

# Raising the transatlantic trade stakes

Guy de Jonquières examines the likely repercussions of today's WTO ruling on Foreign Sales Corporations

Since Robert Zoellick became US trade representative last spring, he and Pascal Lamy, European Union trade commissioner, have worked tirelessly - and with some success - to calm transatlantic trade strife. Today, their peace-making efforts face their toughest test, when the World Trade Organisation's appellate body delivers the final ruling in a four-year battle over a US corporate tax law.

The dispute is the biggest and politically most highly charged yet adjudicated by the WTO. The EU says the law gives US exporters illegal subsidies worth \$4bn a year and has threatened sanctions of similar value on US exports unless it is changed.

Mr Zoellick has said that if retaliation goes ahead, it will unleash "a nuclear weapon on the trading system" and severely damage companies on both sides of the Atlantic.

After winning three previous WTO cases on the issue, Brussels is confident of decisive victory. Washington, meanwhile, seems resigned to defeat. "People here would be amazed if the WTO ruled in our favour. Nobody seems to think we stand a chance," says Bruce Stokes, a trade specialist with the US Council on Foreign Relations.

Brussels says that if the US loses, it must comply with WTO rules by ending the disputed tax break. That would place President George W. Bush's administration in a tight political corner, from which there appears to be no easy escape.

The US Congress has already changed the law on export tax relief once, in response to a WTO decision in 1998 upholding an EU complaint against the For-

ign Sales Corporations act. The act allowed US companies to avoid tax on foreign income by channelling it through special offshore subsidiaries.

However, the EU objected that the FSC's replacement, the Extraterritorial Income Exclusion Act (ETI), also flouted world trade rules. Last summer, a WTO dispute panel agreed, prompting the US to appeal to the organisation's appellate body.

Congress repealed the FSC law reluctantly and seems in no mood to act again. Although some influential Republican members favour changing the US corporate tax system as part of broader fiscal reform, the idea lacks majority support. Removing

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the offending tax break by tinkering with the existing law would also face fierce resistance from companies that stood to lose as a result.

Mr Bush's administration appears to have no clear ideas about what to do. It also lacks senior officials skilled at lobbying Congress on fiscal and economic issues. Mr Zoellick has few admirers on Capitol Hill. Paul O'Neill, Treasury secretary, who is nominally in charge of the ETI case, is under fire from all sides, including the Republican right.

However, the EU has made clear it intends to hold Washington's feet to the fire.

One reason is that it is determined to force the US to comply with other WTO rulings against it on its anti-dumping, copyright and trademark laws.

If Brussels wins today, it plans to ask a WTO panel to authorise in April sanctions on US exports. Washington cannot block the request, though the panel would probably set the value of retaliation at less than \$4bn.

The EU would then publish a preliminary list of products targeted for sanctions but would suspend retaliation temporarily, while it sought a solution with the US. That would set the stage for an elaborate diplomatic poker game.

The EU says it is ready to negotiate constructively but would not wait forever for results. If Washington balks at acting swiftly, Brussels may insist it pay a price by cutting tariffs on exports of interest to Europe. Such a demand could create new frictions, because American companies protected by import barriers would fight their removal.

The US, meanwhile, is warning Brussels not to push it too far. It has hinted that if it loses the WTO case, it may challenge the legality of EU members' corporate tax systems.

In any event, the level of political rhetoric seems likely to rise on both sides of the Atlantic. "There will be lots of tough language and sabre-rattling," says an executive of a large European multinational company.

Some of the grandstanding is expected to be stage-managed by Mr Zoellick and Mr Lamy. Although they co-operate closely behind the scenes, both know that to get a settlement, they must impress their domestic constituencies with tough talk.



Most observers believe that, left to themselves, the two negotiators will manage the dispute responsibly. European multinational companies, many of which have US operations that benefit under ETI, are not pressing Mr Lamy to raise the stakes. In the US, many business leaders are urging an amicable settlement.

However, things could go off the rails if hardliners in the Congress and EU capitals start losing patience. There is a danger that the dispute could become entangled in a looming transatlantic confrontation over US steel imports, on which Mr Bush is threatening to impose stiff tariffs

in the next few weeks. If he does so, pressure may grow within Europe to strike back by imposing sanctions over ETI.

Trade officials fear hostilities could quickly escalate, with both sides taking up the cudgels over other long-standing trade grievances, such as the EU's refusal to approve genetically modified foods and the US Helms-Burton anti-Cuba act.

"If countries start taking aggressive actions, there is a risk of starting a downward spiral of retaliation and counter-retaliation," says William Reinsch, president of the US National Foreign Trade Council, an influential

Washington business association. "Things could easily get out of hand."

Some observers hope the WTO's appellate body will still avert that threat by delivering a less than clear-cut ruling that would make it easier for the US and EU to reach a compromise settlement. However, few are counting on that possibility.

Although the tribunal often disagrees with the legal arguments used by WTO disputes panels, it seldom reverses the substance of their findings. Unless that pattern is broken today, the onset of a new transatlantic war of nerves may be hard to avoid.

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