

COMMISSIONER HILLS: Thank you, Mr. MacGregor. I appreciate your comments, and Dr. Weidenbaum has a question.

COMMISSIONER WEIDENBAUM: I want to thank the panelists for the helpful information in their written statements. My question is for Dr. Mohatarem.

You make a compelling case here for benefits of NAFTA as a market opening activity. I'd like to go back to an earlier period where industry was quite involved in what I would call a market closing activity: the early '80s, the limits on Japanese auto imports in the U.S. Have you had occasion to examine the impacts of that? Are there any lessons for us?

DR. MOHATAREM: As you know, Professor Weidenbaum, that was a very difficult period for the industry from roughly about 1980, when the economy went into very deep recession. We had hundreds of thousands of people unemployed at that point. The simplest solution at that point appeared to be to impose restrictions on imports, which in part were creating some of the dislocations, and that decision was made by the Reagan Administration and we had so-called voluntary export restraint programs.

Now, in hindsight, there are aspects of that program that turned out to be positive and some that turned out to be negative. Let me talk about the negative ones first.

They clearly encouraged the location of manufacturing in the U.S. by many of our competitors, which, knowing the practices of some of the competitors, they would not ordinarily have done so, even if it was economical to do so. So we essentially invited competition into our own market.

On the positive side -- and I'm not sure whether this was planned or was an inadvertent consequence -- was that the VERs provided some measure of protection from imports, but at the same time, because the market to investors was kept open, did not give that protection permanence, so the domestic companies knew they had to respond to the competition over the period of time, and we did.

So both politically and economically, imposing the restraints when they were done in the early '80s probably saved a significant amount of employment in the U.S. It did allow the industry to make the changes that it had to make, but also told

the industry that that protection was not forever, and therefore, if it did not respond, it would soon lose its markets.

COMMISSIONER WEIDENBAUM: Isn't there another, longer term aspect? My recollection -- yours may be much better -- was that the profits per car to the Japanese importers were much higher than to our domestic folks, something about scarcity value, and that helped finance the upscale investment of the Japanese auto industry into the luxury market; one that they had pretty much ignored. And of course, numeric quotas provide a special incentive to upgrade the quality of the restricted import.

DR. MOHATAREM: I think you make the right point. In fact, the quotas had the expected impact, which was that much of the benefit did go to the foreign manufacturer. That's why they tend to support those types of quotas.

Ironically -- yes, you're right. They did make investment in luxury cars. Unfortunately for them, the U.S. market shifted away from luxury cars, and therefore, those investments did not prove to be as successful as they'd anticipated. But I think

that's after the fact; that's hindsight. The reality is when the quotas were imposed, we and I believe everybody else recognized that one of the consequences would be that the Japanese would earn supernormal profits --

COMMISSIONER WEIDENBAUM: They would what?

DR. MOHATAREM: That they would earn higher than normal profits. Now, we did not expect and I don't believe anybody expected that they would plow that much of that profit into investments in the U.S., as they ended up doing.

COMMISSIONER WEIDENBAUM: I must confess -- my memory may be rusty -- I don't recall during the debate on the Japanese import restrictions anyone pointing out the likelihood that the Japanese would get a major share of profit increases. It's an intriguing point --

DR. MOHATAREM: I would point you to testimony by Dr. Marina Whitman before Congress -- I believe it was March of '85 -- in which she made that point. She was the chief economist of General Motors.

COMMISSIONER WEIDENBAUM: Oh, yes, but I'm referring to the much earlier period when the subject

was being debated, before the restraints were put in place.

DR. MOHATAREM: Since I was writing many of the testimonies that Dr. Whitman was presenting, I do recall on at least three different occasions where we made that point. So if you look at GM testimony over that period, you will see reference to that recognition.

COMMISSIONER WEIDENBAUM: Thank you very much. It's been very helpful.

COMMISSIONER HILLS: Dr. Papadimitriou?

COMMISSIONER PAPADIMITRIOU: Thank you very much. I, too, want to thank both of you for your commentaries; and I have a question for Dr. Mohatarem.

You seem to be singing the praises of NAFTA in terms of the sales growth and all other positive things that happened to General Motors as well as to the rest of the players in the automobile industry. I wonder whether the sales growth and the profitability have anything to do with the wealth effect that we have been experiencing in the late 1990s? Unless, of course, you believe that the wealth effect is not a

result of the irrational exuberance in the stock market but of NAFTA?

DR. MOHATAREM: Clearly, the strength of the equity markets in the U.S. and Canada and Mexico are all having a positive impact on vehicle sales. But as we do our econometric work, it's almost a residual because you really can't draw a statistically significant correlation between equity market changes and vehicle sales. But nonetheless, we know it's there through the consumer confidence that people are much more willing to buy vehicles, so it's translating through that.

But I think the one side of the trade debate we tend not to talk about is the beneficial impact of imports in that context. That because of our open markets, the price of goods is falling, and in particular in the last two years after the Asian prices, the price of imports to the U.S. consumers fell, which meant that they had more discretionary income that they fortunately did go out and spend on cars.

And that -- it's a difficult translation to make, that as import prices fall, it raises the real

or discretionary income of the domestic consumer, and that's an important benefit to the domestic auto manufacturers who have to sell to the domestic consumer.

COMMISSIONER PAPADIMITRIOU: I'm not sure I understand the causality here. You're suggesting that the increases in expenditure because of the wealth effect make imports cheap, and therefore, --

DR. MOHATAREM: No, no. Because our markets are open. When a lot of countries suffered currency crises and their currencies depreciated, the price of imported goods to U.S. consumers fell. So if I were buying a computer instead of paying \$1,500, I paid \$1,000 for the computer.

COMMISSIONER PAPADIMITRIOU: But I'm interested in your business, not really in the computer business.

DR. MOHATAREM: Right. The \$500 that was left over apparently was invested or bought -- used to buy cars or vehicles. That's why sales of vehicles jumped by roughly 2 million units last year to an all-time record; that the American consumer had more discretionary income.

COMMISSIONER PAPADIMITRIOU: So you believe there's a collateral benefit?

DR. MOHATAREM: Oh. No question about that.

COMMISSIONER PAPADIMITRIOU: Thank you.

COMMISSIONER HILLS: Commissioner Wessel?

COMMISSIONER WESSEL: I have questions for each of the panelists.

First, Mr. MacGregor, in terms of both transfer pricing and Section 482 changes, I guess, that came post-1990 with some of the changes then as well as if you have knowledge of the deferral of foreign source income issues -- what impact do you think the changes have had in terms of tax payments? Have we seen with the APAs and the other changes in 482 a dramatic change in tax receipts in those areas? Are the changes effective, or do we really need to update all of the various infrastructure under 482?

Separately on the deferral of foreign source income, there are a number of proposals in Congress to eliminate that as it relates to productive overseas enterprises. What's your view on that?

MR. MacGREGOR: Okay. On the second question, I have to tell you that I'm not a tax

expert, so I'm going to skip on that one. My expertise is in the area of Section 482.

And I will tell you that in my experience, it's difficult to say whether tax receipts have increased because of Section 482. What I think is happening since the Section 482 relations became finalized is that there is a significant amount of learning by multinational companies in terms of how to determine transfer prices correctly. It is very possible that the most significant trend that is going on in terms of companies that buy and sell products is that the change has been from a basic just cost reimbursement over cost plus methodology, which would not completely account for all of the value of the product; that those markups have in fact increased as a result of sophistication of -- or the greater understanding of the transfer pricing regulations.

And I think the most significant part that's involved in that is the analysis of intangible assets, as they are attached to many of the products that are sold across borders and in the past, and still in many cases today, profits are not really assigned to the value of those intangibles.

COMMISSIONER WESSEL: The 482 changes, as I recall though, were primarily pushed because of -- it was foreign subsidiaries of -- U.S. subsidiaries of foreign companies that were overpricing the foreign inputs to reduce their U.S. tax burden, and what you're talking about is U.S. multinationals essentially, so do you have a view on what's happened with the foreign --

MR. MacGREGOR: Yes. Part of the changes that came about included regulations that imposed penalties on the misstatement of -- or substantial misvaluation of transfer prices. I do believe -- in my experience I have seen foreign companies that have operations in the U.S. who are significantly more cautious --

COMMISSIONER WESSEL: Significantly more what?

MR. MacGREGOR: Cautious. Careful about establishing their transfer prices. And in some cases, the -- well, in some cases what you have is different rules on two sides of the transaction, for example, the United States and any other country, and

the penalty regulations can be harsher on one side than on the other.

And in fact, what happens is you have a little bit of a tug of war for that tax money and companies will sometimes choose to err on the side where there's a lower likelihood -- or a higher likelihood of having a penalty enforced on them.

COMMISSIONER WESSEL: Thank you.

With regard to GM's activities in Mexico, I'd like to have some information if possible. For example, my understanding is that Ford's operations at Hermosillo have received J.D. Power's ratings as one of the top five of their facilities in North America.

In terms of quality of product as well as the productivity of the operations there, how would you rate your Mexican operations as opposed to the rest of North America?

DR. MOHATAREM: In terms of quality, they rate right up there. In terms of productivity, the way we measure it is -- you're presumably talking about labor productivity -- they're quite a bit lower because they don't have the level of capital equipment that we have in the U.S.

COMMISSIONER WESSEL: Are you producing any of the same built-up vehicles, both in the U.S. and in Mexico?

DR. MOHATAREM: Yes, we are. We do both cars and trucks.

COMMISSIONER WESSEL: I'm sorry?

DR. MOHATAREM: Both cars and trucks.

COMMISSIONER WESSEL: If there were to be a slow-down in the U.S. market, what would that mean for GM's operations? Would you shift to production to Mexico at the expense of U.S., or how would you rationalize production --

DR. MOHATAREM: Well, as you know, the way our labor contracts are structured, we have guaranteed employment to our U.S. manufacturing employees, so that clearly is a priority to maintain full employment in the U.S. plants. The hope is that if there's a slow-down in U.S. demand there would be an offsetting increase in Mexican and Canadian demand so we can maintain the region by production as stable as possible.

COMMISSIONER WESSEL: Thank you.

COMMISSIONER HILLS: Commissioner Angell?

COMMISSIONER ANGELL: Yes. Given the fact that General Motors has a contract to hire labor, that almost makes labor a fixed cost, I presume, and if that were the case then, if there were a decrease in demand for automobiles, I would presume, but I'd appreciate your expertise on this point, I would presume that rebates and other incentives would rise, resulting in a lower price so that General Motors would pretty well run its plants at an optimum level. Is that correct or incorrect?

DR. MOHATAREM: Well, obviously, that would depend on the competitive dynamics of the market, but maintaining full employment at our plants is a priority for GM, and our strategies are aligned with that.

For instance, we tend to use significantly more overtime to meet peak demands rather than to add workers or to add new plants, recognizing that we have to be able to maintain a fairly steady level of employment.

COMMISSIONER ANGELL: Well, I presume that if there were a decrease in demand for automobiles, I would presume that no matter how far cost-cutting

efforts have gone, that cost-cutting efforts that treat labor as a fixed cost, I presume those cost-cut efforts would be accentuated and I presume that we would end up with year over year automobile prices that were negative 2 or negative 3 percent. Is that -

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DR. MOHATAREM: That -- even in a peak year like '99 that was true, the price of new vehicles fell.

COMMISSIONER ANGELL: I know that, but not 2 or 3 percent, I think.

DR. MOHATAREM: No. It wasn't 2 or 3 percent, but the fact is that we're in a very, very competitive market and the only -- you price or have other marketing incentives to maintain your share as much as you can.

COMMISSIONER ANGELL: Thank you.

COMMISSIONER HILLS: Commissioner Thurow?

COMMISSIONER THUROW: Yes. I just wanted for Mr. MacGregor -- if he had judgment call.

If you look at these transfer-pricing issues, the question is how do they affect the statistics. Right? And do you have a judgment -- if

we could kind of play God and do this right, would it make exports bigger or smaller? Would it make imports bigger or smaller, or would it simply affect the statistical discrepancy, because you could say, well, there's a transfer-pricing problem but it's all random. Some companies do it one way. Some companies do the other. If God did it right the numbers wouldn't be any different.

MR. MacGREGOR: And that's a good question. My sense would be that where the greatest discrepancy is in the portion of the transaction that involve intangible assets --

COMMISSIONER THUROW: In what?

MR. MacGREGOR: In the portion of the transactions that involve intangible assets: trademarks and technology. And these assets are very difficult to measure and it's very difficult to allocate the profits to them because of their very nature. Often they involve subjective analysis.

If I had to guess as to where the problem is, I think that because the U.S. exports have increased in their -- proportionately in terms of the technology that is loaded onto a product, that it's

possible that the error is more so in our exports than in our imports. Is it up or down? In my experience, companies that obviously know their business well and know their products well tend to underestimate the value in many cases of their intangible assets.

COMMISSIONER THUROW: So exports should be bigger --

MR. MacGREGOR: That's correct.

COMMISSIONER THUROW: -- in the statistics.

COMMISSIONER HILLS: Thank you. You've done a wonderful job, both of you, and we very much appreciate your comments, and we've benefited from them.

I've been asked to announce to those of you who have attended this hearing that the bank security would welcome you to return for the afternoon session that will commence at two o'clock, but as you leave you will be asked to turn in your badge in the lobby and then you can pick it up when you return, if you return, at two o'clock, and we hope you will.

Thank you, very much.

(Whereupon, at 12:00 noon, the meeting was recessed, to reconvene at two o'clock, this same day, Friday, January 21, 2000.)

A-F-T-E-R-N-O-O-N S-E-S-S-I-O-N

(2:05 p.m.)

COMMISSIONER HILLS: We want to welcome our witnesses. We appreciate so much your time.

If you were here this morning, you know that the rules of the road are that we ask you to try to limit your remarks to seven minutes, and that gives the Commissioners an opportunity to ask questions after your remarks. And as a result, we have a timing device -- while it's green, you're in good stead.

It turns yellow when you really should be thinking about summing up, and when the red light goes on -- we won't be ferocious. We'll let you finish the sentence or even the paragraph -- but it would help us to be able to manage the hearing if you can stay within the general time limits.

And without more ado, I'd like to call on Mike Sheridan, who is from the Texas Workforce Commission, and invite your comments.