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European Trade Retaliation: The FSC-ETI Case

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Summary

Foreign Sales Corporations (FSCs) are subsidiaries of U.S. companies that conduct export sales on the behalf of their parents and the ETI is a successor tax regime. The FSC law initially was found to be inconsistent with U.S. WTO obligations in early 2000. Following the ruling, Congress passed the replacement ETI tax provision, but this law was also found inconsistent with WTO obligations in 2002. Subsequently, the WTO authorized the EU to retaliate in the absence of U.S. compliance, and the EU began imposing escalating retaliatory duties (starting at 5%) on $4 billion of U.S. exports on March 1, 2004. After reaching 14% in December 2004, these sanctions were lifted in January 2005 subsequent to congressional repeal of the FSC-ETI provisions in the American Jobs Creation Act (P.L. 108-357) of October 2004. But a February 12, 2006 WTO ruling determined that the act perpetuated the illegal subsidies with a two-year phase-out of the tax breaks and a grandfather clause covering exporters that had sales contracts dated before September 17, 2003. In announcing the EU's decision to reimpose sanctions, Peter Mandelson, the EU's top trade official, said that "the EU will not accept a system of tax benefits which give U.S. exporters, including Boeing, unfair advantage against their European competitors." The EU had planned to reimpose the sanctions on May 16, 2006, but Congress passed on May 11, 2006, a tax bill which, among other things, repealed the grandfathered FSC-ETI benefits for sales contracts and leases. Subsequently, the EU repealed the countermeasures, thus ending one of the longest-running and most bitter transatlantic trade dispute in recent years. This report describes the EU action within the context of the WTO, evaluates the old EU retaliation list, and the outcome. The report will be not be updated.

Trade Retaliation and the WTO

The initial round of retaliatory tariffs implemented by the EU stemmed from a delay by the United States to comply with WTO rulings. The WTO found that U.S. tax legislation relating to export income constituted 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. When there was no floor action on bills introduced to bring the U.S. into compliance, the EU on March 1, 2004, began imposing retaliatory duties (starting at 5%) on $4.0 billion of U.S. exports.[1]

Subsequently, the Senate passed its ETI repeal bill (S. 1637) by a vote of 92-5 on May 11, 2004 and the House passed its bill (H.R. 4520) by a vote of 251-178 on June 17. In October 2004, conference agreement was reached and President Bush signed the bill, which became known as the American Jobs Creation Act, into law (P.L. 108-357). As a result, the EU suspended retaliation effective January 1, 2005, but moved to challenge the legality of certain provisions (transitional arrangements for its abolition and the "grandfathering" benefits for U.S. corporations that had already signed contracts) in the repeal. In early 2006, the WTO's Appellate Body agreed with an earlier compliance panel that the U.S. repeal legislation failed to comply with its WTO obligations because of the grandfathering and two-year transition period under which the FSC-ETI benefits would be phased out. On January 31, 2006, the EU adopted a regulation (171/2005) providing for the reimposition of retaliatory duties by May 16, 2006. But the countermeasures were never imposed due to the fact that Congress as part of the May 11, 2006 "Tax Increase Prevention and Reconciliation Act" repealed the grandfathered FSC-ETI benefits.

This trade dispute was 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]

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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 (name redacted).

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 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—a matter of considerable continuing dispute between the two sides.

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 EU 2002 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).

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 appeared 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 tilted heavily towards a large number of products that seemingly could be made just about anywhere in the United States. The list also excluded 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 were also targeted less heavily. To avoid disruption to EU production, the list was also skewed towards consumer goods rather than component parts or intermediate goods.

[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.

As shown in **Table 2**, **U.S. Sectors on EU 2003 FSC/ETI Retaliation List,** the *precious stones* and *jewelry* sector, was 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 included 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 EU 2003 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.[4] 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.

Outcome

If Congress had not acted on May 11, 2006, to repeal the grandfathered FSC-ETI tax benefits, the EU planned to reimpose the sanctions by May 16, 2006. Given the value of the tax breaks that remained at the time, the EU reportedly planned to reimpose sanctions (a 14% additional tariff) on $2.4 billion of U.S. exports—an amount of retaliation that would yield around an additional

[4] Data from the World Trade Atlas, a subscription trade statistics database, was compiled by (name redacted), Information Research Specialist, CRS.

$330 million. This tariff rate would not be raised over time, unlike the previous FSC retaliation revoked after Congress repealed the FSC in 2004. The EU added no new tariff items to the 2005 retaliation list, but some products codes were eliminated from the 2003 list (EU regulation 171/2005 adopted January 31, 2005, contains the revised list).

The EU's plan to reimpose sanctions aroused a strong U.S. reaction. The Office of the U.S. Trade Representative issued a statement urging the EU not to reimpose sanctions and argued that "new sanctions will reinforce the perception that the EU is primarily acting in response to the U.S. filing of a WTO complaint against Airbus subsidies." Senate Finance Committee Chairman Charles Grassley stated that the "Europeans seemed to have appreciated and accepted our compliance efforts until we raised the issue of Airbus subsidies in the WTO. The blatant linkage of WTO disputes is a dangerous precedent."

But after President Bush signed on May 17, 2006, the repeal of the grandfathered tax provisions into law, the EU countermeasures were definitively repealed as announced in a Commission Notice published in the Official Journal (2006/C 126/07) on May 30, 2006. Thus ended one of the longest running and most bitter transatlantic trade disputes in recent years.

Table 1. U.S. Sectors on EU 2002 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 2003 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 2003 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.

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