

CATO INSTITUTE POLICY FORUM

WILL THE FSC DISPUTE IGNITE A
TRANSATLANTIC TRADE WAR?

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Featuring:

Rep. Phil English, R-Pennsylvania;

John Richardson, European Commission;

Willard Berry, Europe-American Business Council; and

Gary Hufbauer, Institute for International Economics

The Cato Institute

F.A. Hayek Auditorium

1000 Massachusetts Avenue, NW

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P R O C E E D I N G S

MR. GRISWOLD: Good morning, everybody. Welcome to the Cato Institute's F.A. Hayek Auditorium. I am Dan Griswold. I am the Associate Director for Trade Policy Studies here at Cato. Our mission at the Trade Center is to educate the public and policymakers about the moral and economic benefits of free trade and the costs of protectionism.

One program note, Congressman English should be here any moment. Here we go. Perfect. The Congressman will be our first speaker.

The most urgent topic in trade policy today is the dispute over America's Foreign Sales Corporation tax law. This long-simmering dispute boiled over last year when the European Union took the United States to the WTO Dispute Settlement Panel and won a favorable ruling that America's FSC law grants tax breaks to U.S. multinational companies based on export performance, a practice rightly defined and prohibited as an export subsidy under mutually agreed upon WTO rules.

A WTO appellate body confirmed the ruling in February and set a deadline of October 1st, which, if you have seen the news over the weekend, has been extended to November 1st, for the United States to bring its tax law into compliance.

But if the revised law now working its way through Congress is not found to meet the requirements, the United States could be subject to trade sanctions on as much as \$4 billion in exports to the European Union. This trade dispute could rightly be called "Nightmare in Geneva." It combines the arcane provisions of the WTO's agreement on subsidies and countervailing measures with the complexities of the U.S. corporate tax code. It dramatically raises the ante on retaliation at a time when the United States is bidding to do exactly the same with its carousel legislation.

Finally, its timing could not be much worse. It pits the world's two largest trading entities against each other at a time when WTO members are struggling to get trade negotiations back on track after Seattle.

Despite some of these ominous implications, there are reasons for hope. Both sides have shown some evidence of good will. The U.S. Congress is working with surprising speed to pass legislation, and the European Union has pulled back from the brink of a managed trade war by this agreement over the weekend, and also signaling a willingness to consider trade liberalization as an alternative to self-destructive trade retaliation.

Specifically, the E.U. has proposed that the United States lower barriers to certain imports from the E.U. to compensate for the alleged distortions caused by the FSC law.

The E.U. also offered to further open its own market as a way of resolving the ongoing dispute about its own WTO-inconsistent policies regarding bananas and hormone-fed beef.

If the FSC dispute manages to revive the idea of liberalization as a tool of enforcement, then, in the words of the most recent Economist magazine, "The cycle of retaliation between the two sides could turn from vicious to virtuous."

Our own blueprint for WTO negotiations, the trade policy analysis, titled "Seattle and Beyond," published by Cato last year, contains a section written by my colleague, Brink Lindsey, detailing just how such a system could work in practice. And I would urge you all to take a look at it.

Finally, like so many trade issues, the FSC dispute is in desperate need of a dose of economic rationality. U.S. policymakers should realize that export subsidies are just as economically harmful as trade barriers. The intent of the FSC law, to promote exports, makes no more economic sense today than when its predecessor was passed in 1971, as a way of dealing with what was then a balance of payments crisis.

And both the United States and the E.U. should acknowledge that nobody wins a trade war. Trade sanctions are not a reward for the country that imposes them. They are a cost. They punish consumers, distributors and import-using industries in the country that imposes them, just as they punish exporters

in the target country. Trade retaliation is a fine that both countries pay but nobody collects.

Well, to bring light, and maybe a little heat to the FSC dispute today, we have gathered a distinguished panel of experts and principal players. Our first speaker will be Congressman Phil English, third-term Republican from Erie, Pennsylvania, and member of the tax-writing House Ways and Means Committee. Along with Chairman Bill Archer, Congressman English has been a leader in the congressional effort to rewrite the FSC law.

Congressman English has compiled a voting record that is generally supportive of freer trade. Out of nine major votes in the 106th Congress that we looked at, he voted for expanded openness eight times, including permanent normal trade relations with China, continued U.S. membership in the World Trade Organization, and the freedom of Americans to travel to Cuba.

We may need to have a little chat about steel quotas, but we will leave that for another day. Please join me in welcoming Congressman Phil English.

(Applause.)

REPRESENTATIVE PHIL ENGLISH,

R - PENNSYLVANIA

CONGRESSMAN ENGLISH: Thank you. It is a real privilege to be here today.

As a representative of western Pennsylvania and the State that produced the tariff of abominations, let me just say that it is an opportunity to be here today to maybe set the record straight on this dispute and hopefully also generate a good discussion. Because I think that the FSC issue is going to have a profound effect on trade policy for a long time to come.

I think it is important in any discussion of FSC to recognize that there is a history here. There was a predecessor to the FSC, called the DSC, that went back to the mid-1970's. And like the FSC, it was an attempt to address a problem in our tax system. It was an adjustment. And it was challenged in the mid-seventies by the Europeans. And what happened subsequently was very interesting.

The FSC was developed as a result of discussions with European members and, in 1982, was passed. To put it into context, the United States had made similar challenges to the tax systems of France, Belgium and The Netherlands. What resulted was a deal that we would pass the FSC and that the Europeans would not challenge it; and, in return, we would not engage in similar challenges.

What happened subsequently was very interesting. We had our FSC grandfathered in as part of a deal in the WTO, but it

subsequently was challenged after the U.S. chose to challenge the protectionist European regimes in the areas of bananas and beef. We won there. Unfortunately, there was not real implementation of our victory on the part of our competitors.

We now have faced a challenge to FSC and lost, and we now have an obligation to move forward. We need to recognize, though, in moving forward, what FSC has done. It is an attempt to adjust our tax system to address the realities of international trade, not to create a special advantage, but instead to create a level playing field.

We have a system, which is a worldwide system in terms of the treatment of how we tax profits. By contrast, most of our competitors have territorial systems. What that means in real terms is that a country with a territorial system does not tax profits from activities that occur outside of its territory. Thus, a country with a territorial system would not tax the sales profit from marketing and promoting an export, provided the activity took place outside of the country.

Under the worldwide system that we have in the United States, all income of all U.S. citizens and all income of all U.S. corporations is taxed no matter where derived. Under the worldwide rule, even the foreign income of a foreign corporation can also be taxed if it is controlled by a U.S. company. We have

an extraordinarily anti-export tax regime; more on that anon. And that has given rise to this attempt to adjust.

The House has moved forward to pass legislation, recognizing that we have been facing an October 1st deadline, now past. This legislation attempts to deal with the FSC problem in a direct way by taking some of the preferences out of it. It repeals the current FSC laws, as of 9-30-2000. All transactions after October 1st are subject to new rules.

It allows for transactions begun before October 1st to proceed under the current FSC regime. It allows for manufacturing and/or a binding contract to continue under the current FSC law until the end of the year. It also allows elections of current transactions into the new regime at the option of individuals.

What remains unchanged is a 50 percent domestic content requirement, some administrative pricing rules that establish arm's length, and a trimming back of rules related to international boycotts and bribery. In this legislation, which was developed without much E.U. cooperation, we sought the advice of our trading partners and we did not get a lot of feedback. And it is important for us to now pass it.

First of all, it ensures that the United States will honor its signature to the Uruguay Round. In doing so, it also puts pressure on the European Union to honor its trade

commitments, which so far again they have failed to do in the area of beef hormone and bananas.

Second, it also means that the United States is complying with a WTO ruling and, in doing so, will avoid a potentially very large and damaging retaliation by the E.U. Again, as we will discuss today, there are a number of forms that that could take, and we are hopeful that instead of a retaliation we might, if it came to it, be able to accommodate liberalization of trade as an alternative. And that is something members of the Ways and Means Committee are very interested in.

Third, and perhaps most importantly, it moves the United States to a partial territorial tax system by making the exclusion of foreign income the general rule of our law. We then add back certain kinds of foreign income. But under the WTO rules, it is clear that if you can exclude all of your foreign income you can exclude part of it. And the significance of this potentially is enormous.

Again, let me reiterate: FSC lowers taxes on exports. It is an attempt to address one of the central features of our scheme of international taxation. And it has a significant impact on our exports.

For locomotives manufactured by General Electric in Erie, Pennsylvania, the profit on those locomotives is taxed under the FSC at 30 percent rather than 35 percent. And in an

enormously competitive environment that makes a significant difference.

I hope that we are going to be able to move this legislation forward and see it enacted into law very quickly. But in the interim, let's understand that the FSC dispute has the potential to have opened a Pandora's Box, but not with all negative consequences, as was noted.

FSC may end up being a stimulus for tax reform in the United States. We feel this is an opportunity to open a discussion on what kind of tax regime we should have for our whole economy, and particularly on the business side. I think that if we are going to have a strong international, outward-looking economy in the next century, we need to have a tax system that accommodates that.

For those of you who would like to see my solution, I welcome you to take a look at my Web site and take a look at the simplified USA tax, a modification of what Senator Nunn and Senator Domenici put forward a few years ago. On the business side, we create a simple border-adjustable business consumption tax, one that will allow exports to go forward and, if it were in place, would put our economy at a competitive advantage by having a much simpler tax code and a much more pro-export tax code that would clearly be WTO-consistent.

The Pandora's Box may open as far as stimulating other challenges by the United States in the future to other European tax systems. And let me say this: I don't think that in the long run our international trading system is going to sustain public support if it gets into the business of micro-managing its members' tax systems too closely.

But I think it will be fair game, if the FSC challenge goes forward and it's pursued, for the United States or others to consider challenging some of the European tax systems that have some of the same anomalies. For example, the Dutch system. And in the long run, I have a fear that this sort of challenge could lead to significantly lower support for international trade.

My hope, though, is that we can move forward and that we can move in the direction of a much simpler, much cleaner taxing system for the United States that allows us to compete internationally with a level playing field.

I thank you for the opportunity to be here, and I look forward to your questions.

(Applause.)

MR. GRISWOLD: Thank you very much, Congressman. They are taking a series of votes in the House, so the Congressman can only be with us until a little after 12:00. So, I thought what I would do is let our next speaker, John Richardson, make a presentation, and then we would open it up to a few questions to

make sure the Congressman can be asked any questions about any loose ends that need to be tied up.

Our next speaker is superbly qualified to bring the view from across the pond. John Richardson has been Minister and Deputy Head of the European Commission's delegation in Washington since October 1996.

Before that he spent 23 years at the E.U. Headquarters in Brussels. He has served in the past as the Commission's Division Chief for relations with the United States, and before that Japan. And he was part of the E.U.'s negotiating team on services during the Uruguay Round.

Mr. Richardson is probably the most frequently seen and quoted representative of the European Union in Washington today. Please join me in welcoming John Richardson.

(Applause.)

JOHN RICHARDSON,

EUROPEAN COMMISSION REPRESENTATIVE

MR. RICHARDSON: Thank you for that kind introduction. It is a pleasure and a privilege to be here for the first time in this great building, with the Cato Institute.

I am going to concentrate in my introductory remarks, at least, on the new events of the last few days and the end of

last week. As you know, we came to an agreement with the United States in the early hours of Saturday morning in Brussels. It is a procedural agreement on how to handle this particular dispute.

Up front, I have to say that you must realize that the E.U. remains of the view that not only the FSC legislation is contrary to GATT obligations, but also the draft FSC replacement legislation currently being looked at in Congress. So that is clear up front. So we clearly have and continue to have a major disagreement on substance with respect to the FSC and its replacement legislation.

Given that we have that important disagreement on substance, what we have tried to do in the agreement reached last weekend is to avoid escalation of the dispute at this stage while preserving our own rights under the WTO dispute settlement understanding. Preserving rights means preserving the possibility at some stage to request approval of the withdrawal of concessions, colloquially known as retaliation.

One of the key elements of the agreement is that the two sides agree that a WTO panel will review the compatibility of the FSC replacement legislation if adopted. And that panel will report before sanctions could be imposed by the European Union.

That is rather different from the situation in this town when we are faced with similar decisions with respect to bananas. And we might well come back to that.

But in parallel to this review of compliance by the WTO, the E.U. would seek the necessary WTO authorizations to retaliate in a timely fashion in order to preserve its rights. So you have a twin-track approach here. In addition, and this is the second element of last weekend, the U.S. will ask and has asked now the WTO Dispute Settlement Body to postpone the 1st of October deadline until the 1st of November, which would delay any further procedural steps until later in November.

We have agreed in the European Union not to oppose that request by the United States in the Dispute Settlements Body, which will, I believe, be meeting on the 12th of October. We remain committed in the E.U. to managing trade disputes effectively in a non-confrontational manner and in a manner which is conducive to the strengthening of the WTO system.

That is why I say this differs so much from the banana dispute in 1998-99. At that time, the U.S. insisted that it had to introduce its own retaliatory measures, not only before the WTO had approved them but also before the WTO had even reviewed whether our banana regulation was in compliance with our obligations. We said at the time that that was not the right way to go forward, and we are glad that the U.S. has agreed with us now, when the boot is on the other foot.

In this case, of course, one has to admit that the stakes are even higher than they were with bananas. They are an

awful lot higher. We are talking here about the withdrawal of concessions worth billions of dollars.

There is no legislation in place now in the United States. Technically, at the moment the United States is infringing the recommendations of the panel decision on FSC, which gave the United States until the 1st of October to pass new legislation.

But we have chosen not to ask for immediate approval of withdrawal of sanctions. We are aware of the activity in Congress to pass replacement legislation. And we consider that it would be irresponsible not to give Congress the chance. We are not in the business of creating conflict. We are in the business of managing disputes in a responsible fashion.

I actually like to quote my illustrious fellow countryman, John Lennon, on this. What we are saying is, "We will give peace a chance."

(Laughter.)

MR. RICHARDSON: Both sides, it has to be said, showed flexibility in these quite difficult procedural negotiations. So both sides, it would seem to me, are the winners, and the system is the winner. We are going forward in a way which is completely WTO compatible, but a way which gets something for us, which is important, a custom agreement safeguarding our future rights.

So, let's look for a moment at the two elements again. The U.S. is to request an extension of the deadline and the E.U. will agree. That is important. Let's not forget, though, that the other members of the Dispute Settlement Body have to agree, as well. And I can just visualize the scene in Geneva: the U.S. makes its request, the European Union representative sort of nods his head without saying anything, and everyone looks around the room to see who will dare speak up. It will be quite an exciting moment, I think, although I am sure that our colleagues in Geneva will have done some homework beforehand in talking to the other delegations.

The second element, and perhaps more important in the future, the second element is how we are going to reconcile the procedural difficulties which there are in the contradiction apparent between the Article 21.5 compliance requirements in the Dispute Settlement Understanding, and Article 22.6 on retaliation.

The difficulty there is that Article 22.6 says you must ask for retaliation within 30 days, and Article 21.5 says that there are 90 days for the WTO to rule on whether the legislation is compliant or not. There is a clear problem there.

The way forward is what is colloquially known as the Australia salmon case. It was a dispute on salmon between

Australia and Canada, who found a way to comply with the requirements of both articles and thus preserve their rights.

The way this was done was the following: Canada requested authorization to suspend concessions within 30 days from the end of the reasonable period of time, and at the same time requested the establishment of a compliance panel on 21.5. Australia objected to the level of suspension requested by Canada, and the matter was sent to arbitration.

Canada and Australia both asked the arbitrators to put their work on hold, to suspend their work, until the compliance panel had given its ruling. That is possible because Article 22.7 in the Disputes Settlement Understanding does not make mandatory any time limit within which the arbitration procedure has to be completed. And it is the same basis as that on which we have come to an agreement with the United States.

But the fact remains, at the end of the day, that all this is contingent on action by Congress. I want to quote Stewart Eisenstadt who said on Saturday, "We cannot emphasize strongly enough how critical it is that Congress complete action on the FSC repeal and replacement legislation as expeditiously as possible. It is the only way to meet our obligations in the WTO and avoid an unprecedented and immediate confrontation with the European Union."

I couldn't agree more. Thank you.

(Applause.)

MR. GRISWOLD: By the way, before I forget, the Congressman's remarks are available on the table out there, too, as you leave.

Since we are doing pretty well on time let's just move on. Our next speaker is well qualified to sort through the legalities and the economic consequences of the FSC dispute. Gary Hufbauer holds both a Ph.D. in Economics from Cambridge University and a law degree from Georgetown. He served in the U.S. Treasury Department during the Tokyo Round in the late 1970's, where he directed the international tax staff. In fact, Gary was the U.S. Treasury's negotiator for the Tokyo Round subsidy code, which spurred the transition to the U.S., law from what was then the Domestic International Sales Corporation or DSC, to FSC. Gary is currently the Reginald Jones Senior Fellow at the Institute for International Economics here in Washington.

Please join me in welcoming Gary Hufbauer.

(Applause.)

GARY HUFBAUER, SENIOR FELLOW,
INSTITUTE FOR INTERNATIONAL ECONOMICS

MR. HUFBAUER: Thanks very much, Dan. It is a great pleasure to be here with Congressman English and John Richardson, whom we have known together for many years, and Willard Berry.

I want to concentrate my remarks on two issues. One is the substance, and the second is the trade strategy issues. On the substance, I have left some handouts, one a rather detailed analysis of the FSC decisions, both at the panel level and at the appellate body level, and then, secondly, some commentary on the way forward.

Just briefly on the decision. Of course, everybody has their favorite awful WTO decisions; this is near the top of my list, if not at the top of the list. This was a decision that totally ignored the legislative history, which Congressman English referred to. It was judicial activism in the WTO in the following sense: Without any textual support, they said that you can have a mainly territorial system for taxing your foreign income, including your exports, but you can't have the kind of U.S. territorial system.

So if you exempt all export income and all foreign production income, as essentially The Netherlands and France do and some other countries in this world, that is okay. But if you exempt part, and give a little lower tax rate as we do, 30 percent versus 35 percent, that is not okay.

Well, the problem with that is that there is no language support for that, that we are going to cut it here as opposed to here as opposed to here, in the WTO. It is just made up. Of course, they buried the makeup in about 260 pages of legal decision, which itself is ridiculous -- that they should be writing these very long panel decisions.

Out of a bad case, however, good things can come. And, here again, I am in agreement with Congressman English, and I think also John Richardson. One can see some good things and I want to try to turn to those.

Firstly, we have a very antiquated set of rules for dealing with taxes internationally on exports. The rules date back to the last century, and they make this distinction between direct and indirect taxes, taxes borne by the product and taxes not. This is all gibberish and has no economic foundation whatsoever. But they have been carried forward and carried forward until we have this particular case.

What it means in practice is that Europe and many other countries can exclude from their domestic taxation all exports when they impose value-added taxes, goods and services taxes, and the like, which are very spread. So, for Europe, my estimate is about \$100 billion a year of taxes that are not collected on exports to countries outside of Europe.

In addition, they can impose those taxes on imports, which they do do, because those are called indirect taxes. And if you put a different label on direct taxes, then you can't adjust them at the border. And this is a piece of nonsense which Congressman English is valiantly trying to deal with by reforming the U.S. tax system. And I congratulate that very much.

Now, there are some economists who would say, "Well, it all washes out in the exchange rate." That is fine if you are sitting in Washington and in a comfortable place such as Cato or the Institute for International Economics or Brookings. It's not so good if you are in Erie, Pennsylvania, and manufacturing locomotives, because it doesn't wash out in the exchange rate. The exchange rates are driven by capital movements, as we all know today; they are not driven by current account balances. And it doesn't wash out company by company and industry by industry.

So much for the substance. Now, let me turn to the trade strategy issues, which I think are equally interesting, and perhaps more interesting. And here John and I have some differences.

This is a manufactured case. This case has no commercial interest in Europe, or very little. This is bananas-squared or bananas-cubed, or something. The reason for this case was to manufacture a bargaining chip. And they manufactured a big one, a \$4 billion bargaining chip.

Now, the question is how this bargaining chip is going to be spent. That is what is going on right now. That is why it is being kicked down the road. You can't spend it with the Clinton administration. The Clinton administration is almost out of office. So there is a certain kindness in suspending the retaliation.

But, really, the purpose of this chip is to get the next administration's attention on trade issues. Now, the U.S. can respond in various ways, and I think the right way is exactly what the Congress is doing. And I think there is a very good chance that the panel will reconsider and will find the new legislation appropriate, because it exempts some foreign production, as well as exports, from taxes. And, therefore, it is more of a territorial system and gets further past the line. So that is a possible outcome.

Suppose the panel finds it unacceptable and it goes forward in this dispute procedure; where do we go from there? Well, the U.S. has a lot of options. It can start manufacturing bargaining chips, too. There is a lot that countries don't do in their systems that they ought to do in the WTO, where there is no commercial interest, but hey, you let the lawyers loose and they can find cases. That is what they are good at; and they will.

So that would be one avenue, and we can manufacture bargaining chips and get our piles of chips higher, and then we

can have a grand negotiation. And if that grand negotiation leads to liberalization, which is the Brink Lindsey solution and the Dan Griswold solution, that is really great. That is not a bad outcome, especially given that other forms of trade negotiation seem to be stalled at present.

The other good outcome is that we might actually enlarge our territorial system, which is exactly the right way to go. So we can start with the FSC amendment 1, and if that is not good enough for the panel, we just enlarge it a little bit further. And finally we get a tax system which is in the 21st Century.

Thank you.

(Applause.)

MR. GRISWOLD: Thank you, Gary.

I thought at this point I would give the Congressman a chance, if you want to respond briefly to anything you have heard so far.

CONGRESSMAN ENGLISH: No, thanks.

MR. GRISWOLD: Okay. Why don't we move on, then, to our final speaker.

Will Berry represents the private sector caught in the crossfire of the FSC dispute. Will Berry is president of the European-American Business Council, formerly known as the European-American Chamber of Commerce, a position he has served

in since 1992. The Council represents European and American multinational companies that will bear the cost, along with consumers, of any escalation of the trade retaliation between the United States and the E.U. Mr. Berry has worked for leading national and state organizations involved in international trade.

Please join me in welcoming Will Berry.

(Applause.)

WILLARD BERRY, PRESIDENT,
EUROPEAN-AMERICAN BUSINESS COUNCIL

MR. BERRY: Thank you. I am very pleased to be invited here today and be among such a distinguished panel.

As you were just told, the European-American Business Council is a group of both U.S. and European companies. Our concern over this issue has been whether or not it was going to be resolved and what damage it might do to the transatlantic trade relationship.

I am not sure, although the figures are often repeated, how much all of you are aware of how these economies are now integrated. I think if you look at the Web site and you look at Commissioner Monty's list of mergers and acquisitions that are pending, that are being reviewed by the European Commission, which would be similar to a list that would be in the Antitrust

Division of the Department of Justice, you could see what is going on.

But the cross-investment stock between Europe and the U.S. is now over \$1 trillion, and accelerating. If you look at the interdependencies in terms of jobs, if you look at the export figures, if you look at what subsidiaries of Europe and the U.S. sell in each other's market, you have a relationship of over \$2 trillion, or maybe close to \$3 trillion. It is just absolutely enormous and it is very integrated.

So there is a big concern in our membership that this dispute not get out of control. This is something that we have been concerned about and have written about and been involved in since last January.

We have companies that are on both sides of this issue. We have European companies, and some of them may benefit in the United States, through are a subsidiary. We have European companies who feel that they are put at a competitive disadvantage because of the Foreign Sales Corporation. We have a lot of U.S. companies that are beneficiaries.

It is also clear that the U.S. companies that are beneficiaries very much value this benefit and do not want to see it compromised. At the end of this spring, we were involved in organizing a trip of congressional tax staffers to Europe. Congressman English's staff participated in the trip. We went to

some of the member states. We went to Brussels; we were in various places in Europe. And I think the congressional staff were convinced, upon their return, that the European Commission was very much convinced that it was in the right on this. And at that time they had just rejected Mr. Eisenstadt's first proposal to amend the FSC.

But, as I say, at the conclusion of the trip, not only was it found that people who were in Europe at the Commission thought that Lami was right, but most of the business organizations were solidly behind Mr. Lami and felt that Mr. Lami was absolutely correct. So, at that point, we didn't see how this issue was going to be resolved.

And I think it is interesting that the flexibility that has been shown and the interest on both sides, in not letting this get out of hand, that we see this procedural agreement, which was concluded over the weekend. But we are still concerned. There are still possibilities of retaliation. We don't know what will develop in the short term. In the agreement, there is no mention of a retaliation list or what might happen. In terms of a retaliation list being released in November, we are concerned that there is a linkage between that and a carousel list, which may well be released.

So, I think, in the short term, there can be some problems which might churn the waters a little bit in the short

run. And it is a procedural agreement, so we wonder, in the long run, how this solution would work out. So, one of our major interests is in avoiding retaliation and also trying to raise the awareness of companies in our membership, and on both sides of the Atlantic, about what retaliation could look like.

There is a little paper that we did, and I did bring some copies; I guess they are probably outside. But we tried to do some scenarios to look at what retaliation would look like. And the primary conclusion is that everybody gets hurt. And it is fairly obvious when you realize how integrated these economies are.

Just for purposes of illustration, we broke down all of the exports from the U.S. to Europe in 98 categories. And then the first scenario assumed that, well, you want the broadest possible impact, so you would start at the bottom of the list and work your way up. And if you just look at the categories of exports, that is over half of the categories of exports. That is a pretty broad impact on the U.S.

The second scenario was that if you looked at the products which are the biggest exports, maybe where you could hurt people the most, and if you look at that and you look at European exports to the United States, essentially you have the same products. And if you look at the top 20 categories, the overlap is substantial. It is 14 or 15 of the categories, which

reflects not only the integration, it reflects the intercompany trade and, particularly with the digital revolution and high tech, how much things just go back and forth between the U.S. and Europe.

The third scenario was to look at those products where the U.S. has the greatest comparative advantage. And of course a lot of that impact would be on agricultural and related products. But still, there would be consumers, there would be processors and there would be other people involved.

And just as a reminder, and it is not in that paper, but a few years ago, with the Mad Cow disease, the European Commission wanted to stop the use of Special Risk Materials, SRM's. I think people were quite surprised at what happened as a result there, because all of these pharmaceutical products and pills are coated with materials that are related to these SRM's. And when you started looking at all of the things that became involved and which, I think, was a well-intended response to this problem by the European Commission, you could have basically had a public health crisis if you had to pull all of these pharmaceutical products off the shelves of Europe.

The fourth scenario, and something that has been suggested, would be an across-the-board tariff on all exports, which would be, at the \$4 billion level of retaliation, about 2.7. That is pretty dramatic when you realize that, at the end

of the Uruguay Round, if all of the tariff reductions that were agreed to, and with the phasings, you have an average reduction of 3.2. So, essentially, that scenario would basically neutralize all of the progress that was made in the Uruguay Round in terms of reducing tariffs.

So retaliation must be avoided. Clearly, the Congress must pass the legislation, because this procedural agreement assumes that that will happen.

Then, I think, lastly, the U.S. and the E.U. has to continue to negotiate on this issue and find a solution that meets WTO rules, and at least consider contingency planning to avoid the devastating situation of sanctions in the event that, in June perhaps, the WTO rules against the U.S.

Thank you.

(Applause.)

MR. GRISWOLD: Well, two vigorous debates in two days. I guess we can handle that. Let's turn to questions now. If I could ask that right now we just take questions for Congressman English, since he will have to be leaving from us any moment now.

And I would ask you to raise your hand and wait for me to recognize you and then wait, because somebody will bring a microphone around. State your name and your affiliation. And try to keep the pre-orations to a minimum and get right to a direct question starting with the Congressman.

Are there any questions?

MR. GOULDER: Hello. My name is Bob Goulder. I am with Tax Analysts in Arlington, Virginia.

My question is: How do you think the Grassley Amendment that the Senate Finance Committee attached to the FSC bill would fare in the House?

CONGRESSMAN ENGLISH: The short answer: I really don't know yet. I think, as I understand the Grassley Amendment, and I haven't looked at it, but I have had a pretty thorough description of it, I can't say categorically that we couldn't embrace it at this point, but I don't want to make policy on it at this point.

I don't necessarily think it is a poison pill. The biggest problem with it is it forces the issue back to the House, and we may be simply running out of time.

MR. MITCHELL: I am Dan Mitchell, with the Heritage Foundation.

When we got these WTO lemons, why didn't we just make a full glass of lemonade by going to a full territorial system? Was there just not enough time? Because we are, in effect, taking a step in that direction, why didn't we just go all the way to sort of short-circuit the whole process?

And a follow up on that: You mentioned in your talk that you were concerned that if countries were beginning to have

their tax policies micro-managed, it might reduce support for trade liberalization. And I was wondering if you had any thoughts on what the OECD is trying to do in terms of its assault on low-tax regimes and the threat --

[End Side A. Begin Side B.]

CONGRESSMAN ENGLISH: What was the first part of your question?

MR. MITCHELL: Why don't we just move to a full territorial system?

CONGRESSMAN ENGLISH: Lack of time and no consensus. We tried to move this forward as a consensus issue. I would have been delighted if they had embraced my tax proposal. I know one of the other members of our panel, a very senior member, was actually contemplating taking something similar, just applying to the business side, and suggesting this as the way to go.

But tax reform is so controversial, so difficult to move forward on, we didn't feel we could do a comprehensive fix. I would have been delighted if we had tried.

MR. GRISWOLD: Yes?

MR. QUINLAN: My name is Andrew Quinlan. I am from the Center for Freedom and Prosperity. I also have a coalition that I have started for tax competition, which deals with the OECD issue and a few other issues.

One question that is a little bit off the subject is on the issue of the QI, the Qualified Intermediary, which is something the European Union the way I understand this, is going to happen starting January 1st. And the IRS is putting these regulations on other countries. We just feel that it is going to be hurting investment in the U.S. if we are penalizing other countries for investing here. What do you think about that?

CONGRESSMAN ENGLISH: I think you have an excellent point and I think you have an interesting challenge in public education. I don't think I have a complete understanding of the issue, and I don't know that many people, even on Ways and Means, do. I think this is a very important issue, from what I do understand of it, and I think we need to get cracking next year. Thank you.

MR. GRISWOLD: John Richardson did want to make a few follow-up comments. So go ahead, John.

MR. RICHARDSON: I asked for the floor because I would like to say one or two things on taxation before the Congressman leaves and before we get back to WTO questions.

First of all, when Gary Hufbauer talks about indirect taxation in Europe and giving advantages to exporters, nobody should be under any illusions. Indirect taxation is not another way of taxing directly. That is not why it is called "indirect taxation." Indirect taxation is better described as consumption

taxes. We have a very large consumption-based tax component in Europe, which is the value-added tax, VAT. It is collected by manufacturers because it is easier to collect it through manufacturers than through the citizens, and there are various other technical reasons.

But it is a tax on consumption paid by the consumer in the price he pays for a product. Naturally, you don't raise taxes on foreign consumers. I would like to see the outcry if we tried to raise taxes, the same taxes that we take from European consumers, from American consumers in order to finance government expenditure in Europe.

Quite rightly, it is explicitly provided for in the WTO: the consumption taxation can be and should be and must be remitted on exports. The consumption taxes are, however, applied just as it is for good produced and sold in Europe to goods imported into Europe. Why? Because they are consumed in Europe. It is a consumption tax. It is not a company tax.

It affects the company tax situation in no way whatsoever, unless you believe what we have been told by many economists in the United States for something like the last 10 years or so in the run-up to the correction of a single currency, that we are shooting ourselves in the foot in Europe because we have such high rates of taxation overall. But that is something of a side issue.

On the territorial taxation systems, let's be quite clear about this. All the European member states which have territorial taxation systems tax exports in exactly the same way as they tax domestic sales. We are talking company taxation here. Income from exports is taxed in exactly the same way as income from domestic sales.

Finally, I think Congressman English let the cat out of the bag when he said himself that the reason for the introduction of a FSC was the lousy United States trade deficit at the time. And I quote him, "FSC lowers taxes on exports." I rest my case.

CONGRESSMAN ENGLISH: May I speak to that?

FSC does lower taxes on exports. It does it because otherwise our tax system is hopelessly flawed in the treatment of exports. You can't consider FSC out of the context of our entire tax system. Again, I would love to be thrown into that briar patch. If we are forced to get rid of anything like a FSC, if there is no adjustment for our tax system, we will inevitably be forced to reform our system of business taxation and move to a different regime.

I think a consumption-oriented regime on the business side, properly considered, could be the most effective way to go. What that would do is create a competition between the United States and its competitors based on levels of taxation. And we tend to have a lower level of taxation, as Mr. Richardson noted,

in this country and, hence, our goods would be at a competitive advantage.

If we were forced to clean up our tax system, we would be eating their lunch, and they know that. I don't mind having this debate, because, in the long run, we have a more competitive economy and, if stimulated to continue to compete and if stimulated to reform, I think we could take on anyone. That is why I am comfortable supporting open trade.

I believe, though, in the interim, clearly we should be allowed to maintain FSC, and the precedent that they have created is a very dangerous one.

One last point. I have had a couple of meetings with my colleagues, European parliamentarians, and I have been interested to get their take on this issue. Their analysis is very different from mine. They simply look at FSC as a subsidy for Boeing, pretty much the way Lloyd Doggett looks at it.

(Laughter.)

CONGRESSMAN ENGLISH: And let me just say that it is interesting to understand that, because what they are trying to do is make sure that their products, which in the case of Airbus, is very clearly subsidized, continue to be at a comparative advantage because of subsidies. What they are doing is attacking what they consider a subsidy, not as a defense of free trade but as an opportunity to get a competitive advantage.

Now, I hope this can be ironed out. And Mr. Richardson has done a superb job of presenting their position. My hope is that all of these disputes can move forward in a positive way and that we can both be pushed to move toward more open trade and towards support of an international trading regime that is sustainable.

Thank you for having me here today.

(Applause.)

MR. GRISWOLD: Well, I do want to say before the Congressman leaves that we have had some very instructive and sharp differences here, but there was an agreement among all four panelists that retaliation is a losing proposition all around, and that the WTO system should move to some form of liberalization, as an enforcement mechanism. Hopefully, we can see some progress on that.

Well, let's continue with our questions. Again, please raise your hand. And I see one on the way back row there. Please state your name and affiliation and, if necessary, who your question is aimed at.

QUESTION: I found out last week this report that was published by Brookings Institution and OAS, that there had been a dispute going back to 1995. The E.U. had complained about U.S. trade sanctions against Cuba. It seemed like the history of that dispute didn't seem to be really resolved at all. I am

wondering, is that playing a role? The spokesman from Brookings said bananas was a factor in that dispute.

MR. RICHARDSON: I guess what you are referring to is the dispute we have had over the Helms-Burton law, which attempts to apply extra-territorial sanctions to European companies who follow European law which happens to differ from United States law. Which we regard as a somewhat undemocratic thing to try to do.

At present, that dispute is subject to an understanding, which we arrived at during the British presidency with the United States, and there is sort of an uneasy truce on that. And it is not involved at all in the discussions which we have been having on the FSC.

MR. GRISWOLD: Yes, in the back?

MR. GARZA: My name is Chris Garza, with the American Farm Bureau.

We have been very strong advocates of carousel retaliation because of the current beef and banana cases. Recently in the press, we have read that the European Union is looking at proposals in order to bring both of these issues into compliance, with the "first come, first served" issue on the banana list, which we understand that the banana industry does not believe that it would bring them into compliance. But one thing we have not heard was, what is the proposal out there on

bringing the hormone-treated beef into compliance in the European Union?

MR. RICHARDSON: First of all, with respect to bananas, it is absolutely right that there are considerations underway in Europe to bring in yet again a new regime to bring us into WTO conformity. There were discussions on that with the United States and with the other complainants to the dispute.

I have to admit that I have pretty well given up on trying to understand the complexities of that. It is a very technical issue, indeed, how to respect WTO obligations while respecting also the rights of all the different parties, including the Central Americans, the Caribbean countries, and the U.S. banana companies. It is not about U.S. banana exports, as you know.

Part of the problem is that we are dealing with quota systems. All quota systems create systems whereby you have acquired rights to rents. We have companies here who have acquired rights from the past. And it is very difficult to get everyone in agreement on what actually happens.

So I think that at some stage we are probably, in Europe, going to have to bite the bullet on that, either in agreement with the United States or without agreement with the United States, and have another go at bringing the regime into

compliance. I think that can well happen in the fairly near future.

The technicalities, though, are absolutely horrifying. And I would say, whatever we come up with, we will put it to WTO, and then we will sit back and see what WTO thinks of it. It is not simple on bananas. Bananas is terribly technical.

That is not the case with the hormones in beef dispute. That is not about technicalities at all. It is about something quite different. It is about the interface between trade rules and consumer protection rules. As you know on that, we were condemned by the WTO because we had not respected our obligations under the SPS Agreement. Before bringing in the ban on hormones in beef, we had not done a proper scientific risk assessment, and we were condemned for that procedural reason.

Note that the WTO panel decision was not about whether having hormones in beef is injurious to the consumer or not. It was not about that; it was about procedures. We have now carried out what we regard as a full scientific risk assessment by a body of independent scientists. That has come to conclusions which justify, in our view, the imposition of a ban.

So we now have new legislation going through the European Union machinery definitively banning one hormone where there is clear evidence that it is carcinogenic and introducing a provisional ban on the other five because the weight of the

evidence suggests that there may be a problem in terms of creating cancer. We regard that as a perfectly legitimate reaction on the basis of the scientific evidence available.

When that legislation has gone through, which will be sometimes in the first half of next year, we will go back to WTO and say, "We have now got new legislation based on following all the procedures and, therefore, we would ask that this legislation be ruled to be in conformity with our obligations."

Now, that will solve our problem. What it won't solve is the problem of beef producers in the United States. It won't solve the cattlemen's problem. So we are working in parallel on a system to set up -- and we are doing this with the U.S. Government -- to set up a viable system which can reliably certify U.S. beef as hormone-free, if the cattlemen concerned have taken the rights measures to ensure that it is.

If we can do that, then we set up the possibility of the U.S. exporting hormone-free beef to Europe. There is already a quota that can be used for that. And one of the ideas which is around is to replace the current sanctions on beef hormones by compensation in the form of an increased quota for U.S. cattlemen raising non-hormone-treated cattle.

That is a concession that could presumably be prolonged even after we are in conformity through discussions in the agricultural negotiations going on now in Geneva. So, what could

be temporary compensation could thereby be turned into a long-term opportunity for export of hormone-free capital from the United States.

MR. WHITNEY: I am Peter Whitney, Control Risk Group.

I just wanted to follow up on the beef hormone question. You say you have new scientific evidence. It is my understanding that it has been studied back to 1981, and, repeatedly, the amount of hormones that the U.S. beef industry puts in the beef is really insignificant. It is certainly carcinogenic, estrogen is, but the amount they put in is something like two or three nanograms in the ear to make the cow grow faster and produce leaner meat. A birth control pill, conservatively, has 35,000 nanograms, and cabbage and soybeans have much more.

And there is no such thing as hormone-free beef. All beef has hormones. So I find the panel in the WTO pretty convincing that there has been no scientific evidence that the amount of hormones that the U.S. beef industry puts in, which is a pellet in the ear of the cattle, a very, very tiny amount, to less than three nanograms, compared to hundreds and thousands of nanograms we Americans and Europeans consume every day in many products. So I don't really quite understand what you just said.

MR. RICHARDSON: Well, it is an interesting argument that you present there. But I don't understand the panel having

said that. The panel didn't say that. The panel made no finding whatsoever on the scientific side of this. The finding was that we had not done the scientific assessment before we entered the ban. And that is what we are obligated to do under WTO.

The SPS Agreement allows you to choose your own level of protection against identified risks. As you yourself have said, there is --

MR. WHITNEY: [Off microphone].

MR. RICHARDSON: No, no. I'm sorry.

Under the SPS you are allowed to choose your own level of protection against risk, provided you respect certain procedures, which we didn't do at the time and which we have done now. Which is why we fully expect our new legislation to be found to be in conformity with WTO obligations.

Now, this whole question of different types of food products and what they contain is partly a question of whether you are talking about something which governments can influence or not. Governments can't influence how much hormones there are in cabbages. They can influence whether additional hormones are used, other than the natural ones which occur in cattle, in the raising of cattle.

Nobody in Europe sees any good reason to do that and, therefore, to accept the risk, whether small or large, which

comes from the use of that methodology. So that is the situation.

MR. GRISWOLD: Would either of our other panelists like to react to anything that has been said so far on beef and bananas?

(No response.)

MR. GRISWOLD: Okay, next questions.

MR. CERRELLA: Mark Cerrella from Bridge News.

Mr. Berry mentioned potential linkage between FSC and the carousel retaliation list. And Mr. Hufbauer characterized FSC as this kind of huge bargaining chip. So, a question for both these two gentlemen: If the disputes can be seen in those terms, does it seem likely then that the U.S. would hold off on releasing the new carousel retaliation list until there is some, if not resolution, some more progress in the FSC dispute?

Because if it is seen in terms of a bargaining chip, you have a \$4 billion bargaining chip kind of hanging there, why would you release this carousel retaliation list and kind of incur the wrath that may happen? So, if those two gentlemen can address the question.

MR HUFBAUER: Thanks for much. Let me take a shot at this. Firstly, I think Will was doing exactly what he should do from his Association's viewpoint, and also broader transatlantic viewpoints, and point out the dangers of retaliation. However, I

am no record as saying that that is not what this is about.

These dangers, yes, we have to be alert to them. We don't want to fall into the First World War again in trade and so forth, but that is not what is a very likely outcome.

And since I suggested more than a month ago that this would be kicked down the road, and it has been kicked down the road, I will speculate a little bit further on this. There won't be any carousel list published during the Clinton administration. Some reporter asked me, Why don't they do it? Because the Congress said they should do it. What I said was that they have a team of lawyers in the Treasury and the USTR, where are you going to bring the case? Are you going to bring it to the Supreme Court, to the Appellate Court in D.C.?

You can't force the administration to do something it doesn't want to do unless you want to go through three years of litigation. It is very hard to force it, and they don't want to do it for the reasons that are indicated in your question. I expect John will deny this, but let's look at the big picture. The big picture is that at the end of 1993, the peace clause in agriculture comes to an end.

Charlene Barshefsky has said, and I guess she has done her arithmetic on this, that that is \$7 billion of potential retaliation there. Europe knows this. They know that their agricultural programs are completely in violation of the WTO, as

written, once the peace clause expires. Europe needs some big chips to get the U.S. attention to extend the peace clause, to have a longer phase-out, whatever.

There is the Boeing case that was mentioned by Congressman English. That has been a dispute going back for more than 20 years, the Boeing-Airbus dispute. That could always bubble over into some trade litigation. But it has not yet. But Europe wants a bargaining chip to offset that.

And there are other things, but those are two of the really big things right on the horizon, plus this beef and banana heritage we have. So that is what is going on. People are building up their little arsenals, and there will be a negotiation. So that is why I am optimistic. But I would be very surprised if the carousel list is both published and implemented.

MR. GRISWOLD: I just want to make a point that the peace clause is this agreement that subsidies and countervailing measures and retaliation won't apply to agriculture. Is that generally right?

MR. HUFBAUER: For the security fund, yes, right.

MR. GRISWOLD: And 2003 is when that expires, and it could bring a whole new round of trade retaliation.

Will?

MR. BERRY: In working on this issue, we have made contacts with a number of officials and member states, business groups and member states. It is clear how this carousel plays out. It does affect the ability of leaders to be flexible or to be accommodating. One of the people who has led, and one of the leaders who has been public about this, I think, is the Prime Minister of the U.K., who clearly has a problem if Kashmir gets on the list. And that doesn't give him any flexibility.

So, if he, in one way, says, well, we shouldn't push toward retaliation in the E.U., he is hard-pressed to do that if he has a part of his constituency which visibly and publicly experiences severe harm. That is why I say they are linked.

MR. GRISWOLD: Do you want to respond to some of that, John?

MR. RICHARDSON: Yes. Let me first say that one of the things, as a Brit, which I find most difficult to deal with in the United States is the imagery of violence and war, which so permeates U.S. discourse. So, when Gary talks about falling back into the First World War, the danger is that some people may actually believe that that is the sort of situation we are in. I am sure he would agree with me that is not quite what he meant.

We are talking here about disputes under a system of law, which we set up in the GATT first, reinforced by the Uruguay Round Agreement which gave it teeth at last, and very largely

because the E.U. pushed for it and because the U.S. pushed for it, itself pushed by the U.S. Congress, which wanted to have a system of rules which could be made to work by building in incentives to make it work. We are talking here about using that system of law.

All these disputes are about that. And they are all about different aspects and about different rules. They are not connected. It would actually be very, very difficult to imagine any connection with a political package because we are no longer in the negotiating situation. We are in a situation where a system of law which we set up has ruled. And we can't simply agree to things which contradict panel decisions and appellate body decisions. That is not any longer possible, because we wanted it that way.

You in the United States went in the direction of the rule of law after having gone through a period of temptation by the vigilante tradition. You decided in terms of the rule of law, and that is what we have done internationally as well.

Now, with respect to this building up of chips, let's look for a moment at the history of the whole FSC dispute. We first raised our concerns about FSC back in 1985, rather a long time before even bananas got going. Why did we not pursue it then? Because at that time, any member of the WTO, or as it then was, GATT, could block a panel decision. And the United States

made it clear at the time that it would block a panel decision on the FSC. So we waited until we had the teeth, which we both wanted in the WTO, those teeth, in operation.

We raised our concerns already in 1996, long before the panel decisions on bananas and on hormones. In 1996, we raised them at the first review of subsidy notifications. We followed that up with three rounds of consultations to try to get the United States to listen before we went to a panel. The panel has now ruled against the United States. The panel, based on a system we both set up, confirmed by an appellate body of different people.

I'm sorry, Gary. It just doesn't wash. Just because you dislike a decision, there is no reason to call into question the whole system and the people operating within the system. I think that is scurrilous.

MR. GRISWOLD: Gary, that last word sort of obligates me to let you make a brief last statement directly on the point.

MR. RICHARDSON: I would say it is unjustified.

MR. HUFBAUER: No. You can question a decision, as Europe has on many occasions, without challenging the system. That is exactly what I did. I didn't challenge the integrity of any of the jurists, the appellate body that has the American on it. It just shows Americans can make mistakes, too.

MR. GRISWOLD: Just like the debate last night, the character issue comes up right at the end.

I think we will have to close it there. You are all invited to join us upstairs for a stand-up buffet. I have to tell you, John, I can't guarantee that the beef sandwiches are hormone free, but there are alternatives there. We haven't had any reports of anybody getting sick.

MR. RICHARDSON: Life is full of risks.

MR. GRISWOLD: Life is full of risks. Thank you for coming. Please give a hand to our participants.

(Applause.)

(End of Cato Forum.)