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A NEEDLESS TRADE WAR

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The economic press has characterized recent panel decisions on U.S. foreign sales corporations (FSCs) as having the wrecking potential of an atomic bomb on the World Trade Organization. In a definitive ruling released last month, the WTO appellate body affirmed that U.S. FSC legislation establishes a prohibited export subsidy. The decision opens the United States to retaliation that could amount to as much as $4 billion, which, if exercised by the European Union and other affected parties, could severely prejudice U.S. trade. This gigantic amount makes the war analogy so apt.

The appellate body ruling is steeped in legal language based on the wording of the WTO and the agreement on subsidies and countervailing measures. As I understand the reasoning of the appellate body, it would be consistent with the provisions of the WTO to subsidize exports to avoid double taxation if the exemption from U.S. taxes applied to income derived from foreign sources, which the FSC does not. Rather, it permits U.S. corporations to set up FSCs outside the United States and attribute the income to these essentially shell entities.

I am an economist, not a lawyer, and will therefore focus on the economic aspects of the FSC legislation. Indeed, the legal language derives from the underlying economic theory that prevailed when the General Agreement on Tariffs and Trade (the predecessor to the WTO) was established at the end of World War II. That theory, to put it simply, is that indirect taxes, such as value-added taxes and sales taxes, are passed forward to the ultimate consumer, whereas direct taxes, such as the income tax, are not, but instead are absorbed by the producer or seller of the good or service. In this construct, an indirect tax is best levied in the jurisdiction where the sale takes place. Taking this one step further, this means that indirect taxes paid before a good or service is exported can be reimbursed (a drawback can be claimed), leaving it up to the ultimate jurisdiction to apply the indirect taxes that prevail there. Direct taxes that are paid can have no drawback, which is why the U.S. Congress – responding to the urgings of large U.S. corporations – devised the FSC mechanism, and its gimmicky predecessor (the domestic international sales corporation, or DISC).

Today it is evident that this theory of tax incidence is much too simple. Some portion of income taxes surely is passed forward and the seller may absorb some portion of indirect taxes. When this was pointed out as long ago as the 1960s, the argument of many of the experts, including those from the European Commission, was that the issue was being overblown by the United States because shifts in exchange rates – especially under a floating system, such as that which now exists between the dollar and the euro – largely neutralizes these tax incidence distinctions.

This reasoning – that exchange-rate shifts made the economic theory underlying the export drawback rules, even if not airtight, largely irrelevant – did not prevent the European Commission from belatedly launching a case against the United States about the FSC many years after its enactment. The commissioner who spearheaded this action, Leon Brittan, recently wrote a letter to the *Financial Times* (January 16, 2002) to deny the charge that this was done in a fit of pique over U.S. action against EU banana policy. The letter has a sanctimonious tone that the issue had to be pursued in the WTO "in order to protect legitimate commercial interests of EU businesses." The *Wall Street Journal* took an opposite but equally self-serving position when it argued in an editorial (on January 17, 2002) that the FSC case was not about trade, but rather about taxes in the sense that rebates of Europe's value-added taxes were needed in order to make Europe competitive in world markets.

We now have the makings of the mother of all trade wars between the European Union and the United States on an issue on which both sides have little to be proud of and that could seriously damage the WTO. The U.S. Congress deliberately sought a way to subsidize exports by massaging the rules of the GATT, an agreement that U.S. trade and legal experts largely wrote; and the European Commission went looking for a fight that would give it some leverage in bargaining on other issues. (Lord Brittan's letter makes this clear when he suggests that one U.S. concession might be to reduce its "extremely high tariffs on textiles.")

The real issue is where the two sides go from here. One possibility is that, after the legal experts at the WTO decide on the precise amount of damage, the EU can retaliate by raising tariffs or imposing other import restrictions for the full amount. This would be a declaration of war and, in my view, irresponsible. More likely, a mix of actions – EU import restrictions and U.S. concessions – will be worked out. Even this can be obviated if the U.S. Congress alters the legislation in a way that conforms to the guidance given by the appellate body, but this would not be easy to accomplish. U.S. trade officials are also talking about changing the rules about direct and indirect taxes embodied in the WTO, but given the EU preference for the current provisions, this would be an impossible negotiation. The United States can respond by bringing a series of charges against the EU; the *Wall Street Journal* editorial suggested a complaint over Europe's subsidies to Airbus. This is advice to escalate the trade war by bringing in other issues.

This listing of options to resolve the dispute makes it clear that there is no easy solution. We are in a fight that the United States should not have started by instituting the FSC in the first place, and that the EU should not have pursued at this late date. This fight between the world's two largest trading entities is made to order for philosophizing about how the international trading system works.

The GATT and the WTO today establish a body of rules, something that is necessary to the conduct trade among nations. The rules, for the most part, are based on the common-sense principle that countries should not seek special advantage to further their exports that are not available to all other members of the trading regime. This most-favored-nation principle is then encrusted with exceptions, the most prominent of which is the authority to establish customs unions and free-trade areas under a separate set of rules. By now, these preferential arrangements are the vehicles for more trade than the MFN rule itself.

It is well known in trade-policy circles that many countries make a concerted effort to keep their exchange rates slightly undervalued in order to promote exports. There is a downside to this practice in that it can have an inflationary impact, but not an excessive one if the undervaluation is modest. It is tempting to game the rules in order to give one's exporters an advantage, no matter how slight. Rules are fine, but getting around the rules is even more exhilarating.

The FSC idea was premised on getting around the rules. It was an attempt by U.S. corporations to equalize the competitive impact of different tax systems on international trade. The United States relies more on the corporate income tax to raise revenue than it does on value added taxes, whereas the EU relies heavily on the VAT. When the FSC and its predecessor were concocted, the argument made by U.S. corporations was that they were seeking only to correct an injustice written into the GATT articles that favored corporations in countries that relied heavily on indirect taxes. Now that the FSC has run afoul of those who interpret the international trade rules, it is likely that there will be a concerted corporate drive to change U.S. tax laws to reduce reliance on income taxes and move instead to value-added or other indirect taxes. It will not matter that the trade impact of such a change might not be significant over time as relative exchange rates adjust under a floating system.

The concern aroused by the ruling of the appellate body was that a US-EU trade war over the FSC would damage the WTO. We may discover that there is another concern here in the United States, that this ruling, based on the wording of the WTO and related trade agreements, will serve as the basis for changing the nature of the U.S. tax system itself. This, if it takes place, will require time and much bloody argumentation, but there already are a number of proposals out there to take advantage of the WTO ruling in order to make the U.S. tax system more hospitable to international trade rules rather than to tax progressivity. Congressman Bill Thomas (R-CA), chairman of the House Ways and Means Committee is among those who would like to use the WTO ruling to overhaul the U.S. tax system.