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A Clean Escape from \$4 Billion in FSC Sanctions

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Congress will face a stark choice in coming months: Either jettison a 30-year-old practice of granting tax breaks to U.S. exporters, or expose those exporters and others to \$4 billion in punitive trade sanctions by the European Union. Congress can try to finesse the choice, as it has in the past, and risk an escalating trade war with our number one commercial ally, or it can excise the offending section from the U.S. tax code and pass the savings on to all U.S. producers.

A Four-time Loser in the WTO

Beyond debate is the need to alter the way the U.S. corporate tax law treats earnings from exports and overseas production. The U.S. government's existing policy has gone 0-for-4 in recent rulings by the World Trade Organization. In 1999, the European Union initiated a challenge in the WTO against what was then called the U.S. Foreign Sales Corporation tax law. FSC allowed U.S. multinationals to claim a partial tax exemption for income that their foreign subsidiaries earned from handling U.S. export sales. The EU charged, and a WTO dispute settlement panel and appellate body agreed, that the U.S. law constituted an illegal export subsidy under the WTO's code on Subsidies and Countervailing Measures.

In October 2000, the U.S. Congress approved a replacement tax regime, called the Extraterritorial Income Exclusion Act (ETI). The ETI expanded the definition of foreign-derived income that could be excluded, but it retained the condition that the goods must be sold outside the United States and must contain at least 50 percent U.S. domestic content. To no one's real surprise, the EU challenged the new law again in the WTO and once again prevailed before a dispute settlement panel and again on appeal.

The bottom line of all four rulings has been that WTO members cannot make tax breaks conditional on export performance or the domestic content of subsidiary sales abroad. The U.S. government has reached the end of the appeal process and now must either change its corporate tax code to

eliminate any pro-export bias or face the consequences.

If Congress fails to bring the U.S. corporate tax code into compliance with our commitments in the WTO, the European Union has gained a green light from a WTO panel to impose \$4 billion worth of trade sanctions against U.S. exports. Additional duties of up to 100 percent would be aimed at a list of 1,600 high-profile items designed to inflict maximum economic and political discomfort on this side of the Atlantic. The targeted items include dairy and meat products, sugar, cereals, toys, apparel, and machinery. The EU has set a deadline of January 1, 2004, to impose the sanctions if Congress fails to remove the offending provisions.

The Futility of Export Subsidies

The FSC law and its successor are relics of a bygone era. The original Domestic International Sales Corporation, or DISC, law was enacted in 1971, at a time of fixed exchange rates and the attending obsession with the U.S. balance of payments. The DISC and FSC tax laws were aimed explicitly at boosting U.S. exports in the mistaken belief that they would narrow the U.S. trade deficit and offset any tax advantages enjoyed by foreign exporters. But tax breaks conditioned on exports, like any export subsidy, cannot fundamentally change the balance of trade.

A nation's trade balance is determined by the flow of foreign investment.¹ A border adjustment tax such as the FSC or ETI does not directly affect capital flows and thus does not alter the balance of trade. Targeted tax breaks do lower the cost to foreign buyers of a certain small slice of favored U.S. exports—the Congressional Research Service estimates that the FSC tax breaks only boosted exports by somewhere between two-tenths and four-tenths of a percent.² But the increased demand for those favored U.S. exports causes the dollar to appreciate in the foreign exchange market, squeezing some non-favored exporters out of international markets and exposing some domestic producers to increased import competition. In fact, according to the CRS

analysis, the FSC caused an increase in imports nearly equal to the increase in exports. As a result, “The impact [of the law] on the trade balance was probably negligible.”³

U.S. multinational companies do not need direct or indirect export subsidies to compete in the global economy. Despite complaints of an unfairly tilted playing field, America remains the world’s top exporter of manufactured goods. American companies have retained their edge even though the U.S. government has been more restrained than others in directly subsidizing exports. From 1990 to 2000, U.S. exports grew at a much faster rate (100 percent) than those of Germany (34 percent), France (36 percent), and Japan (66 percent), even though each of those three countries subsidized a much larger percentage of their exports than did the United States.⁴ The implicit export subsidies of the FSC/ETI are not only WTO-illegal, they are economically unnecessary.

A Clean and Simple Escape

Two proposals are being discussed in Congress to bring the U.S. corporate tax code into compliance with our trade obligations.

One proposal, championed by House Ways and Means Committee Chairman Bill Thomas (R-Calif.), would replace the FSC/ETI with a new set of tax incentives aimed at the same general group of companies that benefit from the existing law. The new tax incentives, however, would not be conditioned on export performance or the domestic content of offshore production. Among its many provisions, the Thomas proposal would extend a tax credit for research and development and create a six-month window of reduced rates on repatriated profits from U.S.-owned subsidiaries abroad.

A second proposal, a bill sponsored by senior Ways and Means members Philip Crane (R-Ill.) and Charles Rangel (D-N.Y.), would replace existing law with a new, lower tax rate for domestic manufacturers. Their proposal would lower the basic corporate tax rate of 35 percent by as much as 10 percent, or 3.5 percentage points, depending on the share of a firm’s income derived from domestic production of goods. The new regime would be phased in over five years. So far, the Crane-Rangel proposal has garnered a bipartisan list of more than one hundred cosponsors in the House.

Both proposals would fix the problem by ending tax incentives for export performance, although the Crane-Rangel proposal could be challenged on the grounds that it does not completely remove the offending section of the tax code until the end of a five-year phase-out period. Another

legitimate criticism of Crane-Rangel is that it targets the off-setting tax relief almost exclusively to manufacturing firms, a narrow but politically influential sector of the U.S. economy that in 2002 employed fewer than 13 percent of all U.S. workers.⁵

A third alternative would be a more neutral corporate tax code with a lower overall rate. If the FSC/ETI provision were exorcised entirely, the tax liability of U.S. corporations would rise by between \$4 billion and \$5 billion a year. All that money and a bit more could be returned to U.S. corporations by reducing the effective corporate tax rate by 1 percentage point on the estimated \$561 billion of taxable corporate income in 2003.⁶ The beauty of this approach is that it would be absolutely immune from any further challenge in the WTO, cleanly dodging the sanctions bullet, and would at the same time move the corporate tax code incrementally toward the flat-tax ideal of greater neutrality at lower rates.

Conclusion

Congress should seize the latest and final challenge to the FSC/ETI provision as an opportunity to clean up the corporate income tax code, dump an economically dubious provision, and reduce the tax burden on all U.S. corporations. U.S. multinational companies do not need subsidies or tax exemptions to compete in the global economy. Congress can bring U.S. law into conformity with our international obligations without sacrificing the competitiveness of U.S. companies in the global marketplace by cleanly removing the offending section of the tax code and returning the revenues to American producers.

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1. For a more detailed explanation of the U.S. trade deficit, see Daniel T. Griswold, “America’s Record Trade Deficit: A Symbol of Economic Strength,” Cato Trade Policy Analysis no. 12, February 9, 2001.
 2. David L. Brumbaugh, “The Foreign Sales Corporation (FSC) Tax Benefit for Exporting and the WTO,” Congressional Research Service, Publication RS20571, October 11, 2000, p. 3.
 3. *Ibid.*, p.3.
 4. Aaron Lukas, “Rethinking the Export-Import Bank,” Cato Trade Briefing Paper no. 15, March 12, 2002, pp. 9-11.
 5. Joint Economic Committee of Congress, *Economic Indicators*, March 2003, p. 14.
 6. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2004–2013* (Washington: U.S. Government Printing Office, January 2003), Table 3-8, “Taxable Corporate Profits,” p. 65.