THE WTO'S CHALLENGE TO FSC/ETI RULES AND THE EFFECT ON AMERICA'S SMALL BUSINESS OWNERS

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WEDNESDAY, MAY 14, 2003

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS
Washington, D.C.

The Committee met, pursuant to call, at 2:04 p.m. in Room 2370, Rayburn House Office Building, Hon. Donald A. Manzullo, [chairman of the Committee] presiding.

Present: Representatives Manzullo, Chabot, Graves, Capito, Musgrave, Gerlach, King, Velazquez, Udall, Ballance, Christian-Christensen, Napolitano, and Majette.

Chairman MANZULLO. We will call to order the House Small Business Committee.

Today, the Committee will examine one of the most important issues that Congress will have occasion to address this year. We will examine the challenge of the World Trade Organization to the Foreign Sales Corporation and Extraterritorial Income Exclusion rules of the Internal Revenue Code and the effect this challenge will have on America's small business owners.

Like many other countries, the United States has long provided export related benefits under its tax laws. For most of the last two decades in the United States, these benefits were provided under the FSC and ETI tax rules of the Internal Revenue Code. In recent years, the European Union succeeded in having the FSC and ETI tax rules declared prohibited export subsidies by the WTO.

During August of 2002, a WTO arbitration panel determined that the EU was entitled to over $4 billion of annual countermeasures against the U.S. for failure to repeal its ETI rules. The EU has not yet imposed sanctions against U.S. exports, but recently announced it will do so if the ETI regime is not repealed before the end of the year.

A great deal is at stake in the face of the WTO challenge. Our domestic manufacturing base is being hollowed out right before our very eyes. Something must be done to ensure that a viable manufacturing base is preserved in the United States. Otherwise, the economic miracle that has occurred in the United States will be relegated to the dustbin of history.

On our first panel we have Congressman Phil Crane and Congressman Charlie Rangel, who, along with me, recently introduced H.R. 1769, the Job Protection Act of 2003. This bill is the only bill introduced this Congress to address the current WTO challenge.

Once fully phased in, the bill replaces FSC/ETI with an effective reduction in the corporate tax rate of up to 3.5 percentage points for U.S. manufacturers, or 10 percent exclusion from income.

On our second panel we will hear from a panel of experts, Dr. Gary Hufbauer of the Institute for International Economics, and Ms. Thea Lee of the AFL–CIO. We will also hear from two manufacturers, Doug Parsons, president and CEO of Excel Foundry and Machine in Pekin, Illinois, and Wayne Fortun, president and CEO of Hutchinson Technology, Inc. headquartered in Hutchinson, Minnesota, who will provide us with input on how this proposed tax law change would practically work.

I look forward to the testimony of the witnesses. On behalf of the Committee, I wish to thank all of them for coming, especially those who have traveled far.

I now yield for an opening statement by the gentlelady from New York, Mrs. Velazquez.

[Mr. Manzullo's statement may be found in the appendix.]

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Today, international trade makes most of us think about multinational corporations like Coca-Cola, Microsoft or Johnson & Johnson, but, in reality, of all U.S. manufacturers more than 90 percent are small and medium companies, and it is these firms that make up the overwhelming majority of exporters.

These small companies engage in international trade because of the benefits it brings them. International trade is key to the economic well being of our nation. Exports are a powerful engine of economic expansion, accounting for 30 percent of total U.S. economic growth over the last decade. Exports are also of critical importance for job creation and have accounted for the majority of new U.S. manufacturing jobs added to the economy over the last several years.

Recently, globalization, ease of travel and advances in technology have not only changed the way we do business, but also have made the domestic benefits of exporting more difficult to come by. The global marketplace is experiencing an overcrowding with increased competition, causing fluctuations in labor cost and prices.

In an effort to improve the competitiveness of their companies, many countries, including the U.S., create special provisions within their tax system. These tax provisions give domestic producers certain advantages that make their output more attractive to buyers and sellers on the international market.

The U.S. has provided such export related tax benefits under its laws for decades. Most recently, these benefits were contained under the Foreign Sales Corporation/Extraterritorial Income tax rules. These measures provided tax relief to many small exporters that could stay in the game as a result, allowing them to do business the old-fashioned way, produce in the U.S. and sell the products overseas.

Yet, the European Union declared FSC/ETI a prohibitive export subsidy by the World Trade Organization, which is the international body responsible for helping trade to flow freely, fairly and predictably between nations. The European Union has threatened with action if the U.S. fails to repeal the ETI, but such a repeal will prevent small businesses from doing what they do best—cre-

ating jobs for American workers while still generating revenue through exports.

A repeal of the ETI is not good policy or good politics since tax rates matter when companies decide where to locate their facilities. Increasing rates here but not overseas could create incentives to move jobs, plants and production abroad.

With our economy in a weak state and a net loss of more than 2,000,000 manufacturing jobs since President Bush took office, this is exactly the kind of policy that we want to stay away from making. Instead, we want to ensure that jobs stay right here where they belong, here in the United States.

In order to solve this pressing issue, my good friend from New York, Mr. Rangel, along with Mr. Crane, who will testify here today, have introduced legislation, H.R. 1769, the Job Protection Act of 2003. This bipartisan measure, which is supported by large and small companies alike, is a win/win situation. It repeals the current law FSC/ETI benefits, but still provides an effective rate reduction for U.S. manufacturers through a permanent new tax deduction.

It also provides generous transition relief. Without this, many small companies might have to close their doors due to an immediate increase in their effective tax rate. It also averts the European Union's threat of sanctions to take effect next January, and it will likely be met with satisfaction from the WTO and the European Union.

Today, small businesses face the toughest battle they have in a long time—ever increasing competition from overseas, a weak domestic economy and thin profit margins. What they need right now is increased protection that will upset the competitive disadvantages they face in the global arena so they can produce more jobs, train more workers and provide more revenue to this country's economy. Without this support for small businesses, our economy doldrums are certainly here to stay.

Thank you, Mr. Chairman.

[Ms. Velazquez's statement may be found in the appendix.]

Chairman MANZULLO. Thank you.

We have a very interesting pair for this first panel. If this is not an indication that this is a bipartisan bill, then I don't know what is. Would somebody take a picture of these two? I want to capture this moment. I am enjoying it thoroughly. I have been enjoying it thoroughly.

Congressman Crane, because you were here first we will recognize you first and then with Congressman Rangel.

STATEMENT OF HON. PHILIP M. CRANE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr. CRANE. Thank you very much, Mr. Chairman and Members of the Committee. Thank you for inviting me to come before the Small Business Committee to offer testimony on the World Trade Organization's challenge to the Foreign Sales Corporation/Extraterritorial Income rules of the Internal Revenue Code.

Before I get into that, Ms. Velazquez raised a point here that reminded me of when I had Charlie out in my district about five years ago I think it was, and we had a trade hearing. Were you

at that? You know, in my district I have giants like Motorola's corporate headquarters, Sears, Baxter Abbott, so I knew that we were biggies in the export market.

What was revealing that came out of that hearing was better than 90 percent of Illinois' exports came from companies employing 500 or fewer. You raised that point about the importance of this to small businesses, and it really is. A lot of folks do not seem to fully appreciate that we have a lot of small businesses in the world market.

Let me begin by saying that it has been a great pleasure to work with you, Mr. Chairman, to craft legislation, H.R. 1769, the Job Protection Act of 2003, that will both bring us into compliance with our WTO agreements and keep manufacturing jobs in America.

It has also been my privilege to work on this legislation with my good friend Charlie Rangel. While Charlie and I do not often see eye-to-eye on issues that come before the U.S. Congress, in this case, as in all other prior challenges to our FSC/ETI provisions, Republicans and Democrats can and must work together to enhance U.S. competitiveness.

As Chairman of the Trade Subcommittee, I have a special interest in preserving and promoting free trade throughout the world. Trade is fundamental to our relations with other nations, and free trade has been the greatest civilizing force throughout modern history.

I have fought for many years to ensure that the United States, which is the largest exporter in the world, maintains its rightful role as world leader when it comes to trade. The Singapore Free Trade Agreement, which essentially eliminates tariffs on all goods exported to and imported from Singapore and which President Bush signed just last week, is an example of the direction in which we should be heading.

H.R. 1769 achieves two goals. It brings the United States into compliance with our WTO agreements, and it is structured in such a manner as to preserve, protect and strengthen U.S. manufacturing jobs. I would like to take this opportunity to address each of these points.

Mr. Chairman, like our many colleagues who have co-sponsored this legislation, a number of whom sit on this Committee, I believe that we must comply with our international trade agreements. To do otherwise could precipitate a trade war, which would be unacceptable. Therefore, this legislation repeals FSC/ETI immediately and brings the United States into compliance with our WTO obligations.

The issue then is how to best replace FSC/ETI once it is repealed. In recognition of the fact that the repeal of these provisions raises the tax burden of current beneficiaries by at least $50 billion over 10 years, this legislation returns that money to U.S. manufacturers. This stands in stark contrast to another suggested approach to this problem, which spends the money associated with the repeal of FSC/ETI on assorted new benefits for the overseas operations of U.S. multinationals.

In order to understand why the approach taken in H.R. 1769 is so crucial to protecting our job base, it is important to understand why the FSC/ETI benefit exists in the first place. U.S. corporations

that export manufactured goods pay a 35 percent corporate tax rate on their profits. In addition, a U.S. corporation pays a value added tax when it sells its products in Europe. However, current trade agreements allow European countries to fully rebate value added taxes at their borders. Therefore, many European manufacturers are subject to only one level of taxation.

F.S.C./.E.T.I. compensates U.S. manufacturers for this double taxation, thus leveling the playing field. That means jobs stay here. Were FSC/ETI to be repealed with no suitable replacement, U.S. businesses would have very little reason to maintain facilities and, therefore, jobs in the United States.

To that end, PriceWaterhouseCoopers has published a study that indicates 1,000,000 direct jobs and almost 2,500,000 indirect jobs are on the line. After all, what rational business entity would pay two levels of tax when it had the option of only paying one? The net result would be that jobs and wealth would be artificially transferred to Europe.

Therefore, the Job Protection Act provides a permanent new deduction, which is an effective rate reduction for U.S. manufacturers that is fully consistent with our trade agreements. Companies that manufacture domestically will receive the equivalent of up to a 3.5 point reduction in their corporate rate. In addition, this legislation provides a new benefit to thousands of small and medium sized businesses that have never received a FSC/ETI benefit.

This is an issue well worth exploring, and I am very pleased to have had the opportunity to express my views here today. I look forward to continuing to work with you, Mr. Chairman, and with Members of this Committee to pass this legislation.

Thank you.

Chairman MANZULLO. Thank you, Congressman Crane.

Congressman Rangel?

STATEMENT OF HON. CHARLES B. RANGEL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. RANGEL. Thank you, Mr. Chairman. I want to thank the Ranking Member, Ms. Velazquez, my New York colleague, for all the work that she does and all of you do in giving us an opportunity to testify in support of our legislation.

I want the new Members not to misconstrue this relationship as being long lasting. What is long lasting is that Phil Crane and I have fulfilled a tradition of the Ways and Means Committee as it relates to trade legislation.

Believe me, the trade legislation is not Democratic or Republican, but it is what is in the best interest of the United States of America, and that is why we have worked together on the African bill, the Caribbean Basin bill, the Virgin Islands and a variety of pieces of legislation that just cannot allow foreigners to believe that we are not united in our effort to protect the best interests of the United States.

That is why I was shocked and surprised that the Chairman of our Committee would circulate a letter saying that the World Trade Organization did not approve of this legislation and quoted them because they said, according to Mr. Thomas, that they opposed the five year transition.

First of all, it is none of the WTO's business what legislation we have. If the House of Representatives and the Senate decide that we want to legislate they can rule on it, but to have them interfere with our internal legislation powers surprised me that he would do this, and that is why on my own I saw fit to call Mr. Langley of the World Trade Organization to find out whether his spokesperson was evaluating legislation by any Member of the House of Representatives. While he said that he was staying out of it, I made it clear that when that flag goes up do not look for Democrats and Republicans. You look for the United States Congress to respond.

In addition to that, I made it clear to our U.S. Trade Representatives that while I had a difference with the Chairman of the Committee, I was working very closely with the senior Republican of the Committee, and for me that was good enough to be doing.

Now, basically what are we were talking about? We are talking about what we thought was an agreement with the international community as related to how we treat exports, how we treat their imports and how they treat our exports.

We have lost the international law battle as it relates under the FSC program. We are under the gun now because they have threatened some $4 billion worth of tariffs against our exports if we do not come up with a solution, so it is imperative. They are not asking for a Republican solution or a Democratic solution. We have to come forward and say this is what our best thinking is as to how we are going to do it.

The legislation that has been suggested by Mr. Thomas would say that we repeal the existing law, and the billions of dollars that would be so-called saved or erased be given to those people that have seen fit to go overseas to provide the goods and services, an incentive for people to leave the United States of America in order for corporations to receive tax benefits.

We, on the other hand, believe that if we are talking about exports then you are talking about U.S. exporters. You are talking about U.S. jobs. You are talking about providing the incentive for people to want to produce not only the best product, but to know that the United States of America is providing incentives for them to export it. All of those people who are concerned about jobs not overseas, but jobs in the United States of America, you show me anyone that is manufacturing for the purpose of going overseas with it. This is going to provide them incentive.

Again, as Mr. Crane has said to Congresswoman Velazquez, no matter how big a corporation is, it is the subcontracts that really count for small businesses. They are really the heartbeat of providing the work and the subcontracts for small business to survive. If you allow a large manufacturing corporation to collapse, it is not just the jobs there. It is the support of smaller businesses that are going to lose.

Now, we have at least 73 co-sponsors here. We are not saying we are right. We are saying we want to be heard. We are saying that this cannot be business as usual because no matter who prevails what is important, Mr. Chairman, is that this Congress speaks in one voice, especially as it relates to the World Trade Organization.

As I said, this is not the first time that Phil Crane and I have gotten together in saying that this is a policy that supports Amer-

ican businesses, that creates the jobs that are necessary for our constituents to do better.

I appreciate the opportunity for us to come before your Committee, and I only hope the Chairman of my Committee is as gracious as you have been.

Chairman MANZULLO. Thank you for your testimony.

I really do not have any questions. The two of you have pieced this thing together and said it very well.

Ms. Velazquez, do you have any questions?

Ms. VELAZQUEZ. Yes. I just would like to ask you given the fact that Chairman Thomas is opposed to this legislation, what else can we do collectively to get Mr. Thomas to bring this legislation, to allow it to take its course in terms of hearings in the Ways and Means Committee and bring it to the Floor for a vote?

Mr. CRANE. You respond.

Mr. RANGEL. Well, I am inclined to believe that Mr. Thomas thinks that he deals with a higher authority than his colleagues in the Congress. As a matter of fact, it surprises me how little Republicans know about what is going on in the Ways and Means Committee.

Having said that, I would like to believe that this is not our Congress. This is an institution that has been created over 200 years ago, and each of us has an obligation to leave as a legacy a House of Representatives that works not for one party, but for both.

I want to reinforce what I am saying, Mr. Chairman. It is not whether we win or lose that is important. We want to be heard. I think that if we reach the point that 218 people are saying that they signed a piece of legislation, the forefathers and the drafters of the Constitution have provided a way that the majority, if not the minority; the majority can be heard.

Let us work toward getting that majority. I am certain that Phil Crane and I will do all we can to visit each other, caucuses to make certain that we are saying that labor, business people and American workers want this to be voted on.

Ms. VELAZQUEZ. I have another question. If this legislation becomes law, are you concerned that the phasing out aspect of the FSC/ETI will be challenged by the WTO?

Mr. RANGEL. I cannot believe that you can have any law that does not have a reasonable transition period. It just does not make sense when business people have planned on existing law that we would just say that tomorrow morning all of your investment, all of the things you planned on.

I am not the least bit concerned about the World Trade Organization as it relates to the transition. Any reasonable person will have to believe that if you dramatically change the existing law you have to give business people, whether they are U.S. citizens or foreigners, time to adjust to it.

Ms. VELAZQUEZ. Thank you.

Mr. CRANE. Could I add just one thing————.

Ms. VELAZQUEZ. Sure.

Mr. CRANE [continuing]. To what Charlie said, and that is the banana dispute. We gave them a five year transition period. They did not request it even, but we recognized how important that is, as Charlie said, to businesses.

If you are going to change the ground rules, provide for that transition to the change. I think it is something that is not unreasonable, coupled with the fact that I have had input from tax lawyers, and they say that they think it is acceptable, and they think that there will not be a dispute over that transition.

Chairman MANZULLO. Mr. Chabot?

Mr. CHABOT. Thank you. I just have one brief statement, a question for the gentlemen here.

In light of the WTO's recent ruling against the ETI rules adopted by the U.S. in 2000 and amid continuing erosion of manufacturing jobs, including in my district in the City of Cincinnati, it is imperative that we take steps to ensure that U.S. companies exporting goods remain competitive in the global marketplace. I would like to thank both Mr. Crane and Mr. Rangel for their work to address this important issue.

Additionally, I believe it is important for us to modernize our international tax laws to help maintain and improve U.S. competitiveness. As senior and very respected Members of the Ways and Means Committee, I was wondering if you could comment on whether you would feel that support for your legislation could in any way preclude us from also being able to accomplish international tax relief for U.S. based companies this year?

Mr. CRANE. This year?

Mr. CHABOT. Yes.

Mr. CRANE. Above and beyond what we have provided for in the bill?

Mr. CHABOT. Yes. I mean, would passing your bill in any way preclude us from taking action relative to modernizing, improving, reforming the international tax laws?

Mr. CRANE. Well, I would say no, it does not, but to give you an assurance that this year we can accomplish something more, especially with the problems we have going on with that other chamber on the Hill, I think would be presumptuous. I would hope that we could go beyond.

When I first came here I introduced a bill that eliminated any tax on business whatsoever, and it is because businesses do not pay taxes. They gather taxes. That is a cost, just like plant, equipment and labor are costs, and you have to pass it through and get a fair return or you are out of business.

If we did not impose that burden on businesses in international trade, we would have a huge leg up, and that would be totally consistent with any WTO guidelines, but that is a long way off.

At any rate, no. I hope that there are further reforms that we might contemplate. In fact, the Chairman has some other reforms. I know he has talked about a package of some other reforms, and so maybe we will get a chance to do that, too.

Mr. CHABOT. Thank you. Mr. Rangel, I did not know if you wanted to comment.

Mr. RANGEL. I would be more than satisfied if I felt that we could get some legislation through the House and Senate and passed into law on this subject this year.

Mr. CRANE. Yes.

Mr. RANGEL. This is a very controversial subject matter. We face a $4 billion penalty against our exports.

Mr. Chabot, it is not that I like talking to Republicans.

[Laughter.]

Mr. RANGEL. But there are times that it is necessary.

Mr. CHABOT. I know how distasteful that must be.

Mr. RANGEL. I cannot perceive how we as Members of Congress do not believe that we cannot allow the French or the Europeans to interfere with our prerogatives.

You know, even if we have to designate someone to work out these difference, Democrats are not going to walk away from a fight. We have to make that abundantly clear. The speaker and the Minority Leader have to get together and say it is in the best interest of the United States of America and the Congress to get something out before these Europeans try to dictate to us what the hell they are going to do.

You are talking about international tax reform. Mr. Chabot, we are not talking to each other. I think if we can get your help to show what we can do with something where everyone agrees that it has to be done, maybe that could create a climate for us to do more.

Mr. CHABOT. Thank you very much.

Mr. CRANE. One of my great-grandfathers was a Grover Cleveland Democrat, but that has been a comfort to me on trade related issues because historically, and I used to teach this as a former history prop to the kids, and that is that Democrats were the free traders and the Republicans were the protectionists from the beginning of both of our parties, and that lasted until after World War II when we reversed positions generally, but not entirely.

Democrats still had divisions on trade issues within their own ranks, just as we Republicans do. We still have, you know, the Smoots and the Hawleys on our side, and they still have the Grover Cleveland Democrats on their side.

Grover Cleveland got hit with that panic of 1893 when he got reelected to his second term. The Republicans were the ones that passed the McKinley Tariff Act that caused that panic of 1893 to occur. He unfairly took the hit for it, but he dismantled it and got the economy moving again.

He made the observation at the time when you put those walls, those tariff barriers, around your country that way you inflict the greatest injury on the man who earns his daily bread with the sweat of his brow. Amen.

Mr. RANGEL. He has a good memory, has he not?

Mr. CRANE. You know, I know it from my great-grandfather, Charlie.

Mr. RANGEL. I did not know you were that old.

Mr. CRANE. It is so good to have somebody like Charlie next to me. It is like being with my great-grandfather.

[Laughter.]

Mr. CHABOT. Thank you, Mr. Chairman. That was worth asking the question just to hear that. That was good.

Chairman MANZULLO. I was waiting for Mr. Rangel to say I knew Grover Cleveland.

Mr. CRANE. Well, I think he may have.

Chairman MANZULLO. Congresswoman Majette, do you have any questions?

Ms. MAJETTE. Good afternoon. I do not have a question. I just have a brief comment.

As a new Member of Congress and a new Member of this Committee, I want to thank you both for your leadership and the initiative that you have shown on this issue. It really does set a great example for me and for the new freshman class, so I appreciate that.

Mr. CRANE. Thank you.

Mr. RANGEL. Thank you.

Chairman MANZULLO. Dr. Christian-Christensen?

Mrs. CHRISTENSEN. Thank you, Mr. Chairman. I want to thank you and the Ranking Member for holding this hearing and also thank both Chairman Crane and Ranking Member Rangel for the work they have done on this bill.

You may or may not know, Mr. Chairman, but this bill also has a direct impact on my district, and we have for several years now been working to try to develop a way to replace or revise the FSC laws so that we could continue to benefit from new jobs that it brings in my district. I want to thank them on behalf of the small and medium manufacturers of the country who we represent on this Committee and also on behalf of my district.

I know that you did say this is our legislation and no one has the right to interfere, but there have been several attempts to try to address this, none of which have really been successful. How does this legislation differ from some of the other approaches that have already been rejected?

Mr. RANGEL. Why do I not let you handle this, because the WTO—I had not known, and I should have known, that even in the Clinton Administration the legislation that we were supporting never was thought that it was going to be accepted by the WTO, and now it is abundantly clear by Republicans and Democrats it was a holding action.

This is the first real attempt that we are making to deal with the problem that we face rather than taking the holding action approach, and we repeal—not fix. We repeal the impediment that they are raising.

What we do with the tax savings should be a United States concern. If we are dealing with United States business and it is based on the percentage of the credit that you get will be the percentage of your manufacturing that is being exported, to me that is an internal matter, and it is not just served trying to give a subsidy to the exports.

Phil?

Mr. CRANE. I agree with that. The fact of the matter is above and beyond some of the immediate concerns that are obvious to one and all a bigger concern about the impact of this WTO ruling, which is something that we helped to create and to provide the guidelines for setting up the conditions for playing the ball game worldwide.

The impact of this on our manufacturing jobs here in the United States could be awesome, and that has implications that go as far as national security. I think this is a critically important piece of legislation. It is urgent. It needs to be passed, and it is in the interest of all of us.

It does not go as far as I would like. As I indicated before, I would eliminate any tax on business, but at least it provides some relief for those companies that will be taking a hit and provides that relief in a way that is not inconsistent with WTO.

Chairman MANZULLO. Mr. Ballance, do you have any questions?

Mr. BALLANCE. Mr. Chairman, first, this has been one of the most exciting hearings I have had an opportunity to sit in on since I have been here these four months.

I do want to ask a serious question, knowing the residence of these two fine gentlemen. Does this bill apply below the Mason-Dixon line?

[Laughter.]

Mr. RANGEL. And our possessions and territories.

Mr. BALLANCE. Being from North Carolina, we, of course, like many other areas in the country, are being hit very hard with loss of jobs. When I look at the title of your bill, the Job Restoration Act of 2003, immediately it warms my heart because I get a lot of calls from all over my district, people who are really in dire straits in Roanoke Rapids and in Henderson, former textile giants.

A lot of the small businesses, as you have indicated, that were associated with those companies now are looking for the opportunities, and so to the extent that this bill would help small businesses, and I assume based on what you all have said that it would, I certainly would want to be supportive.

Mr. RANGEL. Mr. Ballance, you really do not have to be a tax expert. Basically what we say is that with the tax credits that are available, do you want to give it to businesses overseas, or do you want to give it to businesses in the United States. That is it, clear and simple.

Chairman MANZULLO. Mr. Udall?

Mr. UDALL. I think Ms. Napolitano was here before I was, was she not?

Ms. NAPOLITANO. No. You were.

Mr. UDALL. Okay. Let me thank both of you gentlemen for your hard work, Ranking Member Rangel, Chairman Crane.

You alluded to in your testimony the urgency of this. Could you tell us what you see in terms of the big picture out there and the WTO and how quickly you think this needs to be done and why?

Mr. RANGEL. This is subjective, and the answer to that question is basically in the hands of the House of Representatives.

The WTO has taken the position that they would not go through with the threat of the sanctions if they really thought we were working together toward a solution of the problem that we admit now exists.

Mr. UDALL. Can we not just serve you two up as a great example that we are working together?

Mr. RANGEL. Well, if you exclude other people who are not working with us, I think that would work.

Basically subjectively they want to have the feeling that we are not deliberately stringing them out as we have effectively done in the past, and so if we were just talking together saying it has to be fine tuned that would go a long way in preventing them from pushing the sanctions.

Now, some people believe they cannot afford to do the sanctions, but that is a hell of a thing to find out, to have your exporters find out they really meant what they said this time.

The most important thing that we can do is to, one, unite our efforts to resolve the problem and, two, to let the whole world know it. If we did that and they wanted a trade war, let us get on with it, but we should not do it without coming together as a nation and responding to this need.

Mr. CRANE. I spoke to Mr. Lamee last week on this very issue, and he told me that at the end of the fiscal year they will make the determination as to whether to impose the sanctions. The sanctions would begin starting January 1 of next year.

Mr. UDALL. Thank you both very much.

Chairman MANZULLO. Mrs. Napolitano?

Ms. NAPOLITANO. I am sorry. I came in late so I missed your testimony, so I am going to read about it. I was just with a group of 77 students who were asking me about the economy of California and the rest of the nation, so in essence this is something that I am very, very concerned with.

Coming from California and having a state that does a major amount of trade with the world, this is very, very critical. We established a task force with many factors to find out exactly what some of the issues are. Guess what? It is the valuation of the dollar. It is other countries putting support services and support dollars behind their companies competing against ours so that now we are going to have to start scrambling to keep these people in business to provide the jobs so that we can rebound our economy.

I am looking forward to reading your testimony and to hopefully getting on your bill because I think this is one of the steps that we need to take to be able to move the agenda forward and tell them that we are serious and that we will be even more if we do not get some solutions moving.

Thank you.

Mr. RANGEL. Thank you.

Mr. CRANE. Thank you.

Chairman MANZULLO. We want to thank you for coming here. The unemployment rate in the district that I represent is at 11 percent in Rockford, Illinois. This is the city that led the nation in unemployment in 1981 at 24.9 percent. Our manufacturing jobs are being cored out. Those 2.3 million manufacturing jobs are gone. They are gone forever because of increased productivity and a lack of sales, et cetera.

This bill is a building block in the effort to rebuild the manufacturing base in this country. We will not have an economic recovery unless the people in Washington who make the policy decisions understand how critical it is to have a strong manufacturing base in this country. Unfortunately, very few understand that you have to dig things out of the ground, you have to grow things, and you have to make things in order to have a viable economy.

We want to thank you for—Ms. Musgrave, you just came in. Did you want to ask any questions or have any comments of the two Members that are here?

Ms. MUSGRAVE. No.

Chairman MANZULLO. Again, Congressman Crane, Congressman Rangel, thank you for your testimony.

Mr. RANGEL. Thank you.

Chairman MANZULLO. I appreciate it. We will have the new panel set up. Our next witness, Gary Hufbauer is a Senior Fellow at the Institute for International Economics in Washington. Before joining that organization, he was a professor at Georgetown University, and served at the Treasury Department as Deputy Assistant Secretary to the International Tax Staff.

Doctor Hufbauer will review the tortured history of the WTO challenge to FSC/ETI and its predecessors. We look forward to your testimony.

STATEMENT OF GARY CLYDE HUFBAUER, THE REGINALD JONES SENIOR FELLOW AT THE INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. HUFBAUER. Thank you very much, Chairman Manzullo and members of the Committee.

As you said, Chairman, mine is a bit of a history lesson, but it does not go back to Grover Cleveland. I will try to do it in less than five minutes.

This dispute originates in the ancient, and I think unjustified distinction between a direct and indirect taxes. Direct taxes include corporate income taxes, and indirect taxes include sales, excise, and importantly, value-added taxes.

In 1960, a GATT working party decided that indirect taxes, that is, the sales, excise and then looming value-added taxes, could be rebated or not collected on exports and imposed on imports, but you could not do these same border adjustments for direct taxes; namely, corporate income taxes which were at stake.

Now, as I said, way back in 1960, value-added taxes were just coming in as an important revenue source. They were nothing like they are today.

In 1962, the United States enacted subpart F, which basically says that when U.S. companies sell through a foreign sales subsidiary, located in a low-tax country, that income will be labeled foreign base company income; that is, the selling subsidiary's income will be subject to current tax in the United States. It will not get the advantage of deferral.

Other countries subsequently enacted quasi subpart F provisions, but theirs have never had the teeth, and do not today have the teeth that the U.S. subpart F has.

So when we come to the late 1960s, U.S. manufacturers, particularly firms that export manufactured goods, were triply taxed and disadvantaged by the regime then in place, the GATT rules and our own internal revenue code.

First, their competitors were relieved of taxes when exporting to the United States. Second, U.S. firms who sold into foreign markets had no relief from the U.S. corporate tax, and those that exported through a foreign sales subsidiary, thanks to our own subpart F, were taxed immediately on that sales subsidiary income.

Now, in 1971, or just about 30 years ago now, we had a growing trade deficit at the time, and these tax disadvantages were widely appreciated by the Congress at that time and the administration.

The United States enacted the so-called DISC, the Domestic International Sales Corporation, which took about 12 percentage points off the then 48 percentage point U.S. tax rate, the corporate tax rate.

The European Commission challenged the DISC and the GATT, and the United States, in turn—and what I felt was a good strategy at the time and think would be a good strategy today—challenged the tax rules then applied by three European countries. These four cases came to be known as the tax legislation cases. There is more history in my policy brief, but basically the plaintiffs won in all cases, and the defendants lost. The U.S. lost and also the European countries lost.

That was in the middle of the so-called Tokyo Round of trade negotiations. It was widely appreciated, and I was a negotiator, a Treasury official at the time, that if we all retaliated against each other we would blow up the Tokyo Round.

So we negotiated it out in the Tokyo Round subsidies code and we had a series of provisions which essentially said that the United States would in time repeal the DISC, but laid the groundwork for what came to be know although we did not have the name at the time, the Foreign Sales Corporation. The compromise enabled the European countries to continue their non-use of an effective subpart F; that is, their use of foreign selling subsidiaries for their corporate exports, but they had to observe arms-length prices.

And this agreement and the subsidies code, which is there in the text in the notes, was then codified or repeated in the 1981 GATT Council decision, which then disposed of those tax legislation cases which had been held over.

So in 1981, we had tax peace.

Now, 16 years later the European Union decides to bring this FSC case. I mean, after the 1981 and 1983 decisions, the United States repealed the DISC and introduced the FSC, and everybody thought this was fine, in accordance with the agreements.

So 1997, 16 years later, the European brings forward the case. This had nothing to do with—I know everyone here is aware—with any complaints in Europe over our tax practices. It had everything to do with cases that Europe had lost in the WTO, so they wanted to get tit for tat, and also they were building up a negotiating chip for the Doe-Hall Round in Agriculture.

Now, I see I have run out of time, Mr. Chairman. Do you want me to stop here or continue forward?

[Mr. Hufbauer's statement may be found in the appendix.]

Chairman MANZULLO. That is tough to answer. I mean, the testimony is great, but perhaps we should move on.

Mr. HUFBAUER. Sure.

Chairman MANZULLO. And then come back. I would like to get in as much testimony as we can.

Mr. HUFBAUER. Sure.

Chairman MANZULLO. Before the votes begin if possible.

Mr. HUFBAUER. Sure.

Chairman MANZULLO. Thank you.

Our next witness is—is it Thea?

Ms. LEE. That is right.

Chairman MANZULLO. Thea Lee is the Assistant Director for International Economics of the AFL–CIO. She is involved in the Public Policy Department where she oversees research on international trade and investment policy.

We look forward to your testimony.

STATEMENT OF THEA LEE, ASSISTANT DIRECTOR FOR INTERNATIONAL ECONOMICS—PUBLIC POLICY DEPARTMENT, AFL–CIO

Ms. LEE. Thank you very much, Mr. Chairman, Ms. Velazquez, Member of the Committee.

I appreciate the opportunity to testify today on behalf of the 13 million working men and women of the AFL–CIO and the unions of the Industrial Union Council.

We believe this hearing is timely for several reasons. With sanctions up to $4 billion pending against U.S.-made products and all appeals to the WTO exhausted, it is essential for Congress to respond.

The deep prolonged prices in U.S. manufacturing makes it even more essential for Congress to examine ways to support U.S. manufacturing and exports. The AFL–CIO believes that the FSC/ETI can be replaced in a way to bring the U.S. into compliance with the WTO and boost manufacturing in the United States.

Ninety-five thousand manufacturing workers lost their jobs in April alone. We have now been losing manufacturing jobs for 33 straight months, the longest such stretch since the Great Depression. Since April 1998, the United States has lost 2.6 million manufacturing jobs, nearly 13 percent of the total manufacturing workforce.

Unless these trends are reversed serious damage will be done to the livelihoods of America's working families and to the nation's economy. Manufacturing historically has been a major generator of good, high-skilled, well-paid jobs with many linkages to job in nonmanufacturing sectors, and it remains a mainstay of local and state economies throughout the nation.

Manufacturing decline not only undermines the quality of manufacturing jobs but also contributes to the stagnation in all workers' wages. Moreover, the massive scale of manufacturing plant closings and job layoffs is contributing directly to the serious fiscal crises afflicting virtually every state in the nation.

The forthcoming debate on the FSC/ETI repeal gives Congress a key opportunity to help U.S.-based manufacturing by reorienting tax policy. Replacing the FSC/ETI with incentives to create manufacturing jobs in the United States is vital to the health of the industry and our entire economy. We believes that H.R. 1769, the Crane-Rangel-Manzullo-Levin bill, will help boost U.S.-based manufacturing, which is why the AFL–CIO strongly supports it.

As you may recall, Mr. Chairman, AFL–CIO Secretary-Treasurer Richard Trumka testified before this Committee just last month, and called for legislation to establish a manufacturing tax benefit to replace the FSC/ETI.

We are pleased that there has been a broad bipartisan response to this call on the Congress, and we look forward to working with you and others to secure the legislation's passage.

H.R. 1769 would provide a tax benefit for production of goods in the U.S., adjusted for the percentage of a company's worldwide production that takes place in the United States, and we think this provision is particularly important to leverage the reward for companies that have relatively more U.S.-based production, to reward companies that are producing more in the United States. We think that is entirely appropriate.

In the future the legislation would create an effective tax penalty for shifting production abroad. The legislation would also phase out FSC benefits over five years, allowing time for workers and companies who are FSC beneficiaries to adjust to adjust to a new system.

Representative Bill Thomas last year put forward a proposal to repeal the FSC and replace it with a collection of corporate tax cuts, most of which would mainly benefit companies with overseas production facilities. Multinational corporations could accumulate untaxed profits overseas more easily because base-company rules would be repealed. Multinational corporations would also get tax breaks by using rules that allow profits made in countries like Germany and France to be converted into tax deductions by paying to expenses to wholly or partly owned companies in tax havens like the Cayman Islands.

The Thomas proposal, put simply, would ship more manufacturing jobs abroad.

According to a New York Times story last year even some supporters of the bill said that the ability of companies to avoid taxes on profits from factories abroad so long as they were not returned to the United States encouraged American companies to invest and create jobs overseas.

It is bad enough that bureaucrats at the WTO and the European Union are forcing changes in our tax system, but it is even worse that some in Congress would respond to this challenge by making domestic manufacturing less competitive.

The Thomas approach purports to be about enhancing American competitiveness, but in reality it boils down to boosting the profitability of multinational corporations, and allowing them to produce anywhere they choose so long as they keep an American mailbox.

We strongly encourage Congress to reject the Thomas approach.

We also feel there is an urgent need to reform or existing tax system to remove the tax disadvantages for American manufacturers and exports as has already been discussed.

In addition to these tax policy changes, we believe Congress should make other significant policy changes that are also important. America's manufacturing workers are the most productive in the world, but they operate under enormous competitive disadvantages resulting from several factors in addition to tax policy, such as unfair trade agreements, an overvalued dollar, and foreign currency manipulation, inadequate investment incentives, health care costs not borne by overseas producers, and foreign government subsidies.

Unless these problems are addressed soon, American manufacturing capacity and jobs may end up permanently lagging and our economic strength may be permanently weakened.

The U.S. productivity and wage gains have been largely driven by the performance of the manufacturing sector. We urge Congress

to start with passing a manufacturing tax benefit, but to make that only the first step of a more comprehensive effort.

I thank you, and I look forward to your questions.

[Ms. Lee's statement may be found in the appendix.]

Chairman MANZULLO. Thank you for that excellent testimony.

Our next witness is Doug Parsons, President and Chief Executive Officer of Excel Foundry and Machine, Inc. in Pekin, Illinois. He served as the president and CEO of that company since 1999. He has been with the company since 1993, beginning as the Assistant Vice President for Manufacturing. He is currently responsible for day-to-day management and operation of the company.

Mr. Parsons, we look forward to your testimony.

STATEMENT OF DOUG PARSONS, PRESIDENT AND CEO, EXCEL FOUNDRY AND MACHINE, PEKIN, IL

Mr. PARSONS. Good afternoon, Chairman Manzullo and Members of the Small Business Committee. I appreciate the opportunity to come and talk to you about how I view the WTO's FSC/ETI decision and how it affects small manufacturers.

I am the President and Chief Executive Officer of Excel Foundry and Machine. Excel Foundry and Machine manufactures and supplies precision machine bronze and steel parts for heavy equipment-related industries such as mining, crushing and mineral processing. Founded in 1929, the company had $13 million in sales in 2002. Excel, which operates as a Subchapter S corporation, has roughly 100 employees, and is located in Pekin, Illinois.

The current Extraterritorial Income regime, as well as its predecessor, the Domestic International Sales Corporation and the Foreign Sales Corporation, have been integral factors increasing export activity by U.S. manufacturers.

According to the IRS, there are roughly 4300 FSCs in existence in 1996, 89 percent of them exported manufactured products. Congress first created the DISC in 1971 to level the playing field for U.S. companies, large and small, selling these products overseas.

These three types of taxes it has created over the past three decades were designated to neutralize some of the tax advantages enjoyed by our foreign competitors located in countries with territorial tax systems which generally exempted income earned outside the company from income tax and exports and value-added taxes and other consumption taxes.

Traditionally, much of the attention in this area has been focused on FSC/ETI usage by large companies. These benefits are also important to small and mid-sized manufacturers that export, and exporting goods and services for Excel as well as many other small companies is simply a necessity to stay in business.

Smaller companies often turn to the export tax incentive breakin to and effectively compete the global marketplace. According to a July 2000 survey by the National Association of Manufacturers, small and mid-sized manufacturers save on average $124,000 annually by using the FSC.

It is critically important to continue to encourage export activity by these small companies. Of all the exporting manufacturers in America, 93 percent are small and mid-sized manufacturers. These

firms which individually employ anywhere from 10 to 2,000 employees together employ roughly 9.5 million people.

Small and mid-sized manufacturers that export add jobs 20 percent faster than firms that remain solely domestic, and are nine percent less likely to go out of business.

For Excel Foundry and Machine, selling products in the international market, whether directly or indirectly, is the life blood of the company. International sales are vital to the growth and health of Excel, allowing us to expand by adding new space, hiring more employees, and making capital investments.

Direct international sales account for one-third of Excel's revenue, and these sales are responsible for the tremendous growth, about 30 percent over the past four years. They have enabled the company to recently add 20,000 square foot expansion of our production facilities and hire five new engineers.

In the past, Excel has used the Foreign Sales Corp. and we are currently using the ETI. The benefits provided by FSC/ETI justify the additional efforts needed to go into overseas marketplaces and compete. For example, the tax system in South American countries heavily favor the local suppliers, and the FSC/ETI helps to kind of level the playing field.

The loss of the tax incentives that is provided by the FSC/ETI would have a tremendous impact on the company, affecting revenues and employment.

There are many hidden costs in doing business internationally. In markets where margins are already thin, we lose sales due to the uneven playing field. If these sales slump, Excel would likely have to cut between three and five percent of its employees.

Excel is also a substantial indirect exporter and indirectly beneficiary of the ETI as a supplier to large exporters such as Caterpillar. If these exporters were to ship production overseas, it is likely that the would not maintain the relationship in the United States. So from this perspective it is important to note that what is good for the large exporters is also good for small exporters like Excel.

Given last week's final WTO authorization for the EU to impose more than 4 billion annual sanctions against the U.S. exporters, we are placed that Congress is actively pursuing constructive ways to resolve this issue and minimizing a detrimental impact to the U.S. manufacturers.

I am going to jump ahead here and just say as a small manufacturer, and we have already identified that there are a great number of exporters that are small manufacturers, and most likely S corporations, one of the things I do want to point out is that the current bill does not include such Subchapter S corporation, and I would like to consider having S corporations added.

Thank you.

[Mr. Parsons' statement may be found in the appendix.]

Chairman MANZULLO. Thank you for your testimony. You pointed out correctly that the bill as drafted does not apply to S corporations. We are obviously in favor of addressing that somewhere in the future and we look forward to working with you on that topic.

I had the opportunity to have lunch with our next witness. I was at a different table from Mr. Parsons, and I am sorry we did not have a chance to chat about your business. Wayne, is it Fortun?

Mr. FORTUN. Yes.

Chairman MANZULLO. Mr. Fortun is President and CEO of Hutchinson Technology, Inc. headquartered in—I thought it was in Hutchinson, Minnesota.

Mr. FORTUN. That is correct.

Chairman MANZULLO. Okay. Litchfield, what is that?

Mr. FORTUN. A town maybe 14 miles north of us.

Chairman MANZULLO. We missed the landing on that one. Sorry about it.

But HTI produces over 60 percent of the suspension assemblies for computer disk drives as well as other precision equipment. Mr. Fortun will review the history of HTI, describe some of its products. During the course of your testimony, Mr. Fortun, if you could share how you have withstood the onslaught of manufacturing jobs. You are the only one left in the country that manufacture that product, and 98 percent of your sales are foreign. It is a fascinating story, and we look forward to your testimony.

STATEMENT OF WAYNE FORTUN, PRESIDENT AND CEO, HUTCHINSON TECHNOLOGY, INC., HUTCHINSON, MN

Mr. FORTUN. I will do my best.

Chairman Manzullo, and the members of the Small Business Committee, thank you for the opportunity to present the view of Hutchinson Technology, Incorporated on this very important issue.

Chairman MANZULLO. Could you put the microphone closer to your mouth?

Mr. FORTUN. Sure.

Chairman MANZULLO. Thank you.

Mr. FORTUN. I am Wayne Fortun, President and Chief Executive officer of Hutchinson Technology, Incorporated, or as we call ourselves, HTI. I am here today because of the elimination of the ETI without a suitable replacement would have a sever effect on our company.

Over 90 percent of our product is exported to Asia, and all of our competitors are based there. The benefits of the FSC/ETI have kept the playing field level and enabled HTI to successfully compete on a global market against Asian competitors that enjoy extended tax holidays and pay no income taxes.

Without these benefits, it would be extremely difficult to remain globally competitive, and eventually we would have no choice but to move our operations to Asia in order to compete. This would not only impact our 1900 manufacturing and support employees, but the majority of our 1500 technical and professional staff as well.

To help you understand why we believe it is so important to provide tax relief to U.S. manufacturing companies, I would like to tell you a little bit about our company and the nature of the industry we compete in.

The HTI designs and manufactures suspension assemblies that go into computer disk drives. Suspension assemblies position the recording head above the disk in the disk drive. We manufacture over 60 percent of the worldwide supply of suspension assemblies

for all types of disk drives, from desktop PCs and laptops to servers and enterprise computers that power the Internet and manage information to run our businesses and our government.

The HTI is an example of an American business, small business success story. We were founded by two young entrepreneurs in a rural community in Hutchinson, Minnesota in 1965. In fact, for the first eight years the company was housed in a rented chicken coup. It grew from two employees and make-shift equipment to the leading global suppliers of suspension assemblies. Today we employ over 3,400 employees and have manufacturing facilities located in Minnesota, South Dakota, and Wisconsin.

When we began manufacturing suspension assemblies in the 1970s, the disk drive industry was dominated by U.S.-based mainframe computer manufacturers. Computers were big and expensive, and the gross margins were attractive. That all changed in the eighties when the introduction and rapid acceptance of the personal computer. Small, agile start-up companies emerged, competition was fierce, and the company that could deliver the best drive at the lowest price won.

In pursuit of lower costs disk drive manufacturers started operations in Asia. Correspondingly, HTI's exports grew from less than five percent of revenue in 1988 to 92 percent last year, in 2002. At the same time the number of our U.S. competitors dropped from 34 to zero.

Today, we have only three remaining competitors. As I mentioned earlier, all three are in Asia, and two are in countries that offer extended tax holidays and therefore pay no income tax.

Despite numerous requests and in some cases pressure from many of our cost-conscious customers to relocate in Asia, we have kept our manufacturing operations as well as R&D in the U.S. because our U.S.-based manufacturing model has been and has given us a competitive advantage.

Our strategy has been to leverage technology and automation to win in our markets. HTI's technology leadership is derived from our ability to recruit and retain skilled employees from the Midwest labor market. We currently employ over 500 engineers and technicians, who design and develop equipment, processes and products to meet the ever-increasing requirements for the disk drive industry.

We consider our manufacturing workforce to best in class. They are trained to operate and troubleshoot our sophisticated manufacturing equipment. Each week they produce over 10 million suspension assemblies that must confirm to strict quality and cleanliness requirements.

Through our people and our technology, we are able to produce the best product at the lowest cost in the world. We know we can compete with the best products. However, an increased tax burden would make it very difficult for us to maintain the lowest cost in an industry where every penny counts.

Since 1997, HTI's taxes have been reduced by $15.5 million under the ETI, which has allowed us to invest in technology and jobs here in the U.S. Over that same time period the federal tax revenue from those jobs was $268 million.

We are excited about the future in the disk drive industry and the potential for growth and new applications for disk drives and emerging consumer electronics devices. We believe that the automated facilities we have and the skilled labor force here in the U.S. will help us to meet those future requirements.

All we need and ask for is to retain a level playing field in order to maintain a competitive position. We feel that Jobs Protection Act of 2003 is a step in the right direction, and helping to maintain the level playing field for U.S. manufacturers, and we urge your support of this bill.

However, it still leaves companies like HTI and others that compete in Asia at a disadvantage. To truly level the playing field the issue of tax holidays needs to be addressed. If it is not, we believe there will continue to be an exodus of jobs to Asia, and as we have seen in our industry, it is not the lower skilled positions. Those positions have already been lost. It is the skilled positions that are now at risk.

Thank you for your time.

[Mr. Fortun's statement may be found in the appendix.]

Chairman MANZULLO. Well, this is quite a panel, talk about diverse background. I do not quite know where to begin my questions, but I guess perhaps, Professor, with this question.

Have you examined the two competing bills that are, or at least the two competing philosophies that are underway, that is, the Crane-Rangel, Manzullo bill and the proposed Thomas bill, and if so, could we have your comments on them?

Mr. HUFBAUER. Yes, I have examined both of them. And on careful reflection I think the Job Protection Act is the better one because it more directly answers the problem of manufacturing and other exporting firms.

There are good features of the Thomas bill, in particular, its correction of that 1962 provision I was talking about in subpart F is a good feature, but that only benefits large firms which are able to operate a foreign sales subsidiary, whereas the bill we are discussing now, the Job Protection Act benefits a much wider range of firms.

The Thomas bill also has some features in terms of consolidating this very complicated foreign tax credit system in baskets, dealing with interest allocation provisions—those are all good features, and I agree with the general direction of the reform.

But here we are talking about an immediate hit to firms that are manufacturers mainly and are exporters, and these firms have long been disadvantaged by the U.S. tax law, and I think they have the first claim to the available funds from the repeal of the FSC.

Chairman MANZULLO. What a great answer.

Mrs. Velazquez, after that answer I may not want to ask anymore questions.

[Laughter.]

Ms. VELAZQUEZ. Professor, what would you say to those critics in the administration to make them understand that a strong manufacturing base translates into a stronger national economy?

Mr. HUFBAUER. Well, you know, when I was in the Treasury, I guess I should have left some instructions for my successor. Open this envelope and read it.

But I know where this view that you are speaking of comes from, and I have long disagreed with it.

When you look at the swings in our trade balance, they are all concentrated in manufacturing. All is too strong, but 80 percent is concentrated in manufacturing. We have been running a very strong dollar for quite a few years. It is going in the other direction now, but it has led to a huge decimation of the manufacturing base in this country, and manufacturing trade.

And I do not think you can just kind of say, well, you know, it is going to come back. There is, I think, new evidence coming in that once it goes it stays away.

I guess for people in business that is pretty obvious, but for economists that takes some economic demonstration. So the econometric demonstration is coming in.

Finally, I am very impressed by the evidence that production, and again we are talking mainly manufacturing, is highly sensitive to tax differentials.

Now, this was not known 20 years ago and even 10 years ago the evidence was not so strong. Now it is extremely strong, and some of the best work on that issue has been done in the Treasury Department, echoing some of the comments from my colleagues on this panel who are, you know, directly affected.

The U.S. is not a favorable place from a tax standpoint for manufacturing compared to other countries around the world, not only other countries in Europe and in this hemisphere, but generally. We have now slipped to be a rather high tax country for this important sector. I know that is rambling, but that would be my answer to the Treasury today.

Ms. VELAZQUEZ. Thank you.

Ms. Lee, H.R. 1769 will formally remove the export contingency of tax benefits in the FSC/ETI from the statute, which is the most contentious aspect.

Do you believe that the removal of this provision creates a bill that complies with WTO regulations?

Ms. LEE. I believe that linking the tax benefit to exports was one of the key problems that the EU and the WTO had identified. So I think that it does seem to me that this is very much line with WTO regulations; that it is available to foreign or U.S. manufacturers. It does not distinguish between them, does not discriminate against foreign manufacturers, and for that reason I think we have the right to use our tax system in this way, and certainly to give the tax credit to U.S. manufacturers.

Ms. VELAZQUEZ. Professor, Mr. Thomas, he has not commented on the Crane-Rangel bill, but in February, when he was asked about manufacturing tax credits, he said, and I quote, "I think in the short run it doesn't work, and in the long run it is a disaster."

Can you share your opinion to this Committee on this?

Mr. HUFBAUER. Thank you, Congressman.

I have not read that statement from Chairman Thomas, and it surprises me against the evidence that I have cited, and I will be happy to supply names of authors who have done this econometric work.

Manufacturing is highly sensitive, especially firms involved in exports, they are highly sensitive to tax differentials between juris-

diction, between our own states. There is a lot of evidence that they move to the lower tax states, and certainly internationally.

And I think the responsiveness is growing, and over time because of a more globalized economy, which brings a lot of ability to move which did not exist 20 years ago or even 10 years ago. So the statement seems to me to be at odds with the evidence.

Ms. VELAZQUEZ. Thank you. Yes, my time is up.

Chairman MANZULLO. Yes. Mrs. Musgrave? Mr. Ballance?

Mr. BALLANCE. Thank you, Mr. Chairman.

I have enjoyed the testimonies and I will have no questions.

Chairman MANZULLO. Mr. Graves, any questions?

Okay, who has some questions, just raise their hands? Okay, Mr. Napolitano.

Ms. NAPOLITANO. And I listened to some of it, some of it I can understand, some I am still learning. But a question to anyone of you is, can you explain how the value-added tax is used by the European countries?

And a follow-up to that is, can you explain to this Committee how it is that the Foreign Sales Corporation, the FSC, and its successor, the Extraterritorial Income, ETI, were found to be in violation of the WTO rules while the value-added tax used by most European nations was not?

Mr. HUFBAUER. Thank you, Congressman.

That is a big question, and my answer would take longer than anybody has patience for but let me try to boil it down.

The value-added tax was put in this category of taxes that can be so-called adjusted at the border, and that little phrase means you do not have to charge the tax on your exports, and when imports come in you can put the tax on them.

That was the decision made in 1960 and finally crystallized by the late 1970.

So it is a label. It is a label with a result. I think it is a wrong result, but anyway that label is there.

Now coming to why did the FSC and ETI fail, and here we come to this dramatic testimony I was giving, but I took too long and ran out of time. Basically the reason the FSC failed is that the WTO appellate body tossed out the council decision which had provided the provision where we could have an FSC. It is as simple has that.

We had the biggest, and I get a little excited about this because I was involved in it, we had the biggest negotiation in GATT's history over this up to that point in time. It was the biggest negotiation. Lots of meetings, lots of senior people. We hammered out a deal with the Europeans. It was codified in a GATT council decision.

If you have the time, and I know you are very busy and probably do not spend your time this way, but if you actually read that FSC decision after pages and pages, the appellate body says that GATT council decision was not carried over in the so-called grandfather clause that enacted the WTO at the end of the Uruguay Round.

The finding, to be very precise, was not a legal instrument of the GATT.

Now this was to me an amazing finding. It was a result-driven finding. They wanted to get rid of the FSC. They had to get rid of

this obstacle, this agreement. They said it was not a legal instrument and away we go. Then they applied the rules.

Now on the ETI the story was a little bit different. The Treasury Department and the Congress at the time tried to design a ETI which in its fine textual way met the tests which were put forward in the so-called FSC decision, and that decision emphasized the distinction that the FSC made between taxes on exports and taxes abroad.

So what the Congress did was say, well, the same companies can have the same relief on taxes on foreign production, and that was with the textual reading of the decision. But it was not with the spirit of the decision which was that the appellate body did not like relief for direct taxes on exports, and they came in with the ETI decision, and blew it away. So that is the legal history.

Chairman MANZULLO. Mr. King, did you have a quick question because we have to go vote? Go ahead.

Mr. KING. Thank you, Mr. Chair. I would just quickly toss this out here to Mr. Fortun for starters, and that would be: Do you know what percentage of your export product is embedded federal taxation? If we absolved you of all of that tax lability, how much could you discount your exported product?

Mr. FORTUN. How much could I discount my exported products?

Mr. KING. Yes.

Mr. FORTUN. I am not sure I fully understand the question.

Mr. KING. Okay. If there were no federal tax built into the cost of your products that you export, if we lifted all that tax off instead of a tax credit, what percentage would be embedded federal taxation?

Mr. FORTUN. I am not sure I have the answer, but I have got my tax guy in the back here.

I think that to put it perhaps another way, currently under the ETI/FSC life, we enjoyed a 12.5 percent discount, and we are still paying about a total tax of around 15 to 17 percent. I have competitors that are still paying zero, and so I am still finding a way to compete with them with a 17 percent discount.

And with all due respect to the Professor, any businessman would tell you that of course you are going to go whatever you can to get your lowest cost. Every percent counts these days. And so the fact that we go across state borders or across the Pacific and chasing down lower percentage cost is a matter of survival.

Mr. KING. Okay. Thank you. And in the interest of time and a vote coming up, I will not proceed down that path except just to say that I am, and many of us are interested in getting to that point where you could be far more competitive than you are today, and I think that is the essential core of what we are doing here, and we want to work with you and help you in that regard.

Mr. Chairman, thank you for these hearings, and I appreciate the time, and I yield back.

Chairman MANZULLO. Thanks for the excellent testimony. The committee is adjourned.

[Whereupon, at 3:25 p.m., the Committee was adjourned.]

DONALD A. MANZULLO, ILLINOIS
CHAIRMAN

NYDIA M. VELÁZQUEZ, NEW YORK

Congress of the United States
House of Representatives
108th Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

Opening Statement

Donald A. Manzullo, Chairman

Hearing before the U.S. House of Representative
Committee on Small Business

Wednesday, May 14, 2003, at 2:00 p.m.
2360 Rayburn House Office Building

Today the Committee will examine one of the most important issues the Congress will have occasion to address this year. We will examine the challenge of the World Trade Organization to the Foreign Sales Corporation and Extraterritorial Income Exclusion rules of the Internal Revenue Code and the effect this challenge will have on America's small business owners.

Like many other countries, the United States has long provided export-related benefits under its tax laws. For most of the last two decades in the United States, these benefits were provided under the FSC and ETI tax rules of the Internal Revenue Code. In recent years, the European Union succeeded in having the FSC and ETI tax rules declared prohibited export subsidies by the WTO.

During August of 2002, a WTO arbitration panel determined that the EU was entitled to over $4 billion of annual countermeasures against the United States for failure to repeal its ETI rules. The EU has not yet imposed sanctions against U.S. exports but recently announced it will do so if the ETI regime is not repealed before the end of this year.

A great deal is at stake in the face of the WTO challenge. Our domestic manufacturing base is being hollowed out right before our very eyes. Something must be done to ensure that a viable manufacturing base is preserved in the United States. Otherwise, the economic miracle that has occurred in the United States will be relegated to the dustbin of history.

On our first panel, we have Congressman Phil Crane and Congressman Charlie Rangel, who along with me, recently introduced H.R. 1769, the Job Protection Act of 2003. This bill is the only bill introduced this Congress to address the current WTO challenge.

Once fully phased-in, the bill replaces FSC/ETI with an effective reduction in the corporate tax rate of up to 3½ percentage points for U.S. manufacturers.

On our second panel, we will hear from a panel of experts, Dr. Gary Hufbauer of the Institute for International Economics, and Ms. Thea Lee of the AFL-CIO. We will also hear from two manufacturers, Doug Parsons, President and CEO of Excel Foundry and Machine in Pekin, Illinois, and Wayne Fortun, President and CEO of Hutchinson Technology, Inc. headquartered in Hutchinson, Minnesota, who will provide us with input on how this proposed tax law change would practically work.

I look forward to the testimony of the witnesses. On behalf of the Committee, I wish to thank them all for coming, especially those who have traveled far. I now yield for any opening statement by the gentle lady from New York, Ms. Velázquez.

STATEMENT
of the
Honorable Nydia M. Velázquez, Ranking Democratic Member
House Committee on Small Business
The WTO's Challenge to the FSC/ETI Rules and the Effect
on America's Small Businesses
May 14, 2003

Thank you, Mr. Chairman.

Today, international trade makes most of us think about multinational corporations, like Coca Cola, Microsoft or Johnson and Johnson. But in reality, of all U.S. manufacturers, more than 90 percent are small and medium companies, and it is these firms that make up the overwhelming majority of exporters.

These small companies engage in international trade because of the benefits it brings them. International trade is key to the economic well-being of our nation. Exports are a powerful engine of economic expansion, accounting for 30 percent of total U.S. economic growth over the last decade. Exports are also of critical importance for job creation, and have accounted for the majority of new U.S. manufacturing jobs added to the economy over the last several years.

But globalization, ease of travel, and advances in technology have not only changed the way we do business, but have also made the domestic benefits of exporting more difficult to come by. The global marketplace is experiencing an overcrowding with increased competition, which cause fluctuations in labor costs and prices.

In an effort to improve the competitiveness of their companies, many countries, including the U.S., create special provisions within their tax systems. These tax provisions give domestic producers certain advantages that make their output more attractive to buyers and sellers on the international market.

The U.S. has provided such export-related tax benefits under its laws for decades. Most recently, these benefits were contained under the Foreign Sales Corporation (FSC)/Extraterritorial Income (ETI) tax rules. These measures provided tax relief to many small exporters that could stay in the game as a result, allowing them to do business the old-fashioned way - produce in the U.S. and sell their products overseas.

Yet the European Union (EU) successfully challenged to repeal FSC/ETI before the World Trade Organization (WTO), calling it a prohibited export subsidy.

The EU has threatened retaliatory action if the U.S. fails to repeal the ETI. But such a repeal would prevent small businesses from doing what they do best - creating jobs for American workers while generating revenue through exports.

A repeal of the ETI is not good policy - or good politics. Since tax rates matter when companies decide where to locate their facilities, increasing rates here but not overseas could create incentives to move jobs, plants and production abroad.

With our economy in a weak state, and a net loss of more than two million manufacturing jobs since President Bush took office, this is exactly the kind of policy that we want to stay away from making. Instead, we want to ensure that jobs stay right where they belong - here in the United States.

In order to solve this pressing issue, my good friend from New York, Mr. Rangel along with Mr. Crane, who will testify here today, have introduced legislation, H.R. 1769, the Job Protection Act of 2003.

This bipartisan measure, which is supported by large and small companies alike, is a win-win situation. It repeals the current law FSC/ETI benefits but still gives an effective rate reduction for U.S. manufacturers through a permanent new tax deduction.

It also provides general transition relief - without this, many small companies would have to close their doors due to an immediate increase in their effective tax rates. It also averts the EU's threat of retaliatory sanctions to take effect next January, and it would likely be met with satisfaction from the WTO and the EU.

Today, small businesses face the toughest battle they have in a long time - ever-increasing competition from overseas, a weak domestic economy, and thin profit margins. What they need right now is increased protections which would offset the competitive disadvantages they face in the global arena. This would allow the small business sector to produce more jobs, train more workers, and provide more revenue to our country's economy. Without the support of small business, our economic doldrums are certainly here to stay.

Thank you.

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DONNA M. CHRISTENSEN
DELEGATE, VIRGIN ISLANDS

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Statement of Congresswoman Donna M. Christian-Christensen
Before the House Small Business Committee Hearing on
The Repeal and Reform of the
Foreign Sales Corporation/
Extraterritorial Income Exclusion (FSC/ETI) Tax Regime
May 14, 2003

I want to begin by thanking Chairman Crane, Ranking Member Rangel an our own Chairman Don Manzullo for their thoughtful approach and hard work in crafting this bill which would create an alternative to the FSC/ETI program. The WTO has seemed to create an obstacle course for the U.S. on this issue, and I think that this bill has successfully maneuvered through the road block. I think that we have found a way to restore the incentive to our small and medium manufacturing sector and for places like my district which stand to lose from WTO's ruling and the proposed elimination of the program. The repeal and reform of the FSC/ETI exclusion is of particular importance to the U.S. Virgin Islands, including the many small businesses and workers that comprise the USVI's financial services sector. In working to find a suitable substitute for the FSC/ETI benefits under current law, I hope that this Committee and Congress will be able to do so in a manner that has a positive impact on the business sector, and avoid any inadvertent negative impact on my district.

Because Virgin Islands is an island economy, the USVI and its many small manufacturing and service businesses are particularly dependent on trade and trade-related activities. Over the last three decades, the FSC/ETI program and its various predecessors have provided a significant source of income to the USVI and vitally needed employment in many of the Islands' small businesses. These successive programs were designed by Congress to offset the competitive disadvantage faced by U.S. exporters due to the structure of the U.S. tax system. Under these programs, many substantial U.S. manufacturers have established foreign sales enterprises in the USVI.

The presence of these foreign sales enterprises has benefited the USVI in three important ways. First, corporate franchise taxes and related fees from these operations have been an important source of revenue for the Government of the Virgin Islands. These revenues have historically been on the order of $5 million or more -- a substantial amount for our small Territory. Second, and perhaps more importantly, the ETI program and its predecessors have helped to spawn and support a financial services sector to serve these foreign sales enterprises.

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This sector, which includes corporate management firms, accounting firms, banks and other financial service firms, generates substantial employment and revenue in the Virgin Islands. Finally, these financial service firms, in turn, indirectly support employment at other small businesses throughout the USVI.

Because of the impact on the USVI, as well as Guam, and other Caribbean locations like Barbados, former Congressman Underwood and I worked for over a year with the office of the U.S. Trade Representative and Department of Treasury to try to develop a substitute program that would allow companies to continue doing business in our districts. On several occasions, we thought we had found such a substitute, but did not. Resolving this issue has not been easy. As the Committee is aware, various proposals have been offered in Congress to reform the FSC/ETI program. All of these proposals will impact the USVI. For example, H.R. 1769 -- the bill that is the subject of this hearing -- would potentially benefit the USVI by classifying it as a qualified manufacturing platform. However, the 3½-point rate reduction in this bill may not be sufficient to lure investment to the USVI that might otherwise have gone to foreign jurisdictions. Other proposals, such as H.R. 5095 -- which Ways & Means Chairman Thomas is expected to reintroduce in modified form in the next few weeks -- also have the potential for positive and negative impacts on the USVI and its small businesses.

In working to reform the FSC/ETI program in response to the WTO, it is critically important that Congress recognize the positive contributions that the current program has made to the USVI and its small businesses. Congress must assure the continuation of these advantages vis-à-vis various foreign jurisdictions. The continuation of positive benefits for the USVI's financial services sector is especially important because this sector is one of the engines that will drive the growth of USVI's trade and export businesses as they seek to adapt to coming changes in regional and world trading patterns.

I commend the Chairman and Ranking Member for their interest in this vital issue for all U.S. export-oriented businesses. I look forward to working with the Committee and the Congress as a whole to assure that reforms in current law promote the trade competitiveness of the Virgin Islands, the health of our financial services sector and employment opportunities for workers in our many small businesses.

Committee on Small Business
House of Representatives

Hearing on

The WTO's Challenge to the FSC/ETI Rules And the Effect on America's Small Business

May 14, 2003

Statement of Gary Clyde Hufbauer
Reginald Jones Senior Fellow
Institute for International Economics
Washington, DC

Chairman Manzullo and members of the Committee, thank you for inviting me to testify on the WTO's challenge to the FSC/ETI rules. My testimony is submitted on my own behalf, as a Senior Fellow of the Institute for International Economics, and not on behalf of any government or private entity. In response to House Rule XI, I have not received any federal grants or contracts since October 1, 2001.

My statement first summarizes the long history of the U.S.-EU dispute over the proper taxation of exports,[1] and then offers a comment on the Job Protection Act of 2003 (H.R. 1769).

The dispute originates in the ancient – and now unjustified – GATT distinction between "direct" and "indirect" business taxes. In this dichotomy, direct taxes include corporate income taxes, while indirect taxes include sales, excise and value added taxes.

In 1960, a GATT Working Party decided that indirect taxes could be rebated (or not collected) on exports and imposed on imports, but that no such "border adjustments" could be made for direct taxes. At the time, the important indirect taxes were sales and excise taxes. Only later did value added taxes (VAT) become widespread in Europe and the rest of the world – except the United States.

In 1962, the United States enacted Subpart F of the Internal Revenue Code (IRC). Conceived as an anti-abuse measure, among other things Subpart F denied deferral for "foreign base company income" – meaning export profits earned by a US sales subsidiary incorporated in a low-tax jurisdiction, such as Switzerland. In later years, some European and other countries adopted tax provisions modeled after Subpart F, but without the same tax bite.

Thus, by the late-1960s, U.S. manufacturers – particularly firms that exported manufactured goods – were triply tax-disadvantaged by the GATT rules and the IRC. First, their foreign competitors exporting to the US market were relieved of VAT taxes. Second, U.S. firms had no relief from the U.S. corporate tax burden when they sold into European or other markets. Third, thanks to Subpart F, large U.S. manufacturers that could afford to operate a foreign sales subsidiary were denied the benefit of deferred U.S. taxation on their export profits – even though nearly all their foreign competitors continued to enjoy comparable benefits.

In 1971, faced with a growing trade deficit and more competitive world markets for manufactured goods, the United States enacted the Domestic International Sales Corporation (DISC) to partly redress these tax disadvantages. In essence, the DISC allowed any U.S. firm to defer taxation to the extent of one quarter of its export profits. Since the corporate tax rate was then 48 percent, this amounted to a 12-percentage point reduction.

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[1] A more complete history appears in "The Foreign Sales Corporation Drama: Reaching the Last Act?", *Policy Brief 02-10*, published in November 2002 by the Institute for International Economics (available at www.iie.com).

The European Commission challenged the DISC in the GATT, and the United States challenged European tax practices that (in the absence of effective Subpart F measures) allowed European firms to shelter export profits abroad in low-tax jurisdictions. The cases came to be known as the *Tax Legislation Cases*. When the GATT panel decisions were handed down in 1976, *all the plaintiffs won.* To avoid mutual retaliation that would disrupt the Tokyo Round of Multilateral Trade Negotiations, the parties settled their differences through an agreement that was codified in the Tokyo Round Subsidies Code. The Tokyo Round Subsidies Code, adopted in 1979, allowed European countries to continue their previous tax practices (i.e., they did not need to enact effective Subpart F provisions), so long as the countries ensured observance of "arm's length" pricing behavior in transactions between related firms. The Subsidies Code required the United States to repeal the DISC, but recognized that the United States (and other countries) had no obligation to tax economic processes performed outside the domestic territory. The relevant provisions were repeated, almost word for word, in the Uruguay Round Subsidies Code.

In 1981, the GATT Council adopted a decision that disposed of the *Tax Legislation Cases.* The decision embraced the provisions of the Tokyo Round Subsidies Code, and set the stage for the United States to repeal the DISC and enact the Foreign Sales Corporation (FSC).

In 1997, after some 16 years of tax peace, the European Union brought a case against the FSC -- for reasons having nothing to do with taxation and everything to do with adverse WTO decisions against the EU, and Europe's pre-Doha Round strategy, In a decision too convoluted to analyze here, in February 2000 the WTO Appellate Body tossed aside the 1981 GATT Council Decision and ignored the provisions of the Uruguay Round Subsidies Code. With these obstacles cleared away, the Appellate found against the FSC.

In November 2000, the US Congress replaced the FSC with the Extraterritorial Income Act (ETI). The ETI conformed to a literal reading of the Appellate Body's decision in the FSC case, but not the broad "spirit" of the decision – which was motivated by an effort to stamp out relief for direct taxes on export earnings.

In 2001, the European Union challenged the ETI and again prevailed. In another convoluted decision, the Appellate Body found two technical hooks to hang the ETI. The Body's basic motivation, as noted earlier, was to stamp out relief for direct taxes on export earnings.

In August 2001, the WTO Arbitral panel awarded the EU the right to retaliate against $4.043 billion U.S. exports. The Arbitral panel's method of calculation was badly flawed, right in keeping with the earlier Appellate Body decisions.

In May 2003, the EU announced that it would begin procedures to retaliate if the United States does not move towards compliance by January 2004.

Looking back over this long history, it is evident that the United States has been repeatedly defeated in its effort to redress the triple tax disadvantages faced by US manufacturers and other exporting firms. Moreover, the US Trade Representative has shown no stomach to challenge the ancient and unjustified GATT/WTO distinction between direct and indirect taxes.

This brings me to the Job Protection Act of 2003 (H.R. 1769). Elsewhere, I have advocated an Alternative Corporate Tax – modeled after the subtraction-method VAT – as a solution to the FSC/ETI dispute.[2] However, the business community and the Congress are not in a mood for major tax reform.

Among the alternatives now debated, in my opinion the Job Protection Act best serves the American economy. The Act targets tax relief on manufacturing and other firms with an export history, though carefully it does not discriminate between production for domestic market and production for the export market. Firms with an export history are the ones most disadvantaged by Subpart F and WTO rules. These are the firms most likely to move production and jobs overseas if they do not receive meaningful tax relief for their operations in the United States.

Other proposals under Congressional consideration would reform Subpart F so that "foreign base company income" would no longer be penalized. I applaud this reform of Subpart F. However, it would provide no relief for small exporting firms that cannot afford the expense of establishing a foreign sales subsidiary. Nor would it provide relief for small or large firms that do not wish to expand operations overseas, but instead prefer to maintain their production facilities in the United States and service foreign markets through U.S. exports. By contrast, the Job Protection Act of 2003 provides much-need relief to these firms.

Critics of the Job Protection Act claim that the European Union might bring another challenge in the WTO. Anything is possible. But the EU should have no incentive to further disrupt the fragile Doha Round. If WTO litigation is a matter of concern, the Congress should enact a companion measure to the Job Protection Act.

The Congress should instruct the U.S. Treasury and the U.S. Trade Representative to forthwith bring a WTO case against any foreign country that challenges the Job Protection Act, if elements of that country's tax or subsidy system (for example, EU agricultural export subsidies) arguably violate the WTO. This instruction would reinvigorate the successful offensive/defensive strategy that ultimately resulted in tax peace at the conclusion of the Tokyo Round.

Thank you, Mr. Chairman.

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[2] See *Policy Brief 02-01*, referenced in footnote 1.

TESTIMONY OF THEA M. LEE
CHIEF INTERNATIONAL ECONOMIST
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS
BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS

"The WTO's Challenge to the FSC/ETI Rules and the Effect on America's Small Businesses"

May 14, 2003

Mr. Chairman, Ms. Velazquez, and members of the committee, I thank you for the opportunity to testify on behalf of the 13 million working men and women of the AFL-CIO and the unions of the Industrial Union Council on the issue of FSC/ETI repeal and replacement.

We believe this hearing is timely for several reasons. With sanctions up to $4 billion pending against US-made products and all appeals to the WTO exhausted, it is important for the Congress to respond. The deep, prolonged crisis in US manufacturing makes it even more essential for Congress to examine ways to support US manufacturing and exports. The AFL-CIO believes that the FSC/ETI can be replaced in a way to bring the US into compliance with the WTO and boost manufacturing in the US.

My testimony will focus on four key points: the dimensions of the crisis in manufacturing, the Crane-Rangel-Manzullo-Levin bill to replace the FSC, the plan offered by Ways and Means Committee Chairman Bill Thomas last year to replace the FSC, and the need to address manufacturing in a comprehensive way, including health care reform and altering our flawed trade policies.

THE CRISIS IN MANUFACTURING

The unemployment figures released earlier this month show that 95,000 manufacturing workers lost their jobs in April alone. It is a startling number, but not surprising. For 33 straight months, manufacturing has lost jobs, the longest such stretch since the Great Depression. Since April 1998, the United States has lost 2.6 million manufacturing jobs, nearly 13 percent of the total manufacturing workforce. Manufacturing job loss accounts for a staggering 90 percent-plus of total US job loss since March 2001. Nearly every state in the nation has suffered heavy manufacturing job loss.

Unless these trends are reversed, serious damage will be done to the livelihoods of America's working families—and to the nation's economy. Manufacturing historically has been a major generator of good, high-skilled, well-paid jobs, including in nonmanufacturing sectors, and remains a mainstay of local and state economies throughout the nation. Manufacturing's decline not only undermines the quality of

manufacturing jobs, but also contributes to the stagnation in all workers' wages. Moreover, the massive scale of manufacturing plant closings and job layoffs is contributing directly to the serious fiscal crises afflicting virtually every state in the nation.

The forthcoming debate on the FSC/ETI repeal gives Congress one opportunity to help US-based manufacturing by reorienting tax policy.

MANUFACTURING TAX BENEFIT

Replacing the FSC/ETI with incentives to create manufacturing jobs in the US is vital for the health of the industry and our entire economy. We believe that H.R. 1769, the Crane-Rangel-Manzullo-Levin bill will help boost US-based manufacturing, which is why the AFL-CIO strongly supports it.

As you may recall, Mr. Chairman, AFL-CIO Secretary-Treasurer Richard Trumka testified before this committee last month and called for legislation to establish a manufacturing tax benefit to replace the FSC/ETI. We are pleased that there has been a broad, bipartisan response to this call in the Congress and we look forward to working with you and others to secure the legislation's passage.

H.R. 1769 would provide a tax benefit for production of goods in the US, adjusted for the percentage of a company's worldwide production that takes place in the US. For instance, a company that makes all of its goods in the US would be eligible for the entire benefit, while a company making half of its goods in the US would receive half of the benefit. In the future, the legislation would create an effective tax penalty for shifting production abroad. The legislation would also phase out FSC benefits over seven years, allowing time for workers and companies who were FSC beneficiaries to adjust to a new system.

THE THOMAS OFFSHORE TAX BREAKS

Rep. Bill Thomas (R-CA), chairman of the House Ways and Means Committee, last year put forward a proposal to repeal the FSC and replace it with a collection of corporate tax cuts, most of which would mainly benefit companies with overseas production facilities.

Multinational corporations could accumulate untaxed profits overseas more easily because "base company" rules would be repealed. These rules now subject companies' profits to taxes in one or more countries. Multinational corporations would also get tax breaks by using rules that allow profits made in countries like Germany and France to be converted into tax deductions by paying "expenses" to wholly or partly owned companies in tax havens like the Cayman Islands.

This proposal, put simply, would ship more manufacturing jobs abroad. According to a New York Times story last year, "Even some supporters of the bill said

the ability of companies to avoid taxes on profits from factories abroad so long as they were not returned to the United States encouraged American companies to invest, and create jobs, overseas."[1]

It is bad enough that bureaucrats at the WTO and EU are forcing changes in our tax system, but it is even worse that some in Congress would seek to do the EU's bidding by making domestic manufacturing less competitive. The Thomas approach appears to define "enhancing American competitiveness" as boosting the profitability of multinational corporations to produce anywhere they choose, so long as they keep an American mailbox. We strongly encourage Congress to reject it.

Our existing tax system—through foreign profit tax deferral, the foreign tax credit, and other provisions—already places American-based manufacturers at a terrible disadvantage compared to multinational firms that generate most production offshore. Those tax policies also need to be reoriented.

THE BROADER AGENDA

The manufacturing tax benefit, taken alone, will have only a small effect on enhancing the competitiveness of US manufacturing. It will make our tax policy better, but the AFL-CIO believes Congress should make other significant policy changes.

America's manufacturing workers are the most productive in the world. But they operate under enormous competitive disadvantages resulting from several factors in addition to tax policy, such as unfair trade agreements, an overvalued dollar and foreign currency manipulation, inadequate investment incentives, health care costs not borne by overseas producers, and foreign government subsidies. Unless these problems are addressed soon, American manufacturing capacity and jobs may end up permanently lagging. And our economic strength may be permanently weakened: U.S. productivity and wage gains have been largely driven by the performance of the manufacturing sector.

We urge the Congress to start with passing a manufacturing tax benefit, but to make that only the first step of a more comprehensive effort. Thank you.

[1] David Cay Johnston, "Bill Closing Bermuda Loophole Also Includes Tax Breaks," *New York Times,* July 17, 2002.

Testimony of

Doug M. Parsons
President & Chief Executive Officer
Excel Foundry and Machine, Inc.
Pekin, Illinois

Before the
Committee on Small Business
U.S. House of Representatives

On
The WTO Challenge to the FSC/ETI Rules and the Effect on U.S. Small Business

May 14, 2003

Chairman Manzullo, members of the Small Business Committee, thank you for the opportunity to appear before you today to present the views of Excel Foundry and Machine, Inc., on the impact of the WTO's FSC/ETI decisions on small manufacturers. I am Doug Parsons, president and chief executive officer of Excel Foundry and Machine.

Excel Foundry and Machine manufactures and supplies precision-machined bronze and steel parts for heavy-equipment-related industries such as mining, crushing and mineral processing. Founded in 1929, the company had $13 million in sales in 2002. Excel, which operates as a subchapter-S corporation, has roughly 100 employees at its facilities in Pekin, Ill.

The current extraterritorial income regime – as well as its predecessors, the domestic international sales corporation (DISC) and the foreign sales corporation (FSC) — have been integral factors in increasing export activity by U.S. manufacturers. According to the IRS, of the roughly 4,300 FSCs in existence in 1996, 89 percent of them exported manufactured products. Congress first created the DISC in 1971 to level the playing field for U.S. companies — large and small — selling their products overseas. These three types of tax incentives created over the past three decades were designed to neutralize some of the tax advantages enjoyed by our foreign

competitors located in countries with territorial tax systems, which generally exempt income earned outside the country from income tax and exports from value-added (VAT) and other consumption taxes.

Traditionally, much of the attention in this area has been focused on FSC/ETI usage by large companies. These benefits also are important to small and mid-sized manufacturers that export, and exporting goods overseas for Excel as well as many,of these smaller companies is a simple necessity of staying in business. Smaller companies often turn to export tax incentives to break into and effectively compete in the global marketplace. According to a July 2000 survey by the National Association of Manufacturers (NAM), small and mid-sized manufacturers saved, on average, about $124,000 annually by using a FSC.

It is critically important to continue to encourage export activity by these small companies. Of all the exporting manufacturers in America, 93 percent are small and mid-sized manufacturers. These firms, which individually employ anywhere from 10 to 2,000 employees, together employ roughly 9.5 million people. Small and mid-sized manufacturers that export add jobs 20 percent faster than firms that remain solely domestic, and are 9 percent less likely to go out of business.

For Excel Foundry and Machine, selling products in the international market – whether directly or indirectly – is the lifeblood of the company. International sales are vital to the growth and health of Excel, allowing us to expand by adding new space, hiring more employees and making capital investments. Direct international sales account for one-third of Excel's revenue, and these sales are responsible for the tremendous growth for the company – about 30 percent over the past four years. They have enabled the company to recently add a 20,000 square foot expansion to our production facilities and hire five new engineers.

In the past, Excel used a foreign sales corporation (FSC) and we currently use the extraterritorial income regime. The benefits provided by FSC/ETI justify the additional efforts needed to go into overseas markets and compete. For example, the tax systems in some South American countries heavily favor local suppliers; FSC/ETI helps level the playing field.

The loss of tax incentives like those provided by FSC/ETI would have a tremendous impact on the company, affecting revenues and employment. There are many hidden costs in doing business internationally. In markets where margins are already thin, we would lose sales due to an uneven playing field. If these sales slumped, Excel likely would have to cut between 3 to 5 percent of its workforce.

Excel is also a substantial indirect exporter and indirect beneficiary of ETI as a supplier to larger exporters such as Caterpillar. If these larger exporters were to shift production overseas, it is unlikely that they would maintain our supplier relationship. So, from this perspective, it is also important to note that what is good for these larger exporters is also good for Excel and many other small companies that rely heavily on supply orders.

Given last week's final WTO authorization for the EU to impose more than $4 billion in annual sanctions against U.S. exports, we are pleased that Congress is actively pursuing constructive ways to resolve this issue while minimizing the detrimental impact on U.S. manufacturers.

Repeal of ETI without an adequate replacement would disproportionately affect manufacturers, who are the largest contributors to U.S. economic growth as well as the largest beneficiaries of the FSC/ETI rules. Small and mid-sized manufacturers would acutely feel the burden, adding to the current manufacturing crisis, evidenced by more than 2.2 million job losses in the manufacturing sector since July 2000. As mentioned earlier, approximately 90 percent of

the benefits under FSC and ETI were realized by manufacturers, and the loss of ETI benefits now would amount to a $5 billion annual tax increase on manufacturing when the sector can least afford it. Moreover, loss of these benefits could further exacerbate job loss in the sector. According to a recent PricewaterhouseCoopers study, in 1999, more than one million U.S. jobs were directly attributable to FSC-benefited exports, and another 2.5 million were indirectly attributable to these exports. The study also found that in the same year over $310 billion of the country's $990 billion of exports of goods and services benefited from FSC, accounting for 3.4 percent of Gross Domestic Product (GDP). Because of the importance of exports both to the future of manufacturing and the broader U.S. economy, ETI must not be repealed in the absence of an adequate replacement. Thus, if ETI is repealed, it is critically important that any cost savings are used to benefit U.S. exporters.

We also cannot ignore the WTO decisions. Failure to comply with the WTO findings would subject U.S. industry to more than $4 billion in annual retaliatory sanctions and have significant negative repercussions for U.S.-European trade relations.

Current proposals to resolve the issue vary considerably, ranging from substituting other changes in the international tax area for FSC/ETI to a tax reduction for manufacturing in the United States.

As a small, U.S.-based manufacturer, I am concerned that some of the proposed solutions are targeted to multinational corporations with subsidiaries, operations and employees outside the United States. These changes will not benefit small exporters, like Excel, with operations only in the United States and thus will not serve as an adequate substitute for FSC/ETI.

In resolving the FSC/ETI issue, it is it is imperative that the United States strive to maintain approximately the current level of benefits <u>for all exporters</u> and continue to work

toward a level playing field and a competitive environment for U.S. companies. At this point, it appears likely that the long-term solution will have to involve a combination of negotiations and legislation.

On the negotiations front, I support efforts to reopen this issue in the Doha trade round and negotiate to change the WTO rules so they provide similar treatment for indirect and direct taxes. On the legislative side, the approach taken in the Crane-Rangel-Manzullo bill – providing for a tax reduction based on domestic production – appears to have promise. However, as currently drafted, this bill does not provide a benefit for companies organized as S-corporations. As this is a very significant issue and benefit to Excel as well as other S-corporation exporters, I would urge that S-corporation benefits be added as the process moves forward.

I am grateful to Chairman Manzullo and the Small Business Committee for holding this hearing on the effect of the WTO FSC/ETI decisions on U.S. small businesses. We look forward to working with you and other members of Congress and the Administration to resolve this issue in a fair and expeditious manner that satisfies the World Trade Organization, does not result in a significant tax increase on U.S. companies, avoids sanctions on U.S. products and encourages export activity by American manufacturers of all sizes.

Thank you for working to provide the tools for American manufacturers, large and small, to compete effectively with their foreign counterparts.

Testimony of
Wayne M. Fortun
President & Chief Executive Officer
Hutchinson Technology Incorporated
Hutchinson, Minnesota

Before the
Small Business Committee
U.S. House of Representatives

On
The WTO's challenge to the FSC/ETI Rules
and the effect on American Small Business
May 14, 2003

Chairman Manzullo and members of the Small Business Committee, thank you for the opportunity to present the views of Hutchinson Technology Incorporated on this very important issue.

I am Wayne Fortun, president and chief executive officer of Hutchinson Technology Incorporated, or HTI as we refer to ourselves. I am here today because the elimination of the ETI without a suitable replacement would have a severe effect on our company.

Over 90 percent of our product is exported to Asia and all of our competitors are based there. The benefits of FSC/ETI have kept the playing field level and enabled HTI to successfully compete in the global market against Asian competitors that enjoy extended tax holidays and pay no income taxes. Without these benefits, it would be extremely difficult to remain globally competitive, and, eventually, we would have no choice but to move our operations to Asia in order to compete. This would not only impact our 1,900 manufacturing and support employees, but the majority of our 1,500 technical and professional staff as well.

To help you understand why we believe it is so important to provide tax relief to U.S. manufacturing companies, I'd like to tell you about our company and the nature of the industry we compete in.

HTI designs and manufactures suspension assemblies for computer disk drives. Suspension assemblies are small, intricate components that position the recording head above the disk. We manufacture over 60 percent of the worldwide supply of suspension assemblies for all types of disk drives - from desktop PCs and laptops to the servers and enterprise computers that power the Internet and manage the information to run our businesses and government.

HTI is an example of an American small business success story. It was founded by two young entrepreneurs in the rural community of Hutchinson, Minnesota, in 1965. In fact, for the first eight years, the company was housed in a rented chicken coop! It grew from two employees and makeshift equipment to the leading global supplier of suspension assemblies to the disk drive industry. Today, we employ over 3,400 people and have manufacturing facilities located in Minnesota, South Dakota, and Wisconsin. We are recognized as a technology, quality, and volume-manufacturing leader by our customers and competitors alike.

When we began manufacturing suspension assemblies in the 1970s, the disk drive industry was dominated by US-based mainframe computer manufacturers such as Honeywell, Univac, Control Data and Burroughs. Computers were big and expensive and the gross margins were attractive. That all changed in the 1980s with the introduction and rapid acceptance of the personal computer. Small and agile startup companies emerged. Competition was fierce, and the company that could deliver the best disk drive at the lowest price won.

In pursuit of lower costs, disk drive manufacturers, along with many of the computer manufacturers, started operations in Asia. Correspondingly, HTI's exports grew from less than five percent of revenue in 1988, to 92 percent last year (2002). At the same time, the number of our U.S. competitors dropped from 34 to zero. Today, we have only three remaining competitors. As I mentioned earlier, all three are in Asia and two are in countries that offer extended tax holidays and, therefore, pay no income taxes.

Despite numerous requests, and in some cases pressure, from many of our cost-conscious customers to relocate to Asia, we have kept our manufacturing operations, as well as R&D, in the U.S. because our U.S.-based manufacturing model has given us a competitive advantage. Our strategy has been to leverage technology and automation to win in our market.

HTI's technology leadership is derived from our ability to recruit and retain skilled employees from the Midwest labor market. We've been very successful in recruiting engineers and technicians from state universities and technical colleges in North and South Dakota, Minnesota, Iowa and Wisconsin. We currently employ over 500 engineers and technicians who design and develop equipment, processes, and products to meet the ever-increasing requirements of the disk drive industry. These employees have found they can enjoy the benefits of living in a small town like Hutchinson, Minnesota, or small city like Eau Claire, Wisconsin, and, at the same time, continue their professional growth with a technology company.

We consider our manufacturing workforce to be best-in-class. They are trained to operate and troubleshoot our sophisticated manufacturing equipment. Each week, they produce over ten million suspension assemblies that must conform to strict quality and cleanliness requirements. We enjoy a low turnover rate and receive high scores on our employee satisfaction surveys. Our employees tell us they stay because of the competitive pay and benefits, excellent working conditions and opportunities for

advancement. Over one-third of our employees have been with the company for more than 10 years. The average length of service for our 10-member executive team is 23 years.

Through our people and our technology, we are able to produce the best product at the lowest cost in the world. We know we can offer the best product; however, an increased tax burden would make it very difficult for us to maintain the lowest cost in an industry where each and every penny counts.

Since 1997, HTI's taxes have been reduced by $15.5 million under the ETI, which has allowed us to invest in technology and jobs here in the U.S. Over that same time period, the federal tax revenue from those jobs was $268.2 million.

We're excited about our future in the disk drive industry and the potential for growth. New applications for disk drives are emerging in the consumer electronics market in devices such as cell phones, PDAs, and digital video recorders. Some analysts believe this new market could potentially double the size of the current disk drive market. We have the automated facilities and skilled labor force here in the U.S. to meet this future growth opportunity. All we need is to retain a level playing field in order to maintain our competitive position.

We feel the Jobs Protection Act of 2003 is a step in the right direction in helping maintain a level playing field for U.S. manufacturers, and we urge your support of this bill. However, it still leaves companies like HTI and others that compete in Asia at a disadvantage. To truly level the playing field, the issue of tax holidays needs to be addressed. If it isn't, we believe there will continue to be an exodus of jobs to Asia. And, as we've seen in our industry, it's not lower-skilled positions - those positions have already been lost - it's the skilled positions that are now at risk.

ETI was established to encourage exports, which in turn, encouraged manufacturing here in the U.S. Benefits similar to those earned under FSC/ETI must be retained by those that manufacture in the U.S. Any replacement benefit should inure to those that remain committed to U.S. labor and U.S.-based technology. The benefit should not become part of a lobbying contest to transfer the benefit to those companies that have substantial overseas operations or as a fix for other issues or problems with unrelated international business areas of the Internal Revenue Code.

Since 1990, the rules of FSC/ETI allowed HTI an average annual reduction of 12.5 percentage points in our tax rate. Under the Crane-Rangel-Manzullo proposal, the tax rate reduction would be limited to 3.5 percent. This would result in a significant increase in our cost of manufacturing here in the United States. Although HTI will not earn the same amount of benefit under this proposal as we did under FSC/ETI, we encourage your support of this bill and the U.S. manufacturing, technology, and jobs it is intended to help preserve.

Thank you for your time.

COALITION FOR FAIR INTERNATIONAL TAXATION (C-FIT)

Contact: Washington Council Ernst & Young
(202) 293-7474

May 14, 2003

Statement of the
Coalition for Fair International Taxation

On

The WTO's Challenge to the FSC/ETI Rules and the Effect on America's Small Businesses

Submitted for the Record of the Hearing before the
Committee on Small Business, U.S. House of Representatives
On
May 14, 2003

The Coalition for Fair Taxation ("C-FIT") is a group of 26 U.S. corporations representing a broad cross-section of industries that supports the modernization of the U.S. international tax code to ensure that U.S. companies can effectively compete in international markets. (Please see the attached list of companies.)

Introduction

As explained in the hearing notice issued by the Committee on Small Business, the "purpose of the hearing is to discuss the effect on America's small business owners of the [World Trade Organization's] WTO's ruling that held that our [Foreign Sales Corporation/Extraterritorial Income] FSC/ETI export-related tax benefits violate our trade agreements." The hearing notice also referenced H.R. 1769, a bill introduced on April 11, 2003 by Chairman Manzullo, together with Rep. Crane (R-IL) and Rep. Rangel (D-NY), in order to bring the United States into compliance with the WTO ruling by replacing the current-law ETI benefit with a deduction of up to 10 percent of the income attributable to domestic production. The current ETI regime is intended to create a level playing field for U.S. companies competing in markets outside the United States, including manufacturers and other industries involved in the export of U.S. goods. The current ETI regime is available to both domestic and foreign production. H.R. 1769 focuses on U.S. manufacturing, and thus penalizes U.S. businesses

competing internationally by reducing the 10-percent deduction. Moreover, the bill discriminates against companies in industries other than manufacturing that currently make use of the ETI regime, including services businesses that either facilitate U.S. exports or provide services relating to those exports in foreign jurisdictions.

This statement focuses on the importance of responding to the WTO ruling by enacting FSC/ETI replacement legislation that recognizes the need to maintain the international competitiveness of all American businesses and their workers, without discriminating against U.S. companies that have substantial active businesses abroad and that are responsible for the creation of millions of American jobs.

In responding to the WTO FSC/ETI ruling, the Congress must take account of the vital role that U.S.-based multinational operations play in increasing U.S. exports.

U.S. multinational corporations play a vital and leading role in the U.S. economy, and are responsible for:

- 23 million American jobs
- 21% of U.S. GDP
- 56% of U.S. exports
- $131 billion in annual U.S. R&D spending and
- 49 % of U.S. corporate income tax payments

Moreover, foreign direct investment by U.S. businesses leads to sales in foreign markets that likely would not happen by simply exporting goods, helping to create markets for American products. A recent study by the Organization for Economic Cooperation and Development (OECD) found that each dollar of outward foreign direct investment led to two dollars of additional exports and an increase in the U.S. bilateral trade surplus of $1.70.

The Commerce Department's "Survey of Current Business" indicates that in 2000 (the most recent year for which data are available), U.S.-based multinationals accounted for about two-thirds of overall U.S. merchandise exports. Foreign affiliates of U.S.-based multinationals purchased $203 billion of goods from U.S. sources, while domestic operations of U.S.-based multinationals exported $236 billion to other foreign customers.

Thousands of small U.S. businesses participate in the global economy as suppliers to U.S.-based multinational corporations.

These small businesses support and depend on the global operations of U.S. firms. As the Small Business Administration found in a report discussing the role of small businesses in the global economy, "smaller firms can conduct international expansion on their own, or by collaborating with a multinational firm. The intermediated form of international expansion has certain advantages. The small firm benefits from having access to the multinational firm's global

market reach. From the large firm's perspective, the arrangement enhances the value of its existing contributions to internationalization."[1]

Congress must act to support the competitive efforts of American companies that operate in the global marketplace.

The challenge for U.S. companies to remain competitive on an international basis has never been greater than today. When U.S. firms are competitive in the global marketplace, they are better able to enhance the demand for domestic products, create U.S. jobs, and earn foreign market share.

One significant factor limiting our competitiveness is the basic structure of the U.S. international tax regime, enacted over 40 years ago when the U.S. economy dominated the world. At that time, 18 out of the top 20 global companies were headquartered here, and the United States accounted for over half of all multinational investment in the world. Today, to remain competitive and fuel U.S. economic growth and jobs, domestic companies must compete against foreign-owned firms for clients and customers that are located around the globe. The United States needs a pro-competitive U.S. tax policy.

Conclusion

It is imperative that the United States comply with the WTO's FSC/ETI ruling in a manner that takes into account the interests of *all* American businesses and their workers, and ensures that U.S. businesses and workers are not placed at a disadvantage in relation to their foreign competitors. The ETI regime was created to help U.S.-based companies price their products for export to foreign jurisdictions in order to compete with foreign-based companies that operate under significantly different and more favorable home-country tax rules.

Legislation replacing the ETI regime must continue to pursue this objective of global competitiveness for U.S. goods and services; to do otherwise penalizes U.S. workers whose jobs depend on the ability of their employers to sell products and services throughout the globe. H.R. 1769, on the contrary, focuses on domestic manufacturing, and actually penalizes U.S. companies that seek to compete outside of this country. We believe this is the wrong approach. Instead, the WTO-mandated changes to U.S. tax law should include much needed reforms to our outmoded international tax regime because these reforms will ensure that U.S.-based companies can continue to compete globally against foreign-based companies operating under more advantageous tax regimes. C-FIT stands ready to work with the Congress to achieve this result.

[1] SBA Office of Advocacy, "The New American Evolution: The Role and Impact of Small Firms" (June, 1998).

COALITION FOR FAIR INTERNATIONAL TAXATION (C-FIT)

COALITION MEMBERS

3M
AGILENT TECHNOLOGIES
CARGILL
CISCO SYSTEMS
CITIGROUP
COCA-COLA
COCA-COLA ENTERPRISES
DEERE & COMPANY
THE DOW CHEMICAL COMPANY
EASTMAN KODAK COMPANY
EDS
EXXON MOBIL CORPORATION
FORD MOTOR COMPANY
GENERAL MILLS
GENERAL MOTORS
GEORGIA-PACIFIC
HEWLETT-PACKARD COMPANY
INTERNATIONAL BUSINESS MACHINES
JOHNSON & JOHNSON
MARS
McDONALD'S CORPORATION
PRAXAIR
PROCTER & GAMBLE
TEXAS INSTRUMENTS
WAL-MART
XILINX

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