Statement of
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U.S. Trade Representative
before the
Committee on Finance
of the
U.S. Senate
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Chairman Baucus, Senator Grassley, and Members of the Committee:

First and foremost, I want to thank you, Chairman Baucus, Senator Grassley, and other conferees on the Trade Promotion Authority legislative package for completing your work last week and for producing a strong conference report. I appreciate your leadership, persistence, cooperation, and support. You have broken through a logjam that held back America's trade leadership for eight years.

With the successful vote in the House of Representatives late last week, the President has urged the Senate to complete action this week before its August recess. A great deal rests on Senate passage this week.

As this Committee knows, time is of the essence. As President Bush has stressed, TPA sends an important signal to the American people that the Executive and Legislative branches are working together to strengthen the American economy and open new markets for our workers, farmers, and consumers. Overseas, the four Andean countries have lost their trade benefits under the Andean Trade Preference Act (ATPA) since May 16, 2002; the economic costs for these four fragile democracies have been great - - and equally important, the political signal of U.S. interest in and support for them needs this boost at a time of stress in the hemisphere. With new Presidents being inaugurated in Bolivia and Colombia on August 6 and 7, respectively, Senate passage this week would be auspicious and greatly encouraging.

African countries are eager to receive the political and economic support of the African Growth and Opportunity Act enhancements (AGOA II). And 116 developing economies have been without the special trade access afforded by the Generalized System of Preferences since that law expired on September 30, 2001.

We also want to use rapidly the new TPA authority to take the offense on America's trade negotiating agenda. Just last week, the Administration – with the advice and support of Chairman Baucus and Senator Grassley – launched a far-reaching proposal in the global Doha WTO negotiations to liberalize the world agricultural trade. With TPA, our proposals will be propelled with added force.

Thank you again for your special leadership, and I hope we can work together this week to finish the job.

I also want to thank you, Mr. Chairman, as well as Senator Grassley and other Members of the Finance Committee, for addressing the FSC/ETI issue.

Since Deputy Secretary of the Treasury Dam will speak to the tax policy issues, I would be pleased to comment on the trade aspects of this problem. In particular, I will discuss the reasons why a legislative solution is necessary to ensure that the United States complies with its international obligations, so as to avoid economically damaging trade retaliation. Such sanctions, if imposed, would harm American workers, farmers, and businesses.

Over the course of some 30 years, a number of Congresses and Administrations have devised and revised U.S. tax laws – such as the Domestic International Sales Corporation (DISC) provisions, Foreign Sales Corporation (FSC) provisions, and the provisions of the Extra-Territorial Income Exclusion (ETI) Act – to try to enhance the international competitiveness of the United States. When other countries challenged the consistency of these policies with international trade rules, various Administrations defended them vigorously.

The most recent chapters in this account began in October, 1999, when a WTO panel found against the FSC provisions, a position sustained on appeal in February, 2000. After the United States sought to comply with the WTO ruling in November, 2000, by making various technical amendments through the ETI, a WTO panel determined in August, 2001, that the ETI changes were insufficient to come into compliance. To highlight the significance we placed on this matter, Deputy Secretary Dam led the U.S. legal defense efforts on appeal. Nevertheless, on January 14 of this year, the WTO Appellate Body again ruled against the United States.

Notwithstanding the best efforts of different Administrations, the GATT – and now the WTO – has found consistently that the FSC/ETI tax exemption is a prohibited export subsidy. Now we must look to alternative ways of enhancing U.S. competitiveness other than through the FSC-type tax regime.

On May 2 of this year, President Bush announced his commitment to "work with our Congress to fully comply with the WTO decision on our tax on foreign sales corporations." We now have the need – and the opportunity – to strengthen U.S. competitiveness by making appropriate changes to the U.S. tax system. I defer to my Treasury colleagues on the nature of such changes. However, I have noted that there seems to be a growing group of experts – including Eric Engen of AEI, William Gale of the Brookings Institution, Stephen Entin of the Institute for Research on the Economics of Taxation, William Reinsch of the National Foreign Trade Council, and former Chairman of the Ways & Means Committee Bill Archer – who believe that changes to the U.S. tax system and laws on international tax policy could be useful, and that the current rules in this area diminish – rather than enhance – U.S. competitiveness.

The status of the FSC/ETI case with the WTO is as follows. In finding that the ETI Act – the successor to the FSC – continues to provide a prohibited export subsidy, the WTO Appellate Body made the following principal findings:

(1) The Act confers a subsidy by exempting from taxation income that would be taxed under otherwise applicable U.S. tax rules.

(2) This subsidy is export contingent insofar as U.S.-produced goods are concerned, because the subsidy is provided only if those goods are exported.

(3) This export subsidy is not protected as a measure to avoid double taxation of foreign-source income because, among other things, the Act systematically results in a tax exemption for domestic-source income.

Although the Appellate Body's findings were disappointing, they were in line with the conclusions of previous GATT and WTO panels. The upshot is that it has become clear that simply altering the FSC/ETI regime through a new mechanism for delivering the same benefits will not be found compliant with WTO rules. Instead, we need real legislative reform.

With the issuance and subsequent adoption by the WTO of the Appellate Body report, the WTO arbitration proceeding to determine the amount of retaliation to which the EU is entitled has resumed. Under a procedural agreement the United States reached with the EU in September, 2000, this arbitration was suspended pending the outcome of the EU's challenge to the ETI Act. In the arbitration, we have challenged the EU's claimed amount of $4 billion, and have argued instead that the EU is entitled to no more than $1.1 billion in retaliation. We expect a decision from the arbitrators in coming weeks.

However, even if we prevail in the arbitration, $1.1 billion is still a sizable retaliation figure. Any retaliation of that magnitude against U.S. exports would be extremely damaging to American workers, farmers, and businesses.

Pascal Lamy, the European Commissioner for Trade, has stated publically that his focus is on U.S. compliance with the WTO ruling, and that he would prefer to avoid retaliation if possible: "The name of the game is not retaliation; the name of the game is compliance." He also has told me that he understands that making meaningful revisions to the U.S. tax system is a complex process that takes some time. Accordingly, the EU has been willing to forego retaliation against U.S. exports if the United States demonstrates serious progress toward compliance, including pointing to a path to completion.

In addition, Commissioner Lamy has emphasized that the EU will not link the FSC dispute to other disputes, so that the EU will not exercise its FSC retaliation rights in order to influence the resolution of other differences.

We have been able to manage this dispute and hold off EU retaliation by explaining the Administration's intention to come into compliance and by pointing out the challenges of Congressional consideration of these tax policy topics. To continue to manage the dispute constructively, we need to be able to point to serious progress by the Congress, working in conjunction with the Executive branch. Therefore, if the United States is to avoid large trade retaliation by the EU, it is important that Congress take legislative action to bring the United States into compliance.

Fortunately, we have been able to show some progress. We appreciate that you, Mr. Chairman, and Senator Grassley, have been willing to meet informally with Ways & Means Committee Chairman Thomas and Ranking Member Rangel, along with the Administration, to address this problem. I know that you, Mr. Chairman, have taken the lead in previous bipartisan efforts to reform our international tax rules. Committee Chairman Thomas and Ranking Member Rangel have written to Secretary O'Neill and me on May 21 to express their support for a legislative solution. They explained,

> "we will work to pass legislation that maintains U.S. competitiveness and follows WTO rules now and as they may exist in the future. Therefore, we are committed to pursuing legislative options that meet these dual goals."

Like you and like them, I support the need for a reform of our international tax rules that increases U.S. competitiveness.

In addition, the Ways & Means Committee has held several rounds of hearings to explore the history of the problem, the current situation, and possible solutions. There was a consensus among those testifying that simply altering the FSC/ETI regime in a manner that maintains the same distribution of benefits will neither meet the requirements of the WTO ruling nor serve America's competitive interests. Chairman Thomas has introduced the American Competitiveness and Corporate Responsibility Act of 2002 (H.R. 5095), and has expressed his desire to move a bill forward.

I would urge the Senate to move equally expeditiously to address this problem through legislation.

The EU, of course, understands that the U.S. Constitution requires legislation to be passed by both the House and the Senate before it can be presented to the President for signature to become law. Nevertheless, the European Commission is likely to turn to retaliation if the Congress is perceived as making little or no progress regarding implementing legislation.

In coming weeks and months, I expect that the European Commission is likely to publish draft retaliation lists for public comment. I expect the EC will then prepare a final list, even as it considers the prospects for Congressional action.

I am aware of the preference of some to hold off on implementing legislation and to seek a solution to this matter in the new global trade negotiations that we launched in Doha last November. While I appreciate the apparent appeal of deferring the problem through negotiations, I need to advise you that a strategy based on this approach will not avoid trade retaliation.

To begin with, there is a problem of timing. We just began the Doha Development Agenda, and it is not even scheduled to be completed until 2005. And that is assuming that everything goes as planned.

In the meantime, we are faced with a WTO finding that the United States is in violation of the current rules. We cannot justify non-compliance on the grounds that we are attempting to negotiate a change in the rules by which we lost. If the shoe were on the other foot, we would not accept such an approach.

As a practical matter, the EU is highly likely to retaliate if we take this course.

Thus, the United States will have to come into compliance with our obligations well before the global trade negotiations are due to conclude.

For the longer-term, Congress has stated an interest in pressing in the Doha negotiations to change the current GATT/WTO rules concerning taxes, and particularly addressing the way in which those rules treat indirect taxes differently from direct taxes, such as income taxes. Congress has also sent a very strong signal about not renegotiating this area of WTO rules, which concern topics such as subsidies that underpin U.S. laws against unfair trading practices. Since a push on the tax items would be part of larger negotiations, we will need to consider together the possible tradeoffs and changes that others might seek from the United States in return.

Finally, I would note that Congress included the objective of changing WTO rules on direct and indirect taxes in setting negotiating goals for the Tokyo and Uruguay Rounds, but there was no consensus in support of the U.S. proposals in those rounds.

My colleagues in the Administration with responsibility for tax policy are the appropriate ones to offer counsel on what should replace the DISC/FSC/ETI. However, as a trade official, I can say that it is critically important that the United States, as the world's largest exporter, support the credibility of the multilateral trading system by following the rules of that system. To do so, we need to revise our tax system to come into compliance with our WTO obligations *and* simultaneously make America more prosperous by reforming our own international tax policies.

In conclusion, I greatly appreciate the Finance Committee's willingness to face this issue, difficult though it is. I would be pleased to continue to work together with you to bring the United States into compliance with its international obligations and to ensure that our tax system enhances the international competitiveness of U.S. businesses. Thank you.