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How to Start a Trade War

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The Federal Reserve will announce today whether it will cut interest rates once again. In an effort to stave off deflation and boost the economy the Fed has already cut rates 12 times since January 2001, pushing the funds rate down to 1.25%. These measures, combined with the passing of President Bush's growth and jobs package, have had a stimulative effect. As Fed Chairman Alan Greenspan recently noted, the financial markets are already signaling a revival of U.S. growth. Indeed, the stock market is up more than 20% since March.

But the global economy remains fragile. Declining economic activity in Japan and parts of Europe means that the risk of global deflation is still with us. More ominously, trade frictions are becoming more of an irritant. With economic prospects increasingly bleak in Europe, labor strife increasing, and the political positions of some European governments under pressure, the possibility of retaliations on the trade front are ominous.

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Unfortunately, the U.S. is particularly vulnerable to European trade retaliation. Last year the World Trade Organization found that an important part of our tax rules relating to American companies' foreign sales violate international trade rules. Unless we remove those provisions, Europe is entitled to levy $4 billion annually in retaliatory tariffs on U.S. exporters.

Last year, the Bush administration negotiated a delay in this retaliation in order to give Congress time to act. Europe recognized that political stalemate in the previous Congress made reform impossible. This is no longer the case. Unfortunately, some special interests are hoping to delay action further in order to protect the status quo. These large corporations are beneficiaries of the special provisions that were found in violation of international trade agreements. They also suspect that European retaliation will not be targeted against them, but against other, more economically vulnerable exporters. They therefore view the retaliatory tariffs as less costly to them than would be the removal of the special tax breaks they get from current law.

These large multinationals have successfully lobbied some in Congress to continue to protect them by extending their current illegal trade benefits for six years. This will almost certainly invite European retaliation that could begin a global trade war.

This bill, sponsored by Congressmen Phil Crane (R., Ill.) and Charlie Rangel (D., NY), is also crammed with special interest provisions. Crane-Rangel provides for a corporate rate reduction for manufacturing operations, but reduces this rate reduction in proportion to foreign manufacturing activity. That sounds "fair." But, a "special provision" in the bill classifies some of Caterpillar's French and German manufacturing operations as American. I

can only wonder how returning American veterans from Iraq will feel when their jobs are placed at risk by European retaliation while manufacturing jobs in France and Germany, of all places, are protected.

A second special-interest supporter of the bill is Microsoft. Crane-Rangel redefines "manufactured" to include software; but not all software, just the kind that Microsoft markets. Why is software that allows me to run my Word program different from software that runs networks, for example? Why is Microsoft's software "manufactured" but IBM's is not?

Ultimately, America needs a new approach to taxation, particularly in the trade area. While Europe and others rely on indirect taxes like a Value Added Tax, rebated on exports and imposed on imports, we have an income-based tax system under which differentiation between earnings from exports and other earnings is difficult under global trade rules. One legal way of doing this is to improve deferral rules on foreign source income and to ensure that U.S. companies are not double taxed on their foreign earnings. The Ways and Means Committee is considering a corporate tax reform bill that contains such an alternative.

In the meantime, something must be done. It is hard to imagine that the Crane-Rangel bill is actually viewed as a solution to our impending trade conflict with Europe. The president's budget proposal included recommendations in this area that are the antithesis of Crane-Rangel. Even if it could pass the Senate and be signed by the president it would never be accepted by the World Trade Organization as legal under international trade law.

This leads to the suspicion that the real goal of the special interests backing the bill is delay. The backers of the bill must feel that they have less to lose with retaliation than with the status quo.

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Crane-Rangel is old-style pork-barrel tax law. Special interest driven legislation like this is why American tax law has evolved to its current state of complexity. Of course, it is the legal right of special interests to try and get Congress to pass legislation that is in their narrow self interest. But, given that Congress just passed a bill that removes some of the distortions caused by the tax law, it would be unfortunate for them to turn to adding new ones.

Worse, from an economic perspective, this is a particularly risky time to do business as usual in the international tax arena. A $4 billion retaliation is roughly the equivalent of 20% of all the tariffs we now levy. The last thing the global economy needs right now is to begin a round of trade inhibiting retaliatory measures. We tried that once before in a time of global economic fragility with the Smoot Hawley tariff. It did not work out well.

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