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Responding to the Final Decision of the World Trade Organization Against the U.S. Extraterritorial Income Exemption Legislation

My name is Michael J. McIntyre, and I teach international tax and various other tax courses at Wayne State University in Detroit, Michigan. I thank the subcommittee for inviting me to participate in this hearing. In the time allotted to me, I will explain why I believe the United States should promptly repeal what the World Trade Organization has found to be an illegal export subsidy. I also will explain why I believe it best serves the interests of the American people and the American economy for Congress to support free trade by refraining from adopting any type of replacement for that subsidy.

History of U.S. Export Subsidies

The United States has provided a tax subsidy for exports since 1971. The subsidy was initially provided by granting tax deferral for export income earned through a U.S. corporation that qualified as a Domestic International Sales Corporation (DISC). In 1984, Congress largely replaced the DISC subsidy with an subsidy for export income channeled through a foreign corporation that qualifies as a Foreign Sales Corporation (FSC). The FSC legislation was adopted in an attempt to avoid conflicts with U.S. trading partners under the General Agreement on Tariffs and Trade (GATT).

In 1997, the European Communities, with support from Canada and Japan, challenged the FSC legislation before the World Trade Organization (WTO), asserting that it constituted an impermissible export subsidy. That FSC was an export subsidy was beyond debate. The issue was whether the United States would be able to get the WTO to accept certain technical arguments that the particular type of subsidy was not inconsistent with the language of the GATT. A final decision against the FSC subsidy was issued on February 24, 2000.

Congress responded in 2000 to the WTO decision against the FSC legislation by repealing FSC and enacting a new export subsidy called the Extraterritorial Income Exclusion Act of 2000 (ETI). ETI borrowed many features of FSC, but it avoided those features of FSC that the WTO had specifically cited as objectionable. Not surprisingly, the ETI legislation was again challenged by the European Communities, this time with support from Australia, Canada, India and Japan. The WTO again rejected the U.S. attempt at subsidizing exports in a broad-gauged opinion that evaluated the legality of ETI by reference to its substance rather than its form.

Congressional Options

The Congress of the United States must now decide how it should respond to the decision of the WTO. I suggest that Congress has the following four options:

(1) *Do Nothing*. Congress can do nothing and simply allow the United States to remain in violation of its international trade agreements. This option would open the United States to sanctions by our trading partners. More fundamentally, it would undermine the movement towards free trade that the United States has championed for over half a century.

(2) *Support Free Trade*. The most attractive option, from a public policy perspective, would be to support free trade by repealing the ETI provisions without any replacement. The virtues of free trade have been well known at least since the publication of *Wealth of Nations* by Adam Smith in 1776. Free trade — the removal of export subsidies and import barriers — strengthens a nation's economy and lifts the living standards of its workers. These benefits of free trade have been touted by politicians from both of our major parties in every election I can remember. As an added bonus, support for free trade and honoring our international agreements will foster improved relations with U.S. allies. Avoiding needless conflicts with our trading partners is particularly important at a time when we must rely on them for support in our efforts at combating international terrorism.

(3) *Grandson of FSC*. A third option, which is not really a practical option at all, would be to develop some revised version of ETI that would subsidize exports without violating the WTO agreements. The game of disguising a trade subsidy as a normal part of the tax code, however, is no longer winnable. The ETI legislation is skillfully drafted. It adopts a mechanism for delivering a subsidy to exporters that is export-neutral in form. It might even have been approved by adjudicators in some forums. It had little chance of approval, however, in a forum that is dedicated to upholding the substance of free trade

against the inevitable pressures from governments to obtain an unfair trade advantage over their trading partners. It should now be clear that the WTO is not prepared to uphold a U.S. export subsidy, however well disguised it may be. Further legislative efforts at hiding the subsidy will simply antagonize our trading partners.

(4) *Radical Reform.* The fourth option is to repeal ETI as part of a plan to repeal or radically modify the corporate income tax. One radical reform plan floated by some commentators is to adopt what they characterize as a "territorial" tax as a replacement for the corporate income tax. Another plan would substitute a broad-based consumption tax for the corporate income tax. The United States would not have a problem with the WTO if it repealed the corporate tax completely, and the territorial system also would be acceptable to the WTO as long as it was clear that it was not intended as a disguised export subsidy. These radical proposals, nevertheless, are disproportionate and inappropriate responses to the ETI problem, for reasons discussed in detail below. They also would not be helpful in dealing with the ETI problem unless they could be enacted quickly, before the ETI problem provokes a trade conflict that would be harmful to the U.S. economy and to U.S. interests abroad.[1]

Option 2 is the free-trade option, and options 1 and 3 are the anti-free-trade options. The case for adopting option 2 depends, therefore, on the strength of the case for free trade. I set forth that case below. I argue that the United States policy over the past half-century of fostering free trade has enriched Americans and strengthened the U.S. economy. I also argue that under the widely accepted theory of free trade, export subsidies distort trade patterns, resulting in a decline in worldwide welfare. Export subsidies do not produce, however, a net increase in jobs or economic activity in the exporting country even ignoring the likelihood that they would provoke retaliatory measures. In brief, free trade makes America richer, and export subsidies make us poorer.

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[1]I have two reasons for believing that radical reform of the corporate tax is unlikely in the near term. First, the radical reform proposals are likely to attract serious opposition from one or both political parties as their economic and political implications become better understood by Congress. Second, the radical proposals, if enacted in a revenue-neutral way, would shift tax burdens significantly — increasing taxes on some taxpayers and lowering them on others. I believe that Congress would find some difficulty in acting swiftly to raises taxes on a large segment of the voting public.

The radical reform proposals that I have labeled Option 4 should not be evaluated only or even primarily with respect to their potential for dealing with the ETI issue. Those proposals should be accepted or rejected — and I would hope rejected — based on their substantial impact on the distribution of U.S. tax burdens generally, with the trade issue being a relatively minor consideration.[2]

The only reason for considering the radical reform proposals in the context of a discussion of ETI is the claim of their proponents that enactment of one or the other proposal would stimulate U.S. exports. If the radical reform proposals would stimulate exports, they become variants of option 3. As a result, they are not an appropriate response to the ETI issue because, according to the theory of free trade, they would make America poorer rather than richer.

The radical reform proposals are also an inappropriate response to the ETI issue for another reason, namely that they are unlikely to actually stimulate U.S. exports. The impact on exports of income tax concessions is a complex issue, which I address in some detail below. I conclude that the impact of the radical reform proposals on exports is likely to be negligible. I reach a similar conclusion with respect to ETI itself. That is, I believe that income tax concessions directed at profits derived from exports or from foreign activities are likely to have little or no impact on the overall level of exports. Lobbyists seeking to retain or replace ETI apparently agree, for it seems unlikely that they would be working so diligently to preserve a tax subsidy if most or all of the benefits of the subsidy were being passed on to foreign consumers.

The Virtues of Free Trade

The primary purpose of the WTO is to promote and safeguard free trade. In playing a major role in the establishment of the WTO, the United States showed its commitment to free trade. It recognized that some international institution is needed to get national governments to give up their predilection to manage trade for the benefit of the few and to allow the free market to operate as Adam Smith envisioned.

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[2]In my view, these radical proposals have nothing to do with genuine tax reform. As the Enron debacle illustrates, the starting point for genuine corporate tax reform is to close off opportunities for offshore tax avoidance and evasion. The effect of both radical reform proposals, however, would be to enhance and legitimize those opportunities.

In the ETI case, the WTO has operated exactly as it was designed to operate. It correctly labeled ETI as an export subsidy and determined that the continued operation of ETI was inconsistent with U.S. treaty obligations. Any other decision would have struck a blow for protectionism and undermined the credibility of a major international institution that serves America's long-term economic and political interests and the long-term interests of its trading partners.

Some advocates of managed trade contend that ETI is necessary to allow American companies to compete against foreign firms that are obtaining export subsidies in their home country. They become vague to the point of incoherence, however, when they are asked to identify these foreign subsidies. If there are identifiable foreign subsidies, the proper U.S. response is to point them out and bring an action for relief to the WTO. The United States should not ignore the rule of law and take unilateral actions contrary to our international agreements. The precedent set by the WTO's decision in the ETI case should make it quite easy for any member of the WTO to challenge successfully any export subsidy that it is able to identify.

According to free-trade theory, export subsidies benefit the recipients of the subsidies at the expense of the general population and the national economy. If that theory is correct — and most commentators believe it is — then the WTO decision against the U.S. government will actually advance the best interests of the American public and the American economy if it leads to the demise of ETI. That is, the WTO decision can be a major victory for free trade and therefore a victory for America if Congress simply repeals ETI.

As a simplified illustration of the case for free trade, assume that Country A decides it wants to stimulate exports by providing a subsidy of $25 per spool for each spool of copper wire that is exported, provided that the exporter demonstrates that it lowered the price of copper wire in the foreign market by the full amount of the subsidy. XCo manufactures wire in Country A. It takes advantage of the subsidy to lower the unit price of its wire in foreign markets by $25, resulting in an increase in its exports. To meet the new demand, it hires some additional employees in Country A. So far, the subsidy seems to be working.

A trade subsidy, however, is unlikely to have just one effect. Assume that YCo is a domestic company that manufactures electric motors in Country A and sells them domestically and abroad. Copper wire is a major component of an electric motor. YCo's price for wire, which it buys from XCo, is not changed by the export subsidy. Its foreign competitors, however, can now buy copper wire at the subsidized price. As a result, they are able to reduce their price for electric motors in Country A and in foreign markets, creating competitive problems for YCo. As a result of the new competition, YCo experiences a reduction in its domestic and foreign sales of motors and is forced to reduce the number of employees at its production plant in Country A. Whatever jobs were gained from the expansion of XCo's business might be lost from the contraction of YCo's business. In addition, Country A is now paying the bill for an export subsidy that probably has added no new jobs and certainly has distorted normal trade patterns.

The above example may appear to be something of a special case. In a world of floating exchange rates, however, an export subsidy is likely to have negative effects on domestic production of unsubsidized products. The reason is that an export subsidy is likely to cause an increase in the relative value of a country's currency when currency exchange rates are set by the market. That increase obviously would affect trade flows. In general, the changes in trades flows would tend to wash out any economic benefits that a country would hope to obtain from pursuing a beggar-thy-neighbor trade policy.[3]

To illustrate the above point, assume that no companies in Country A manufacture electrical motors or anything else using copper wire. In that case, Country A would not have to be concerned that the export subsidy for wire would harm its domestic industries directly. Because of the currency-exchange effect, however, Country A almost certainly would be harmed by the export subsidy. The subsidy, by increasing the demand for the products of Country A in foreign markets, almost certainly would increase the value of Country A's currency relative to other currencies. As the following example illustrates, the expected result of the higher exchange rate would be an increase in imports into Country A and a loss of jobs in the businesses in Country A that make products in competition with the new imports,

The facts of this example are similar to the facts in the example above, with the additional facts that Country A uses the dollar as its currency, and Country B uses the franc. The exchange rate before the export subsidy for copper wire was one dollar for two francs. After the subsidy was granted and exports of wire increased, the value of a Country A dollar rose so that it now

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[3]When the DISC legislation was first under consideration in 1969, the value of the dollar was fixed as $32 per ounce of gold. When DISC was adopted in 1971, however, the United States had replaced the gold standard with a floating rate system. This change to floating rates made DISC obsolete just as it was going into effect. See Michael J. McIntyre, "DISC After Four Years: Reassessment Needed," 3 TAX NOTES 9-14 (September 29, 1975) (Based on testimony as invited witness before Ways and Means Committee, July 23, 1975).

commands three francs. Country B produces apples, which it sells for 30 francs a crate. The price of apples in Country A is 14 dollars (28 francs at the pre-subsidy exchange rate). Before the export subsidy caused the exchange rate to change, apples produced in Country B were not competitive with apples produced in Country A. After the exchange rate adjustment, however, a producer in Country B that sold apples in Country A for 10 dollars a crate could convert the proceeds into 30 francs. As a result, apples produced in Country B are now competitive in Country A, and exports of apples from Country B should be expected to go up. Producers of apples in Country A would lose sales, and jobs in the apple business in Country A would be lost.

In the above examples, the violation of free trade by Country A produced a bad result, for it and the rest of the world, even without any retaliation by Country A's trading partners. The worldwide economic costs of Country A's conduct would be magnified many times if other countries responded by erecting barriers to trade or by adopting their own export subsidies. One of the major purposes of the United States in helping to establish the WTO was to keep countries from making themselves poorer by behaving like Country A. Another major purpose was to prevent the almost inevitable disputes over trade practices from escalating out of control.

Why the Radical Proposals Do Not Solve ETI Problem

There are two major proposals for radical reform of the corporate income tax currently being floated. One is to convert the corporate income tax into a "territorial" system. The basic idea is that U.S. corporations would be exempt from tax on dividends, rents, royalties, interest, and other receipts from their foreign affiliates, and they would be able to more fully utilize foreign tax havens to avoid both U.S. taxes and the income taxes imposed by our trading partners. I call the territorial system "Enron on stilts" because of its clear potential for promoting unbridled tax avoidance and evasion.[4]

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[4]Some proponents of a territorial system assert, contrary to fact, that Canada operates a territorial system. For a discussion of the Canadian international tax system by a leading Canadian commentator and a clear refutation of the arguments being advanced for a territorial system, see Brian J. Arnold, "Comments on the Proposed Adoption of a Territorial Tax System in the United States," 25 TAX NOTES INT'L 1091-94 (March 11, 2002).

The tax revenue cost of moving to a territorial system would be many, many times the tax savings from the repeal of ETI. [5] As a result, its adoption would require a sharp increase in other taxes or a sharp increase in the budget deficit.

The other proposal for radical reform is to adopt some form of consumption tax as a replacement for the corporate income tax. One variant of this proposal is a European-style value-added tax (VAT). The European VAT is a tax on domestic retail sales collected in stages from manufacturers, wholesalers and retailers.[6] Another variant is a business activity tax (BAT), similar to the business-tax component of the Hall-Rabuska flat tax.[7] Both the VAT and the BAT have economic effects similar to a retail sale tax. That is, the burden of a VAT or a BAT would be passed on to consumers in the form of higher prices.

Advocates for these radical reform proposals obviously have agendas that extend well beyond ETI. They attempt to link their proposals to ETI by claiming that elimination of the corporate income tax on profits earned abroad would stimulate foreign sales of goods and services produced in the United States by making those goods and services cheaper in foreign markets. This claim is unsupportable. The U.S. corporate tax on foreign profits is not currently being paid by foreign consumers, so its elimination would not lower the price of goods and services in foreign markets.

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[5]A detailed revenue estimate of adopting a territorial system is not possible at this point, due in part to the lack of specificity about the intended features of the system. Some idea of the costs can be gotten by realizing that Enron enjoyed the benefits of a self-help territorial system through mechanisms that would become perfectly legal under a territorial system.

[6]In Europe, the VAT is imposed in addition to a corporate income tax.

[7]This business activity tax was promoted by the Kemp Commission in its 1996 report. Its appeal is due in part to the fact that it is likely to be a hidden tax on consumers. Quite comically, the particular form of value-added tax proposed by the Kemp Commission called for the imposition of the tax on exports and the exemption of imports from the tax. See Michael J. McIntyre, "International Aspects of the Kemp Commission Report," 70 TAX NOTES 607-609 (Jan. 29, 1996), reprinted in 12 TAX NOTES INT'L 417-420 (Feb. 5, 1996).

To be sure, in some quarters it seems to be an article of faith that the corporate income tax is passed on to consumers through higher prices.[8] There is little in the tax literature, however, to support that belief. According to standard economic theory, the price of goods and services in a market is set by supply and demand in that market. The U.S. corporate tax paid by a U.S. corporation is highly unlikely to affect significantly either the supply or the demand for goods and services in foreign markets. Consequently, the tax would not affect the price of those goods and services significantly.

Consider, for example, PCo, a U.S. manufacture of children's clothing that manufactures dresses in the United States for $10 and sells them in France for $20. French, German, Dutch and Italian companies are selling similar dresses for $20. Their cost of producing a dress is also $10. Now suppose the U.S. Congress adopts a corporate income tax that requires PCo to pay a tax of $3.50 (35% of $10) on the profits it earns on each dress sold in France. The officers and shareholders of PCo are unhappy with the tax and would like to pass some or all of the tax on to consumers. PCo can attempt to do so by advertising its dresses for a price above $20.[9] If it refuses to sell the dresses for the market price of $20, however, it will end up making no sales at all in the French market because it cannot control the supply or demand for dresses in that market. Because it is still making a good profit on its sales of dresses in France at $20, it has no incentive to forgo those sales.[10]

An argument I have heard on occasion in support of the proposition that an income tax cut on export profits would result in lower prices for exports is

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[8]In allowing U.S. corporations to claim a credit for foreign income taxes, Congress has implicitly treated those corporations as having paid the tax. If the tax is passed on to consumers, no credit should be allowed. See Michael J. McIntyre, THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES, Lexis Publishing (2000) at ch. 5/G.2.

[9]To fully pass on a 35% corporate income tax, PCo would need to sell its dresses for $25.39 each. That amount is determined as follows: If N equals the pre-tax profit on a dress and $10 is the after-tax profit, then N – (35% of N) = $10. Thus N = $10/0.65 = $15.3846, and the price necessary for PCo to bear no net tax burden would be $15.39 pre-tax profit + $10 cost = $25.39.

[10]The example is intended as a counter to the claim made by some supporters of export subsidies that U.S. corporate taxes paid with respect to profits on export sales are routinely passed on to foreign customers. The incidence of the corporate income tax is a complex and controversial issue. My own view is that the tax generally is paid by equity investors, although some portion of the tax may be shifted to workers and even to consumers under some circumstances.

that business executives set their prices so as to obtain a target after-tax profit. According to that argument, if the tax rate is cut, then business executives would cut their prices so as to maintain the same after-tax rate of return. I have not seen any empirical support for the argument. Its implausibility is illustrated by the following example.

Assume that Country A has an income tax with a top marginal rate of 39.6 percent. Among those paying at this rate are some wealthy doctors and lawyers. The legislature of Country A cuts the top marginal rate to 30 percent, resulting in a big tax reduction for the doctors and lawyers. How likely is it that the doctors and lawyers will respond to the tax rate cut by lowering their prices for medical and legal services in the hope of attracting more customers? I expect that few people would anticipate that the price for medical and legal services would be dropped. There is little reason to believe, moreover, that corporate executives seeking to maximize their profits would be more inclined than the doctors and lawyers to share their new-found tax benefits with their customers.

Conclusion

Of the four options available to Congress, only the second option — repeal of ETI without any replacement — is consistent with free trade and offers Congress an honorable and effective solution to its ETI problem. It is mistaken to think that some drafting wizard can come up with a new export subsidy that will reward the current beneficiaries of ETI and still pass muster with the WTO. It is equally mistaken to think that some embryonic plan for radical tax reform will suddenly solve the problem. The clear reality is that ETI must go if the United States is to satisfy its obligations under international law and maintain its position as a leader of the free-trade movement. It is equally clear that any alternative mechanism for stimulating exports, even one that is acceptable to the WTO, will simply distort trade patterns without increasing U.S. jobs or strengthening the U.S. economy. The best course of action for Congress is to stay the free-trade course that the United States chartered more than a half-century ago.

Although free trade can provide many economic benefits, it is not a free lunch. It can bring dislocations to communities and to workers when established businesses are unable to compete with foreign-based competitors. Many proponents of free trade, myself included, support the use of government authority to ameliorate hardships resulting from robust international competition. Programs that provide job retraining, unemployment benefits and community support are all consistent with a commitment to free trade. Free trade provides major economic benefits to the U.S.

economy, and those benefits should be shared equitably. Fortunately, the revenue generated from repeal of ETI is fully adequate to deal with the short-term dislocations of American workers that may result from that repeal.

A repeal of ETI presents Congress with a political dilemma. The costs to U.S. consumers and U.S. companies from the ETI export subsidy are substantially greater in aggregate than the benefits to the users of ETI. Those costs, however, are often hidden and diffused. In contrast, the benefits to the companies that use ETI are palpable and large. For example, a handful of U.S. airplane manufacturers garnered hundreds of millions of dollars in tax savings from FSC and presumably are benefitting similarly from ETI. I do not pretend to have a solution to this political dilemma. The best that those of us in the academic community can do is to make the case for repeal of ETI as forcefully and clearly as we can, with the hope that our defense of free trade will be helpful to Congress in resisting the inevitable political pressures for protectionism.