Appendix B
The US-EU Dispute over Border Tax Adjustments

Since 1971, the United States and Europe have been at odds over the taxation of exports. The drama revolves around the GATT/WTO distinction between indirect and direct taxes, the former adjustable at the border, the latter not. The distinction itself is based on a doubtful premise: that the economic burden of VAT, an indirect tax, falls on the purchasers of goods and services (like an excise tax on whiskey), while the economic burden of the corporate income tax, a direct tax, falls on the producers of goods and services (like a tax on real estate).[1]

While the distinction has no foundation in today's world of business taxation;[2] it became part of the GATT/WTO system in the early 1960s. Since the Nixon administration, the White House and Treasury have chosen not to fight a pitched battle with Europe over the arcane distinction made in trading system rules between direct and indirect taxes. Instead, starting in 1971, the White House and Treasury persuaded a willing Congress to enact a series of modest adjustments to the US corporate income tax to provide relief to US exporters.[3] The domestic international sales

1. In reality, VAT is nothing more than the sum of two direct taxes: a tax on labor value added and a tax on capital value added. In the absence of tax adjustments at the border, a competitive world economy for goods and services ensures that the economic burden of both the corporate income tax and VAT would fall primarily on the labor and capital that produce the goods and services rather than the purchasers who buy the final output.

2. The distinction between direct and indirect taxes originated in an earlier era, when excise taxes, customs duties, and property taxes were the main sources of public revenue. See Hufbauer and Gabyzon (1996).

3. In fact, the DISC had precursors in the China Trade Corporation (1939), the Western Hemisphere Trading Corporation (1942), and the Export Trade Corporation (1962). However, none of these was used nearly as extensively as the DISC.

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corporation (DISC) reduced the corporate income tax by about 12 percentage points on export earnings. The European Commission challenged the DISC in 1974, arguing that it violated GATT Article XVI dealing with export subsidies. The United States in turn challenged the territorial tax practices of Belgium, France, and the Netherlands under the same article. In 1976, a GATT panel affirmed both challenges in its *Tax Legislation Reports*. Thereafter, a tax truce was negotiated in the GATT Code on Subsidies and Countervailing Duties, part of the Tokyo Round of Multilateral Trade Negotiations concluded in 1979.[4] The truce was codified in a GATT Council Decision issued in 1981 (Hufbauer 2002).

In 1984, to fulfill its obligations under the GATT, Congress repealed the DISC and replaced it with the foreign sales corporation (FSC). The FSC reduced the corporate income tax by about 5.25 percentage points on export earnings. There matters stood, through the Uruguay Round of Multilateral Trade Negotiations concluded in 1994.

In 1997, the European Union broke 16 years of tax peace (dated from the 1981 Council Decision) and launched a WTO case against the FSC, contending that the FSC violated the Uruguay Round Code on Subsidies and Countervailing Measures (SCM).[5] Ignoring evidence that the FSC had been "grandfathered" into the Uruguay Round agreement (Hufbauer 2002), the WTO Appellate Body ruled against the United States in February 2000.

In November 2000, with bipartisan support, Congress enacted the Extraterritorial Income Act (ETI). The ETI was designed to answer the technical objections enumerated in the WTO Appellate Body report, while retaining the substance of FSC benefits. In December 2000, the European Union challenged the ETI, and in January 2002 the WTO Appellate Body held that the ETI, like the FSC before it, violated the Uruguay Round SCM Code. In August 2002, the WTO Arbitral panel authorized the European Union to impose $4 billion in countermeasures annually against US exports.

Congress then began the difficult process of repealing the FSC/ETI provisions, using the revenue, about $5 billion annually, to provide relief elsewhere in the corporate tax code. To accelerate congressional deliberations, in March 2004, the European Union began to impose retaliatory tariffs at a rate of 5 percent on selected imports from the United States,

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4. See Hufbauer and Erb (1984) and Hufbauer (2002) for a history of the tax truce. In the truce, European tax practices were shielded from further GATT/WTO scrutiny by a European commitment to observe the arm's-length pricing principle in transactions between a European exporting firm and its sales subsidiary located in a low-tax jurisdiction. Other GATT/WTO members make the same commitment. No one knows in practice how well these commitments are enforced.

5. The European Union's case was prompted not by commercial objections against the FSC, but rather as a diplomatic retort to successful US cases against EU import restrictions on beef and bananas.

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promising that the rate would rise 1 percent per month for 12 months unless the FSC/ETI was repealed. In October 2004, the House and Senate enacted a repeal bill, known as the American Jobs Creation Act of 2004 (AJCA), with numerous extraneous provisions and possibly costing $137 billion over 10 years (Edmund Andrews, "How Tax Bill Gave Business More and More," *New York Times*, October 13, 2004, 1). President Bush signed the AJCA into law on October 22, 2004, and the European Union agreed to lift its sanctions the day the law went into effect, January 1, 2005.[6]

Nevertheless, the fundamental tax tension between the United States and other trading powers, arising from the difference in border adjustment rules for direct and indirect taxes, was not resolved. It will linger for as long as the United States relies on the corporate income tax. US business firms will continue to complain about paying upwards of 15 percent VAT on their exports to Europe and other destinations, while facing competition in the US market from the European Union and other firms that pay no VAT. At this point, econometric analysis shows little evidence that a VAT system makes a difference to aggregate trade performance. Desai and Hines (2002) examined panel data on 168 countries from 1950 to 2000. Their analysis found that the countries using VAT systems actually have fewer exports, after allowing for several control variables. The authors speculate that these findings might be explained both by the tendency of countries to levy higher VAT rates on traded than nontraded goods, and by the tendency to underrebate input taxes when goods are exported.

Whatever the explanation for the Desai-Hines results, their findings provide little comfort to US firms facing the immediate burden of paying VAT on their exports while foreign competitors pay no VAT on sales into the US market. If the United States replaces the corporate income tax with a national retail sales tax or a corporate activity tax, it can adjust its business tax at the border under long-standing WTO rules, just like other trading countries. That change will, in a stroke, eliminate the source of transatlantic tax disputes.

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6. However, the European Union initiated a new round of WTO litigation to determine whether the US phases out FSC/ETI benefits at a sufficiently rapid pace (Chuck Gnaedinger, "EU Challenges US ETI Repeal Transition Rules," *World Tax Daily*, November 9, 2004, WTD 217-1). Pascal Lamy, the outgoing EU trade commissioner, implicitly linked the new round of litigation to the Boeing/Airbus dispute over launch aid (Edward Alden and Raphael Minder, "EU to Lift Sanctions on US but Warns on Boeing," *Financial Times*, October 26, 2004, 12).

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