POSSIBLE MEASURES TO RESTRICT THE INFLOW OF FOREIGN CAPITAL

Summary

Introduction

In view of (a) the better prospects for appreciation of American securities and increases of dividends in comparison with foreign securities and dividends and (b) the better prospects for peace and political stability here than abroad, there is a strong likelihood that capital will continue to move toward this country. This note is designed to indicate very briefly the case for taking measures to check a further inflow and to list the possible measures that might be taken to this end.

The Case for Restriction of Capital Inflow

1. Monetary Control.

(a) General. The general experience in this and other countries has been that capital flows in during an upswing and out during a downswing. In other words, foreign capital movements are inflationary rather than compensatory in action, work against monetary policy and tend to make for instability.

(b) Specific. Excess reserves are now around $2.3 billion. Experience in the past has been that in prosperous periods it is necessary to put member banks about $1 billion in debt to the reserve banks to arrest expansion of demand deposits. With the power to raise reserve requirements by $1.5 billion and the ability to sell $2 billion of securities, the System is in a position to put member banks over $1 billion in debt if this should prove necessary. If, however, another $1 or $2 billion of gold enters the country, this will not be possible.

In addition to increasing bank reserves, an inflow of gold results in a corresponding expansion of checking accounts in banks. The volume of checking accounts and outside currency is already nearly $5 billion in excess of the figure in 1929.

2. Security Prices.

One of the factors that makes more difficult the attainment of economic stability is the instability of security prices. Foreign capital movements tend to aggravate rather than to moderate such instability.


The inflow of foreign capital made a negligible contribution to our recovery and yet, if stock prices continue to rise and dividends to increase, foreigners will be richly rewarded. They will be in a
4. War.

Large foreign investment here is a source of danger to us in the event of a foreign war. Foreigners might sell securities, as happened at the outbreak of the Great War, or foreign governments might sequester and sell the property of their nationals here, using the proceeds to purchase American goods. Both security prices and production would be disturbed and it would be more difficult for us to maintain our neutrality status.

5. Threat to our Freedom of Action.

The more foreign capital there is in this country, the more is our freedom of action circumscribed by the possible action of foreign investors.


The relative capital scarcity of the Nineteenth Century has been replaced by a superabundance of investable funds.

Possible Ways of Deterring Foreign Purchase of American Securities.

1. The Imposition of a Capital Gains Tax.

2. The Imposition of a Security Purchase Tax.

3. Raise the flat income tax on interest and dividends payable to foreigners. This tax would be deducted at the source or paid by agents or nominees carrying securities for foreigners. A rate of 22½ percent in Great Britain is said to be a decided deterrent to the purchase of British stocks by foreigners.

Both a capital gains and a security purchase tax appear easy of evasion. This was one of the reasons given for the repeal in 1936 of the capital gains taxes applicable to foreigners. The advisability, therefore, of imposing either a capital gains tax or a stock purchase tax cannot realistically be considered without reference to the possible ways of checking evasions. In this connection consideration might be given to the requirement that all American listed stocks be legally transferable only by gift, private sale approved by the S. E. C., or by sale on American stock exchanges. This suggestion is designed to check the growth of trading in American securities abroad which enables
both foreigners and Americans to evade American taxes and American margin requirements. In addition consideration might be given to a requirement to the effect that agents of foreigners be responsible for the repayment of the purchase tax or the capital gains tax when the transaction occurs. In general it appears easier to check evasions by residents than by non-residents.

If the above taxes were accompanied by compulsory registration of all transactions in foreign exchange, with a declaration of purpose in each case, the possibilities of evasion would be still further reduced.

4. Prohibiting borrowing on stocks by or on behalf of foreigners.

Possible Ways of Deterring the Inflow of Foreign Capital in the Form of Short Term Balances.

1. Give the Board of Governors discretionary power to raise reserve requirements against deposits held by or on behalf of foreigners.

2. Cause exchange rates to vary within a limited range. This would render more hazardous short-term capital movements motivated by interest rate differences.

Conclusion

It may be remarked, in conclusion, that for present purposes it is not necessary to check all evasion. Any action that will make foreign investment here less attractive, or attractive only on condition that our laws are broken, may be expected to deter the inflow of a substantial amount of capital. Illegal evasion might be practised by individual wealthy speculators but it is not likely to be attempted by institutional buyers or people of moderate means.