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European Trade Retaliation: The FSC-ETI Case

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Summary

The European Union (EU) on March 1, 2004, began imposing retaliatory duties of 5% on selected U.S. exports in the dispute over U.S. compliance with a World Trade Organization (WTO) ruling involving the Foreign Sales Corporation (FSC) and its successor Extraterritorial Income Exclusion (ETI) export tax regime. Despite final passage on October 11, 2004, of legislation (H.R. 4520) that repeals the ETI-FSC tax benefit, the EU did not act to end the sanctions until January 21, 2005. On that day EU member states approved a new regulation to end the tariffs retroactively from January 1, 2005, but also to re-impose the sanctions on $2.4 billion of U.S. goods if the WTO should rule later this year that the new U.S. tax law, the American Jobs Creation Act (P.L. 108-357), also contains provisions that are violative of WTO rules. Specifically, the EU is challenging provisions under Section 101 of the Jobs Act. This section allows U.S. exporters to continue to benefit from FSC/ETI tax breaks through the end of 2006 for all export transactions and "grandfathers" export breaks for some existing contracts, in particular leasing arrangements, that the EU claims will benefit companies such as Boeing, Microsoft, and Catepillar. Both the Bush Administration and a number of members of Congress have argued that this EU challenge is needlessly prolonging the dispute. This report describes the EU action within the context of the WTO, evaluates the EU retaliation list, and assesses possible consequences of EU retaliation. The report will not be updated.

Trade Retaliation and the WTO

Retaliatory tariffs that have been implemented by the EU stem from a continuing delay by the United States to comply with WTO rulings. The WTO found that U.S. tax legislation (the FSC and ETI provisions) relating to export income constitute an unacceptable export subsidy under the Agreement on Subsidies and Countervailing Measures. When the WTO arbitrator determined on August 30, 2002, that the EU could impose tariffs on $4 billion (an amount roughly equal to the annual value of the U.S. export subsidy) of U.S. exports, EU officials indicated they would not apply the tariffs as long as the United States was making progress towards WTO compliance. However,

upon receiving final WTO authorization to retaliate on May 7, 2003, EU officials stated they would begin imposing tariffs by January 1, 2004, if the repeal of these tax provisions was not signed into law by then. In November 2003, EU officials again delayed the imposition of the retaliatory tariffs until March 1, 2004, provided that Congress passed legislation to bring the United States into compliance with its WTO obligations. While bills (H.R. 2896 and S. 1637) that would repeal the ETI over a three-year transition period were reported out of both the House and the Senate tax-writing committees in 2003, there was no floor action on the bills in either chamber prior to March 1, 2004.[1]

Subsequently, the Senate passed its ETI repeal bill (S. 1637) by a vote of 92-5 on May 11, 2004. The House passed its bill (H.R. 4520) by a vote of 251-178 on June 17. The Senate voted July 15 to replace the language of the House-passed bill with the wording of its own bill, a procedural step necessary to take the two bills to conference, and also appointed conferees. In October 2004, conference agreement was reached and President Bush signed the bill, which became know as the American Jobs Creation Act, into law (P.L. 108-357).

This current episode of trade brinkmanship is being fought out under the auspices of the WTO's Dispute Settlement Understanding (DSU). According to the DSU, a WTO member found to have violated WTO obligations is expected to comply by withdrawing or eliminating the offending measure. If the complaining party believes that the other Member has not complied by the end of the compliance period, it may negotiate a compensation agreement or it may ask the Dispute Settlement Body for authorization to suspend concessions (usually the imposition of higher duties on items from the other country). The purpose of "suspension of concessions," which is referred to interchangeably as retaliation or countermeasures, is to restore the balance of concessions that existed before the adoption of the rule or provision that had been nullified, as well as to serve as an incentive for compliance.[2]

Since the WTO went into effect in 1995, the United States has imposed retaliatory duties on EU exports in two cases: bananas and beef. In both cases, after many years of litigation, the WTO found in favor of U.S. petitions alleging that an EU import ban on beef treated with hormones and a system of import quotas for bananas were discriminatory and violated WTO rules. In 1999, EU offers of compensation for lost exports in lieu of lifting its beef hormone ban or changing its banana regime were rejected by the United States and 100% tariffs were imposed on $307 million ($191 million for the banana case and $116 million for the beef case) of imports from the EU, principally luxury products such as Danish ham, truffles, Roquefort cheese, and Italian handbags. Exports from Britain, Spain, and France were mostly targeted in the banana case and exports from France, Germany, Italy, and Denmark in the beef case, because these countries were deemed most responsible and supportive of the discriminatory policy in

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[1] For background and summary of this dispute, see CRS Report RS20746, *Export Tax Benefits and the WTO: The Extraterritorial Income Exclusion and Foreign Sales Corporations*, by David L. Brumbaugh.

[2] For elaboration see, CRS Report RL32014, *WTO Dispute Settlement: Status of U.S. Compliance in Pending Cases*, by Jeanne J. Grimmett.

the respective cases.[3] Although the United States in 2002 lifted the 100% retaliatory duties related to the banana case after changes in EU policy, the tariff on beef remains in effect today.

For its part, the EU came to the brink of imposing retaliatory tariffs in reaction to President Bush's March 2002 decision to provide the U.S. steel industry with safeguard tariff protection. Claiming that this action violated the WTO safeguard agreement, the EU won its challenge before the WTO and was prepared to impose retaliatory tariffs against $2 billion in U.S. exports. In drawing up its retaliation list, the EU targeted goods made in states that are considered swing states in the presidential election. As shown in Table 1, **U.S. Sectors on Steel Retaliation List,** categories of *steel, textiles and apparel*, *citrus* (found in the vegetables, edible fruits, and nuts category) and *fruit juice* accounted for 53% of the total trade targeted. Ohio, Pennsylvania, and West Virginia are prominent steel producing states, the Carolinas prominent textile and apparel producing states, and Florida a prominent citrus producing state (California also is a large citrus producer but exports a relatively small amount to Europe).

While U.S. trade officials argued that President Bush's December 4, 2003 decision to lift the steel tariffs was made "independently," (i.e., not influenced by the EU threat of retaliation), many observers opined that the potential loss of export sales and jobs in politically sensitive states may also have played a role. And on December 5, 2003, Pascal Lamy, the EU trade commissioner, announced that he would use the same tactics in pressuring the U.S. to comply in the FSC/ETI dispute. Mr. Lamy emphasized that the EU's key goal is compliance and that it would not change its March 1, 2004 deadline.[4]

FSC Retaliation List

Unlike the steel dispute, Congress, not the President, has to take action to bring U.S. law into conformity with WTO obligations in order to settle the FSC/ETI case. Perhaps with this important difference in mind, the EU drew up a retaliation list that appears much more diffuse in terms of geographic impact on producers and states than in the steel case where retaliation was concentrated in a few states arguably pivotal to next November's presidential election. The list tilts heavily towards a large number of products that seemingly could be made just about anywhere in the United States. The list also excludes politically sensitive products such as citrus fruits, orange and grapefruit juice, cigarettes, apples and rice that were on the steel list. Steel and textile and apparel products are also targeted less heavily. To avoid disruption to EU production, the list is also skewed towards consumer goods rather than component parts or intermediate goods.

As shown in Table 2, **U.S. Sectors on FSC/ETI Retaliation List,** the *precious stones* and *jewelry* sector, is most heavily targeted. Accounting for 36% of the total trade targeted but less than 3% of total U.S. exports to the EU, this sector consists of products such as diamonds, gold, silver base metals and jewelry. Major jewelry producing states

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[3] Higher tariffs are intended to increase the cost of targeted items to consumers and, thus, lead to declining purchases. Companies and workers hurt by declining sales, in turn, could be expected to lobby their representatives for a change in policy.

[4] Cowell, Alan, "Europeans Plan to Press For Tariffs Against U.S.," *New York Times,* December 5, 2003, p. B1.

include New York, Massachusetts, Rhode Island, and to a lesser extent California, Florida, Texas, New Mexico, and New Jersey.

The next four sectors impacted most heavily — *machinery* and *mechanical appliances, wood and paper articles, leather* and *leather articles,* and *toys and sports equipment* — account for 35% of the total targeted trade. Products listed from these sectors also could be made in many different states and regions of the United States. For example, in the machinery and mechanical appliances sector, products such as piston engines, hydraulic turbines, refrigerators, household scales, cranes, fork-lift trucks, and machine tools are included. The wood and paper products sector includes products such as particle board, building materials, plywood, wood panels, paper and paperboard, wallpaper, toilet paper, note books, and unused postage stamps. The leather sector comprises products such as raw hides and skins, and articles of leather such as handbags, briefcases, and gloves. And the toys and sports equipment sector includes such items as doll carriages, dolls, electric trains, billiard tables, cross country and downhill skis, tennis racquets and balls, ice skates, and fish-hooks.

As shown in Table 3, **Major U.S. Sectors Excluded From FSC/ETI Retaliation List,** sectors totally left off the retaliation list account for close to 40% of U.S. exports to the EU. In addition, exports from the two largest U.S. export sectors (machinery and electrical machinery) were targeted minimally (less than $1 billion of the $49 billion in exports from these sectors). As these latter two sectors account for 34% of U.S. exports to the EU, it can be seen that close to 75% of U.S. exports to the EU were basically non-targeted.

The non-targeted sectors are characterized by massive amounts of cross-investment and intra-industry trade that integrates markets tightly. Trade data, for example, show that the seven largest categories of U.S. exports to the EU (machinery, electrical machinery, optical equipment, aircraft, vehicles, organic chemicals, and pharmaceuticals) are also among the top nine categories of imports from the EU. These seven sectors accounted for 70% of U.S. exports to the EU and 61% of imports from the EU in 2002.[5] Many of the products in these key sectors, such as aircraft parts, auto parts, and chemicals, are components in products that EU companies export back to the U.S. or components in products that European subsidiaries of U.S. companies use in their production process. Other items such as optical devices and medical equipment may not necessarily be produced in the EU. Most of the exports from the machinery and mechanical appliances and electrical machinery sectors were left off the list as well, due perhaps to similar concerns about hurting or disrupting EU producer interests.

Possible Consequences

The economic consequences of the EU tariffs are likely to be relatively mild during the first year. Political repercussions could be more significant.

Given that Brussels was permitted to impose 100% tariffs on $4 billion of U.S. exports, the EU decision instead to impose the escalating tariff beginning at 5% and

[5] Data from the World Trade Atlas, a subscription trade statistics database, was compiled by J. Michael Donnelly, Information Research Specialist, CRS.

culminating at 17% a year later indicates restraint. A 100% tariff on $4 billion of U.S. exports could cause most trade in the targeted products to dry up after a short period of time. But due to the fact that the dollar has depreciated against the euro by about 40% over the past two years, making U.S. goods considerably cheaper, most affected U.S. exporters can probably absorb the added cost imposed by the higher escalating tariff for a number of months, if not a year, and still maintain market share. What happens after a year would depend on what the EU decides to do about the tariff and the value of the dollar versus the euro.

A number of U.S. companies and workers affected by the retaliatory tariffs have complained bitterly to their representatives. These complaints, in turn, have provided impetus to passage of the repeal legislation, contained in H.R. 4520, the American Jobs Creation Act of 2004.

Table 1. U.S. Sectors on EU Steel Retaliation List

Sector (Harmonized System 2-Digit Level)	Percent of Total U.S. Exports to EU-15, 2002	Estimated Value Targeted (millions of dollars)	Percent of Total Targeted
Steel (HS, 72, 73)	0.8	572	25.7
Cotton, Textiles, Carpets, and Footwear (HS 61, 62,63,64)	0.3	488	21.9
Paper Products (HS 48)	0.7	359	16.1
Vegetables, Edible Fruits & Nuts (HS 7,8,10)	0.8	252	11.3
Yachts and Pleasure Boats (HS 89)	03	192	8.6
Processed Food-Primarily Orange and Grape Fruit Juice (HS 20)	0.2	116	5.2
Furniture and Bedding (HS 94)	0.5	87	3.9
Optical Equipment (HS 90)	9.8	63	2.9
Tobacco (HS 24)	0.5	41	1.8
Machines and Mechanical Appliances (HS 84)	22.5	28	12
Misc. Manufactures and Sports Equipment (HS 95,96)	0.7	26	12

Sources: European Commission and World Trade Atlas.

Table 2. U.S. Sectors on EU FSC/ETI Retaliation List

Sector (Harmonized System, 2-digit level)	Percent of Total U.S. Exports to EU-15, 2002	Estimated Value Targeted (euros in millions)	Percent of Total (Targeted)
Precious Stones and Jewelry (HS 71)	2.1	1,431	36.0
Machinery and Mechanical Appliances (HS 84)	22.5	627	15.6
Wood and Paper Articles (HS 44, 48, 49)	2.1	300	7.5
Leather Articles Thereof (HS 41, 42, 43)	0.1	289	7.2
Toys, Games, Sports Equipment (HS 95)	0.6	181	4.5
Copper and Aluminum Articles (HS 74, 76)	0.4	181	4.5
Electrical Machines (HS 85)	11.8	146	3.6
Cotton, Textiles, and Footwear (HS 61, 62,63, 64)	0.4	139	3.4
Vegetables, Fruits, Grains, and Oils (HS 7, 8, 10, 11, 12, 15)	2.2	138	3.4
Iron and Steel (HS 72, 73)	0.8	131	3.2
Certain Prepared Foods and Food Residues (HS 19, 20, 21, 23)	1.3	123	3.0
Ceramic Glass Products (HS 69, 70)	0.5	113	2.8
Meat and Dairy (HS 1, 2, 4, 5)	0.2	72	1.8
Prepared Foods and Sugar (HS 16, 17)	0.1	71	1.7
Tools, Implements (HS 82, 83)	0.6	88	2.2

Sources: European Commission and World Trade Atlas.

Table 3. Major U.S. Sectors Excluded from EU FSC/ETI Retaliation List

Sector (Harmonized system 2-digit Level)	U.S. Exports to EU-15 in 2002 (Dollars in millions)	Percent share of U.S. Exports to EU-15
Optical and Medical Equipment (HS 90)	14,104	9.82
Aircraft/Spacecraft (HS 88)	13,055	9.09
Vehicles/Not Railway (HS 87)	8,032	5.59
Organic Chemicals (HS 29)	7,282	5.07
Pharmaceuticals (HS 30)	6,985	4.86
Plastics (HS 39)	4,211	2.93
Art and Antiques (HS 97)	1,595	1.11
Totals	**$55,264**	**38.47**

Sources: European Commission and World Trade Atlas.