 5.)

4. Repeal of DISC would simplify our tax laws. In testimony presented to the House Ways and Means Committee in 1971 I stated:

> "The DISC legislation is amazingly complex. . . . The original DISC proposal was several dozen pages of very technical prose, and it has gotten even more complex along the way. There are over 30 new concepts in the proposed bill, each requiring pages of regulations for explication. It is unlikely that any but the most tax sophisticated companies could deal with these complexities."

My prediction turns out to have been conservative. Even sophisticated companies have had trouble understanding DISC. The resulting uncertainties have rewarded the more adventurous and penalized those with more refined tax consciences.

As the above statements indicate, none of the major objectives of DISC have been achieved. What is perhaps more important, the objective of artificially increasing exports is no longer in the national interest. If DISC does in face have a positive impact on exports, the effect is to create unnecessary shortages of goods at home.

Similarly, since the introduction of floating exchange rates in February 1973, exports and imports are kept in rough balance. Any increase in jobs from export stimulation would be offset by a loss of jobs from increased imports.

Trade Negotiation Chip?

Most supporters of DISC, including Secretary of the Treasury William E. Simon, seem to acknowledge that the old justifications no longer have much merit. The most interesting new argument being advanced is that DISC is needed as a bargaining chip for the multilateral trade negotiations under way in Geneva. Its usefulness as a bargaining chip is certainly questionable, since our major trading partners feel that DISC violates our international obligations under the General Agreement for Tariffs and Trade (GATT). They have, in fact, lodged a formal protest against us which is now in litigation. Aside from such practicalities, one would think Congress would be unwilling to relinquish control over a piece of tax legislation of such major importance. Our domestic tax rules for our oil industry, for our export businesses, or for any sector of the economy should be set by Congress, not by Treasury in consultation with foreign governments.

If Congress moves to abolish DISC as tax reform leaders on the Ways and Means Committee have urged, some attention would have to be given to a technique that would be fair. One method would be to treat all DISC income earned after a certain date as being currently distributed to shareholders with transitional rules providing for realization of all deferred income over a five-year period.

Questions and Answers About DISC

Following are a series of questions put to Dr. McIntyre by the House Ways and Means Committee during testimony last July 23 and his answers to those questions.

1. Question: Does DISC act as a significant stimulus to U.S. exports?

   Answer: No. All of the available data, including two studies of DISC by the Department of Treasury, indicate that DISC has not caused a measurable increase in overall exports. The huge revenue loss from DISC has simply increased the profits of the export sector of the economy. Our trade picture is determined almost exclusively by the relative cost structures of U.S. producers and their competitors and by the relative value of the dollar against foreign currencies.

The ineffectiveness of DISC has two causes. First of all, by applying to all exports, not just the increase in exports, the bulk of the tax revenue lost through DISC goes to exporters for simply maintaining the status quo. Even the revenue loss resulting from increases in exports does not act as an incentive in most situations, since the increases in sales are generally caused by economic factors not within the control of individual businesses. For example, the increase in grain sales abroad over the past few years is widely acknowledged even by supporters of DISC to have been caused by external factors unrelated to any export subsidy.

The second cause of the ineffectiveness of DISC results from the change to a system of floating exchange rates in February 1973. It should be noted that the Treasury studies which found no substantial incentive effect of DISC related to periods before the floating exchange system went into effect. With floating exchange rates, international money markets tend to adjust for any export incentives. Even if the incentives stimulated certain exports, these gains would be at the expense of other exports or would be offset by increased imports.

2. Question: What is the relationship between the rate of unemployment and the condition of our balance of payments? In particular, is there evidence to show that balance of payments surpluses enjoyed by some of our trading partners have resulted in lower unemployment rates?

   Answer: Rates of unemployment seem to result from the basic structure of the domestic economy and are quite insensitive to international trade. For example, Germany, which over the past several years has had a surplus in its balance of payments, and the United Kingdom, which has had a deficit, both have unemployment rates significantly below the U.S. rate. Economists who have attempted to find a correlation have been unsuccessful, and the general conclusion of economists is that whatever connection may exist is too insignificant to measure. . . .It should be kept in mind that even if we could export unemployment by means of export subsidies, any temporary gain would soon be offset by retaliatory measures by our trading partners.

3. Question: Is there no merit to the claims of DISC supporters that the incentive has a significant impact on U.S. jobs?

   Answer: No. There is no evidence that DISC has had any overall impact on jobs.

   As stated above, unemployment rates are not very sensitive to changes in international trade. In any case, as long as our imports and exports are in balance, jobs gained by increases in exports will in large measure be lost by increases in imports. In evaluating claims by individual companies that DISC has increased jobs, the following points should be kept in mind: (1) Gains by one company may be offset by losses from another company. Generalizations from the experience of a few companies does not give a reliable picture of what is going on for the whole economy. (2) Corporate executives are poor judges of the economic factors determining their conduct. What may appear to them to be the result of DISC is much more likely to be the result of a relative change in the value of the dollar. (3) DISC provides large tax savings to exporters. Statements on the effects of DISC are therefore self serving and will tend to be optimistic.

4. Question: If DISC has not had a significant impact on exports, why are our European trading partners protesting our use of DISC to the Council of the General Agreement on Tariffs and Trade (GATT)? In other words, can't we assume that DISC is working if our trading partners are objecting to it?

   Answer: Relying on the judgment of our trading partners on this issue is nonsensical; they do not, after all, have the data on DISC available to this committee. It is equally reasonable to ask: Why, if our trading partners think DISC is effective, have they not followed our example and set up DISC legislation of their own?

   Three possible explanations are available to explain the protest of the European Economic Community to the GATT Council. First of all, the protest was lodged back in 1971, well before the shift to floating exchange rates in 1973 which now make export subsidies obsolete. Secondly, the EEC may simply be uninformed about the effects of DISC. Or they may believe that it distorts the pattern of trade, even though it does not affect our overall trade picture, since the benefits of DISC are not the same for all types of industry. Thirdly, they may be protecting their rights under GATT as a matter of principle. If DISC went unchallenged, a precedent would be set which they might feel went against the spirit of GATT and against their long range economic interests. A loss of our case at GATT would of course hurt our bargaining position in future GATT negotiations.

5. Question: Would it make sense for this committee to eliminate DISC benefits for certain segments of the economy, such as agriculture, while retaining DISC for the manufacturing sector.

Answer: No, it would not. The arguments against DISC are relevant for all sectors of our export economy. In 1970, in testimony presented to the Treasury Department, I suggested that if DISC were to be enacted, the benefits should be limited to products which were likely to be affected by an export subsidy. At that time, our agricultural products were very competitive as to price and the obstacle to export was the restrictive trade practices of our trading partners, who felt it necessary to protect an inefficient but politically powerful agricultural sector. I therefore suggested that agricultural products be excluded from DISC benefits, a suggestion which, if followed, would have saved the Treasury millions in windfall tax expenditures. The situation in 1975, however, is quite different. With floating exchange rates, the dollar is no longer overvalued. The windfall to agricultural exporters is no greater than the windfall to any other exporters.

6. Question: Supporters of DISC claim that its repeal would amount to unilateral economic disarmament. Is this claim correct?

Answer: Only in the sense that disbandment of the mounted cavalry in the 1940's constituted unilateral military disarmament. DISC is obsolete. It makes no more sense in this day of floating exchange rates than the mounted cavalry did in the age of tanks and high powered artillery.

The views expressed in this article are those of the author and do not represent a position on legislation by Tax Notes or its publisher, Tax Analysts and Advocates. Tax Notes strives to present a variety of views on tax policy and welcomes articles presenting opposing views on policy options.

FORD NOMINATED FOR WAYS AND MEANS

Rep. Harold E. Ford, D-Tenn., has been nominated by the Democratic Steering and Policy Committee to the seat on the Ways and Means Committee left vacant by the resignation of Richard H. Fulton, D-Tenn., elected mayor of Nashville, Tenn., August 7.

The Democratic Caucus will meet Tuesday, September 30 to act on the nomination. Ford is a freshman from the Eighth District of Tennessee. He is also a member of the Banking, Currency and Housing Committee, the Select Committee on Aging, the Veterans' Affairs Committee and the Congressional Black Caucus. He scored 57 out of a possible 100 on a tax reform voting scale prepared in July 1975 by Taxation with Representation. (See Tax Notes, July 14, page 3.)