



## End This Damaging Tax and Trade Charade

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US Congress is about to increase the tax burden on exports of American-made goods and services. Why? Because the World Trade Organisation says it must. To avoid a trade war, Congress will probably go ahead and repeal the Foreign Sales Corporation, a tax relief device that has been used in one form or another for 30 years. But when Congress does repeal FSC, it should call a halt to the charade that forces the US to tax its exports, while allowing other countries not only to exempt exports from value-added tax but also to impose VAT on imports from the US.

The WTO says this huge distortion of free trade - a net disadvantage for US exporters of more than \$100bn annually - is justified because our corporate income tax is a "direct" tax, whereas tax on value added is an "indirect" tax. That distinction is a pernicious fiction, created and perpetuated by trade mandarins, that has no place in either logic or fact and no place in America's trade relations. Enough is enough, and Congress should so declare.

When it repeals FSC, it should also call on the European Union and all other countries to join the US in correcting the mistaken distinction between direct and indirect taxes. Congress should simultaneously urge US trading partners to cease exempting their exports from VAT and cease imposing those taxes on imports. If they do not amend their tax practices within a decent period, the US tax code should at least be amended to exclude export income from US corporate income tax and allow American-made goods and services a fair opportunity to compete in world markets.

The mistaken distinction between direct and indirect taxes dates from the late 1960s, when the French were converting their old "cascade" taxes on gross business receipts to new taxes on net business income that later came to be called value-added taxes. The French desperately wanted to exempt exports from VAT and impose it on imports, so their trade mandarins pretended that VAT was an indirect tax, like the duty on whisky. Our trade mandarins acquiesced, because that was the era of European reconstruction and dollar shortages. All the US asked was leeway to reduce the corporate tax on exports, a request that was consistently denied by the EU, the General Agreement on Tariffs and Trade and its successor, the WTO. Today, the pretence is all that remains - and the enormous artificial trade advantage enjoyed by the EU and others.

For more than three decades, Congress has laboured under the false impression that basic principles of international law and economics having to do with direct and indirect taxes

require the US to tax its exports in full - unless it joins other industrial countries and adopts a VAT system. Deep political misconceptions have made it impossible for Congress to consider the merits of value-added taxation. The EU and others, as part of a prolonged game of "Gotcha", have insisted that the only way the US can ever exempt its exports from tax is to adopt the European tax system. Who can blame the Europeans? In 1970, they pulled off one of the biggest trade heists in history and they want to keep their multi-billion-dollar advantage - even though it is based on a false premise.

The false premise is the assumption that the economic burden of the VAT falls totally and uniformly on the purchasers of goods and services (like an excise tax on whisky), whereas the economic burden of the US corporate income tax falls totally and uniformly on the producers of goods and services (like a tax on property). But the predominant view today is that, in the absence of tax adjustments at the border, the economic burden of both corporate income tax and VAT falls primarily on the labour and capital that produce goods and services. In this sense, both taxes are direct taxes.

Whatever may have caused past presidents and Congresses to accept the false distinction between direct and indirect taxes, this Congress and this president should re-examine the issue as they repeal FSC, and think about what comes next. There is a compelling need for a coherent policy on the role that taxes play in distorting free trade. The stakes are high, payable in US jobs in sectors that make traded goods and services. In a global trading system free of distortions, US jobs lost to foreign competition are usually replaced by even better ones. But when US jobs go overseas because of tax distortions, something is badly wrong.

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