Is the Crisis Provoking Protection in Services?
A Case Study of the United States

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Summary: The United States has so far taken few explicitly protectionist measures in services during the current crisis. Even as goods imports have declined, imports of private services have continued to grow, particularly of business services by around 7 per cent. However, employment in virtually all services sectors has declined significantly - in business services by as much as 6 per cent. The changing political climate, as well as the growing influence and widening boundaries of the state, may introduce an implicit national bias in firms' procurement and location choices. Against explicit protection there exist some multilateral and regional trade rules. Against the more far-reaching – though possibly temporary - threat of implicit protectionism, there are currently no international disciplines.

Keywords: Services, trade, crisis
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Executive summary

The US accounts for about one-fifth of the services imports and exports of all OECD countries. For many developing countries, the US is the most important market by virtue of its size and openness; for example, more than half of India's services exports to the OECD go to the US. Even more significant than the US' share of trade is the power of example it sets. Whether the current crisis is provoking the US to raise its level of protection is, therefore, an issue of both substantive and symbolic significance.

In this paper, we first examine changes in US policy for any sign of explicit protection so far and find only a few examples. Each is of limited economic significance, and to some extent constrained by multilateral or regional trade rules. We also identify certain developments that could lead to more subtle forms of protection – notably, increased government ownership of, and conditional financial support to, firms, as well as the growing political and social aversion to "moving jobs abroad." These nascent forms of protection could have much more serious economic impact because they affect a much larger share of economic activity and are not meaningfully restrained my international rules.

An examination of recent trends in US services imports, however, reveals no sign of adverse policy effects. Even as goods imports have declined, by as much as one-third, imports of private services as a whole and business services in particular, have continued to grow. Imports of transport, travel and financial services have declined but that was only to be expected in current circumstances.

The domestic services sector is, unfortunately, less resilient. We show that services employment has not suffered the precipitous declines seen in durable goods and construction (of 12 per cent since April 2008), but it too has declined, by around 4 per cent. How can we reconcile sustained growth in imports of business, professional and technical services (by about 7 per cent) with significant declines in employment in domestic business/professional services (by about 6 per cent)? One possibility is that firms in industrialized countries, under increased pressure to cut costs during the crisis, are turning to outsourcing.

While growing trade and declining employment can generate pressure to protect, there are other countervailing forces. Industrial country firms have made large relationship-specific investments in outsourcing intermediate services; in turn, developing countries have become important markets for industrial country banks, retailers, telecommunications and transport providers. As a result, the business functions of customers and suppliers of services are highly intertwined. Any protectionist action would be self-defeating, because of its direct costs and because it could provoke retaliatory protection.

Nevertheless, it would be wrong to be complacent. We suggest, first of all, greater efforts to monitor new protectionist actions in services – which have so far largely escaped WTO

scrutiny (with the exception of financial bailouts). Second, the Doha negotiations must aim to lock-in existing policies in at least the major trading countries. Third, there is need for greater discussion on how to address the possible home-market bias created by the widening boundaries and increasing influence of the state.

INTRODUCTION

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In this paper, we first examine (in Section I) changes in US policy for any sign of explicit protection so far and find only a few examples. Each is of limited economic significance, and to some extent constrained by multilateral or regional trade rules (Section IV). We also identify certain developments that could lead to more subtle forms of protection – notably, increased government ownership of, and conditional financial support to, firms, as well as the growing political and social aversion to "moving jobs abroad." These nascent forms of protection could have much more serious economic impact because they affect a much larger share of economic activity and are not meaningfully restrained my international rules.

An examination of recent trends in US services imports (in Section II), however, reveals no sign of adverse policy effects. Even as goods imports have declined, by as much as one-third, imports of private services as a whole and business services in particular, have continued to grow. Imports of transport, travel and financial services have declined but that was only to be expected in current circumstances.

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While growing trade and declining employment can generate pressure to protect, there are other countervailing forces (Section III). Industrial country firms have made large relationship-specific investments in outsourcing intermediate services; in turn, developing countries have become important markets for industrial country banks, retailers, telecommunications and transport providers. As a result, the business functions of customers and suppliers of services are highly intertwined. Any protectionist action would be self-defeating, because of its direct costs and because it could provoke retaliatory protection.

I. PROTECTIONISM: EXPLICIT AND IMPLICIT

As in the case of goods, we have not seen significant reversals of policy in services. The commitment of the G-20 Joint Declaration of November 15, 2008, to refrain from raising new barriers also covers services trade and investment flows. But protection may be beginning to take a subtle form, perhaps in deference to the invisibility of services and the fact that they are increasingly delivered electronically. First, explicit discrimination through preferential procurement seems at this stage less damaging than the implicit social and political disapproval of outsourcing as well as the growing influence and widening boundaries of the state. Developing country service exporters argue that it is the latter that is beginning to introduce an implicit national bias in firms' procurement and location choices. Similarly, the few visible explicit restrictions on employing or contracting foreign services providers in specific areas (e.g. financial services) are not as costly for both host and source as the increasing social and political aversion to immigration. In the longer term, subsidies to banks are probably less damaging than "financial nationalism". The former are temporarily necessary to ensure the stability of the financial system. The latter seriously erode the case for openness. Inducing national banks to lend domestically in a crisis deprives developing countries in particular of capital when they most need it and greatly strengthens the case for financial self-sufficiency.

Table 1 presents examples of restrictions drawn mostly from the United States, which because of its size and openness to trade in services, is of greatest significance to services exporters. These measures include, first of all, the observed and explicit: preferential procurement by state entities and firms; restrictions on the employment of foreign nationals; and subsidies to rescue national firms. Then there are measures which have not been observed but may be taken: inducements to lend locally; increased state ownership, conditional subsidies, or political and social pressure inducing firms to buy, locate and employ nationally.

Table 1: An Illustrative List of Recent and Potential Protectionist Measures in Services

Measure	Implementation Status (actual / potential)	Impact on Services Trade	Legal Recourse
Preferential procurement by state entities and firms	New Buy American measures (e.g. in the US fiscal stimulus) do not cover services, though existing preferences may apply to new expenditure	**None** (as of yet). History of sub-federal legislation to reverse outsourcing shows it was largely inconsequential. And government share of total domestic demand tends to be small, except in state-level purchases of construction services.	For signatories to the WTO's Government Procurement Agreement (GPA) or regional GPAs to the extent that both procuring entity and service is covered. For non-signatories: None.
Preferential employment requirements for private firms	"American Recovery and Reinvestment Act of 2009": Financial institutions receiving bailout funds face increased restrictions on hiring specialty occupation (H-1B) visa holders. [Durbin-Grassley Bill "The H-1B and L-1 Visa Fraud and Abuse Prevention Act" of 2007]	**Not significant** since binding constraint are quotas on total number of specialty occupation visas, but may hurt foreign professionals with finance-specific skills.	GATS commitments on national treatment on mode 4 (limited in scope).
Subsidies to rescue financial and other services firms	○ 237 Capital Purchase Contracts under Capital Purchase Program ○ 7 Contracts under Making Home Affordable Program ○ 1 Contract (Citigroup) under Targeted Investment Program ○ 1 Contract (AIG, several Series) under Systemically Significant Failing Institutions ○ 3 Contracts under Automotive Industry	**Significant** because it affects structure of financial industry. But temporary(?) interventions may be justified to ensure systemic stability.	GATS commitments on national treatment on mode 3 in financial and other services give foreign firms rights to same treatment.

Measure	Implementation Status (actual / potential)	Impact on Services Trade	Legal Recourse
	Financing Program (as of April 21, 2009)		
Local lending requirements a) guarantees for local loans b) explicit requirement c) implicit pressure	Some evidence No [UK example: RBS]	**Possibly significant** impact on access to capital abroad and exports of financial services, but difficult to isolate the impact of inducements to lend locally from other reasons for reversals of capital flows.	None (unless the beneficiaries of directed credit are services firms, and any implicit subsidy violates a national treatment commitment under GATS).
Widening state boundaries through acquisition of firms and hence inducing a national bias in firm choices	Increased ownership of troubled firms (e.g. "The American Recovery and Reinvestment Act" of 2009) but no sign yet of induced national bias	So far limited (because government share of total demand and economic activity is still limited and no obvious change in firm behavior); but **potentially significant** if more "state" firms are obliged to procure preferentially and (re-)locate activities domestically.	For signatories to the WTO and GPA, to the extent that both procuring entity and service is covered (unlikely). No recourse for decisions of state firms on where to locate economic activity.
Subsidies to private firms contingent on national procurement, location and employment	Rumors of new measures but no concrete evidence	**Potentially significant** because larger share of demand and economic activity would be covered	GATS commitments on market access and national treatment in affected sectors (limited in scope)
Political and social pressure on private firms to procure, locate and employ nationally	Sallie Mae's relocation of 2,000 jobs back to US.	**Potentially significant** because larger share of economic activity would be covered	None

1. Preferential procurement

Regarding explicit protectionist measures, the Buy American provisions in recent US legislation do not extend to services. Yet it is instructive to recall the history of past sub-federal initiatives that sought to promote onshore employment. For instance, in the years 2001-02 New Jersey drafted legislation for preferential procurement, including stipulations that work was to be done by firms with US employees rather than firms that outsourced. However, the bill was progressively diluted as it passed through the legislative process. To begin with, the Act would only apply to government funded projects, thereby excluding any private sector financed projects. Moreover, in case of a cost differential between potential providers exceeding a certain percentage (approximately 15-20%) a waiver would be automatically granted. These modifications rendered the Act ultimately ineffectual, and the New Jersey experience seems to represent the fate of several similar legislative projects in other US states. The apparent popularity of such measures notwithstanding, there appears to be a sizable US business constituency that would potentially be hurt by such measures, as reflected in a recent letter addressed to President Obama in which 125 companies and a number of business associations caution against the Buy American initiative.

There is also a well-known analytical reason to be relatively sanguine about preferential procurement (Baldwin and Richardson, 1972). If the government switches its purchases towards national suppliers, then the resulting increase in prices of domestic services will induce private consumers to switch their purchases to foreign suppliers. As long as the government's share of the total quantity demanded at the original price is less than the quantity supplied by national suppliers, preferential procurement will have no significant effect.[1] In fact, the US Government accounts for a relatively small share of domestic demand for most services, except in state-level purchases of construction services (Francois and Nelson, 1997).

2. Restrictions on foreign employment

An example of an explicit restriction that does affect services is the provision in the recent US stimulus bill making it difficult for financial institutions that have received taxpayers' funds to hire specialty occupation (H-1B) visa holders if they have recently made US workers redundant. Given the binding aggregate quota on H-1B visas, a restriction on employment in a particular sector probably has limited impact, other than on foreign workers with skills that are specific to the restricted sectors. Thus the restrictions on employing or contracting foreign services providers in specific areas (e.g. financial services) are not as costly for both host and source as the increasing social and political aversion to immigration of service providers and the possibility of retaliatory restrictions. As Lloyd Blankfein, the chief executive of Goldman Sachs warned, the company had 200 people in the US on H-1B visas but also 2000 employees

[1] In a recession, if there is excess capacity in the relevant sector, then increased government purchases may not lead to an increase in prices and so there may be no offsetting changes in private demand. Also, if domestic and foreign services are differentiated, or oligopolistically provided, then again we may see real effects of preferential procurement (Mattoo, 1996).

who worked overseas but paid US taxes; the latter could be the target of retaliatory measures by other governments.[2]

3. Changing political and social climate

Turning now to the mounting pressure to support domestic job creation, consider the following example of how firms' choices are being influenced by the change in political mood. On April 6, 2009, Sallie Mae, a company which manages $180 billion in education loans and has 10 million student and parent customers, announced plans to move 2,000 overseas jobs back to the United States from India and the Philippines, reversing a cost-savings measure the company took a year ago.[3] The company said it plans to fill jobs, including positions in call centers, information technology and operations, in the United States over the next 18 months. The projected cost is about $35 million annually because of higher labor expenses. The Sallie Mae chief executive Albert L. Lord was quoted as saying: "It's the right thing to do. The value of a company's franchise is essentially measured in financial terms, but there are a lot of values in a company that relate to the long-term value of a franchise. It's a wise investment in the company's future…It was a tough decision to move these jobs overseas. It was a lot easier to make the decision to bring them back." Rep. Paul E. Kanjorski (Democrat from Pennsylvania), who's Wilkes-Barre district will receive 600 new Sallie Mae jobs was quoted as saying: "It's a patriotic act. It sends a great message to corporate America to think as deeply as you can."

4. Widening boundaries of the state

In addition to the changing political climate, a related concern is the widening boundary of the state as a result of increased government ownership of firms during the crisis. The US Government has already spent $245 bn under the Capital Purchase Program (CPP) to hold preferred stocks in more than 200 financial companies. Particularly large investments have been made in the financial giants, Citigroup and Bank of America, under the Targeted Investment Program and Asset Guarantee Program, and on AIG under the Systemically Significant Failing Institutions Program. General Motors and Chrysler have received $30 bn under the Automotive Industry Financing Program and the Automotive Supplier Support Program. The worry, for which there is as yet no concrete basis, is that state ownership will induce a national bias in firms' choices on procurement and location of economic activity. An important determinant of the significance of this potentially protectionist development is the time horizon of public intervention. If government influence on the private sector turns out to be temporary, then there is in principle little cause for concern. Nonetheless, it should be borne in mind that even during a relatively short-lived "public interregnum" at major private sector companies, long-lasting decision regarding the location of economic activity could be made that are not easily reversed even if public influence over corporate decision-making were to wane quickly.

[2] Francesco Guerrera, "Blankfein attacks bankers' pay," Financial Times, April 8, 2009.
[3] SLM to Transfer Overseas Jobs to US: Reston Student Lender to Move 2,000 Workers Out of Asia, by Thomas Heath in the Washington Post, April 7, 2009.

Apart from the widening state influence via ownership in formerly private companies ("extensive margin" of government influence), the crisis is also provoking calls for strengthened prudential regulation ("intensive margin"), i.e. rules governing the behavior of private sector firms. While such regulation is usually de jure non-discriminatory, it can tend to have de facto protectionist effects. It is too early to judge how far efforts to coordinate re-regulation internationally can ensure that national regulation does not impede international competition.

5. Financial protectionism

In the longer term, subsidies to banks are probably less damaging than financial protectionism.[4] The former are temporarily necessary to ensure the stability of the financial system. The latter seriously erode the case for openness. Inducing national banks to lend domestically in a crisis deprives developing countries in particular of capital when they most need it and greatly strengthens the case for financial self-sufficiency. [5]

II. WHAT DO TRADE FLOWS TELL US?

There is no sign that services trade is being adversely affected by protection. In fact, we show in a companion paper using the latest trade data from the United States, and more aggregate data from other OECD countries, that services trade is weathering the current crisis much better than goods trade. If there had been protectionist action by the US against foreign services exporters, then perhaps it would be reflected in import figures. Figure 1 shows that as of April 2009, the value of US goods imports had declined year-on-year by 35 percent and the value of goods exports by 27 percent; in contrast, services imports and exports each had declined by around 10 per cent.[6] Within services, not surprisingly, trade in goods-related transport services and crisis-related financial services has shrunk, as has expenditure on tourism abroad. But trade in a range of business, professional, and technical services – which encompass politically sensitive outsourced services – is still increasing, with US exports growing even faster (at 10 percent) than US imports (at 7 percent).[7] As a consequence, developing countries like India, which are relatively specialized in business process outsourcing and information technology services, have suffered much smaller declines in total exports to the United States than countries like Brazil and China and regions like Africa, which are specialized in exports of goods, transport services, or tourism services. We suggest that services trade is buoyant relative to goods trade for three reasons: demand for a range of traded services is less cyclical, services trade and production are less dependent on external finance, and because there has been no serious reversal of openness.

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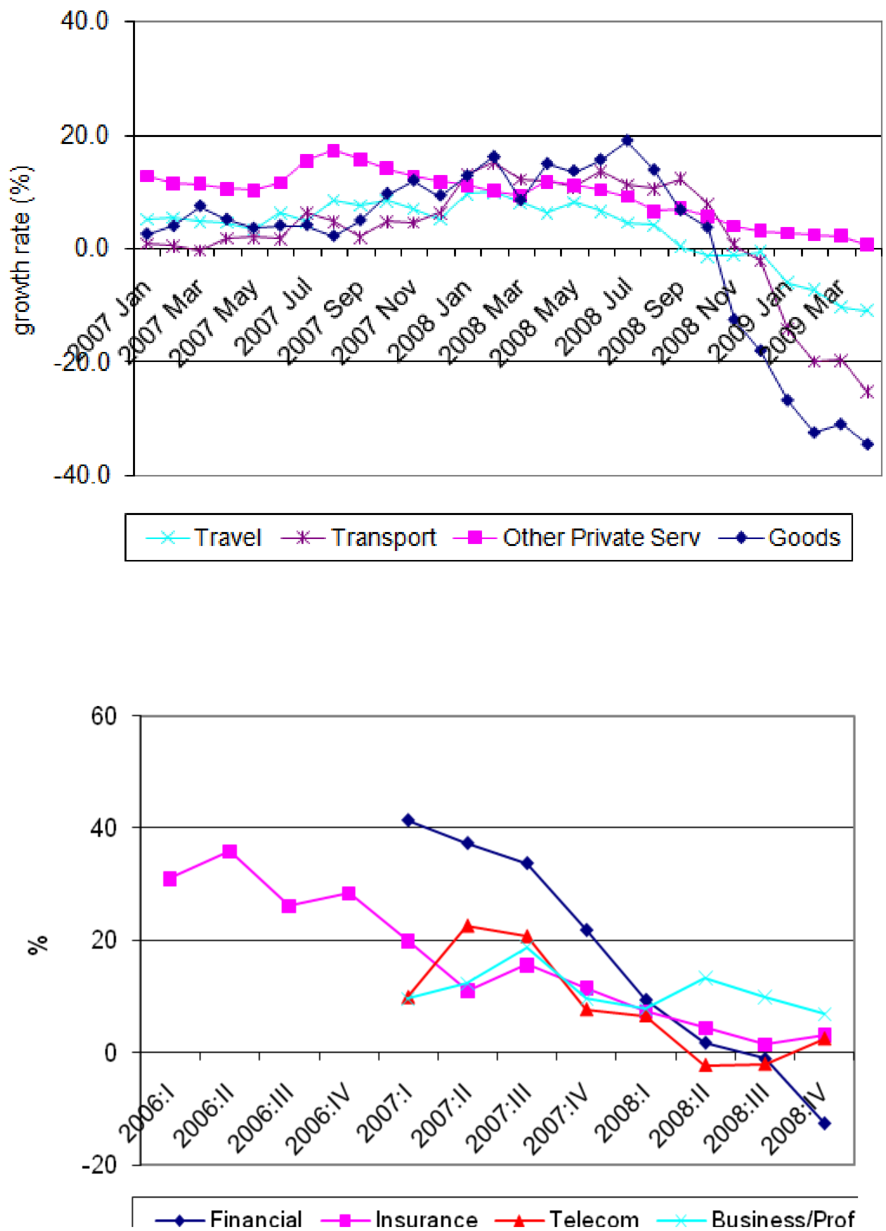
[4] See, for example, Anthony Faiola and Mary Jordan, "British Bank To the World Takes Its Cash Back Home: Battered RBS Caught In Protectionist Storm," Washington Post, March 28, 2009.

[5] In one respect, the crisis has actually resulted in greater openness: the pre-crisis concerns about investments by sovereign wealth funds have been replaced by a craving, at least in the financial sector, for greater capital injections from these entities.

[6] Services account for around one-sixth of US imports and over one-fourth of US exports. The Annex 2 charts present further detail on the share of services sub-categories.

[7] This data pertains to the last quarter of 2008 – the latest period for which data on services sub-sectors is available.

Figure 1: US Monthly Imports of Goods and Subcategories of Services



Source: Borchert and Mattoo (2009)

III. THE POLITICAL ECONOMY OF PROTECTION

Given the absence of serious protectionism so far, is there still reason to be concerned? On the political economy of protection, there are two views: the sanguine and the pessimistic.

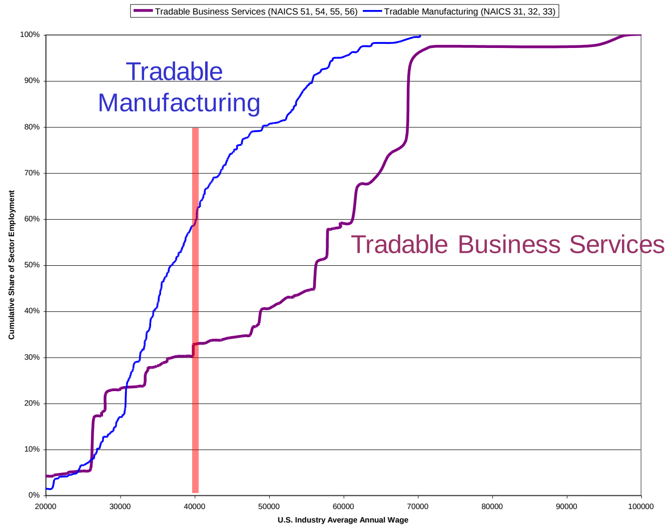
1. “We are ever so intertwined”

One reason for the absence of protectionist measures is the high degree of international integration. Industrial country firms have made large relationship-specific investments in outsourcing intermediate services; developing country firms have formed strong links with locally-established foreign banks, retailers, telecommunications and transport providers. As a result, the business functions of both customer and supplier of services are highly intertwined. Any protectionist action would be self-destructive. This mutual dependence situation gives rise to political economy forces that counteract protectionist pressures. A case in point is the open letter, signed by a number of services business associations, including the Coalition of Services Industries and the U.S. Chamber of Commerce, to Congressional Leaders on January 22, 2009. The undersigned associations note “the vitally important role that international markets play in sustaining U.S. jobs today and the role they will play in economic recovery. Without sales abroad and access to inputs, many U.S. workers would be out of a job.”

2. Only some of us are really threatened by trade

Jensen and Kletzer (2008) innovatively use evidence of the geographic concentration of production in the US as an indicator of tradability. Figure 2 below, taken from Jensen and Kletzer (2008), plots the cumulative distribution of employment in tradable manufacturing and tradable business services. It shows that the share of manufacturing employment in industries below the critical $40,000 threshold is almost two-thirds (i.e. about 60 per cent of 13 million workers in manufacturing). In contrast, the share of tradable business services employment that is in industries with average wages below the $40,000 threshold is only about one-third (of about 15 million workers in tradable business services). Based on these numbers, Jensen and Kletzer suggest that only about one-third of tradable business services are likely to face competition from low-wage countries in the medium term.

Figure 2: US Employment Shares in Tradable Manufacturing and Services Industries



Source: Jensen and Kletzer (2008)

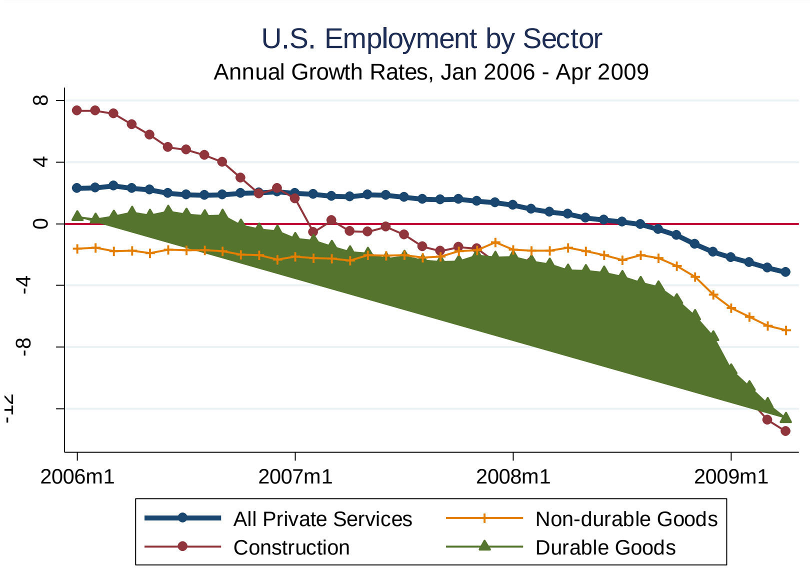
3. But we are all suffering - Services employment in the US

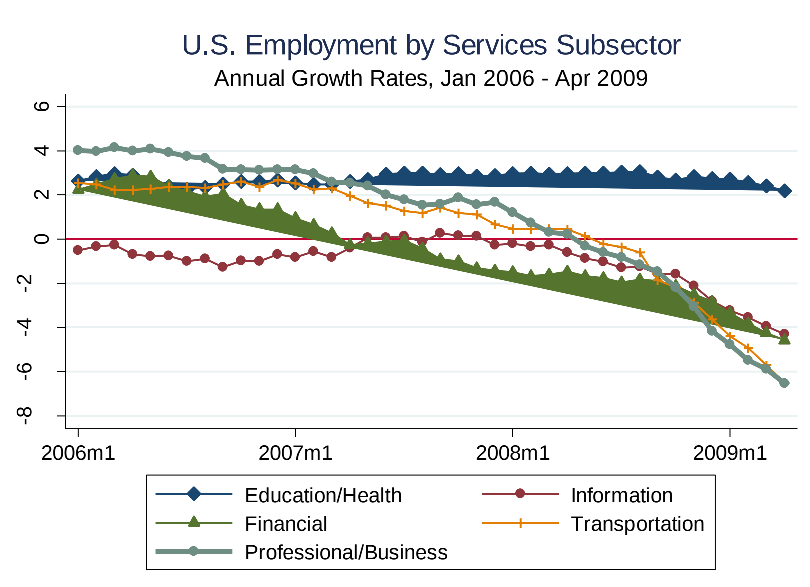
Even though most services employment, like services trade, has been relatively resilient in the recession, it has still declined by around 4 per cent – while employment in durable goods and construction has declined by over 12 per cent since April 2008, see Figure 3 below. Within services, employment in education and health services has continued to grow by around 2 percent, but there have been declines of over 4 per cent in information (including telecommunications and audiovisual) and financial services and over 6 per cent in transport and business/professional services.

In principle, demand for both imports and domestically produced services should be expected to contract in a recession. How then can we reconcile sustained growth in imports of business, professional and technical services (see above) with significant declines in employment in domestic business/professional services? One possibility is that firms in industrialized countries, under increased pressure to cut costs during the crisis, are turning to outsourcing. Industry sources in developing countries suggest that in traditional BPO areas, outsourcing options are now being pursued more vigorously both with captive firms and at arms-length. There has also been a discernable acceleration in the speed with which outsourcing decisions are being taken. While decisions were being taken within 9-12 months before the crisis, the decision time has now shrunk to 6 months.[8]

Figure 3: US Employment in Manufacturing and Services Industries

[8] Crisis-induced pressure to engage in outsourcing would reinforce the ties of integration mentioned above in section III.1. This incentive to outsource would thus generate political economy forces that countervail protectionist pressures.





Source: Bureau of Labor Statistics (BLS), Current Employment Survey, and authors' calculations.

4. *The restraining effect of the threat of retaliatory protection*

The growing political and social aversion to outsourcing in industrial countries is obscuring the economic stake that all countries have in open global services markets. While developing countries like India have seen rapid export growth, by far the largest exporters of these services are the US and the countries of the European Union. The EU and US account for 65 percent of world services exports; China and India for 6 percent. The US and EU have both consistently run a huge annual surplus on services trade, currently nearly $160 billion for the US and $220 billion for the EU countries. While US services imports from India and China have indeed grown to around $22 billion in 2008, US exports to these countries have expanded even faster, to over $26 billion. Even during the crisis US exports of key services are growing faster than its imports.

Both the US and EU have been powerful advocates of open services markets all over the world. Many developing countries have begun to reform their markets for communications, transport, financial, distribution and other business services. A retreat from openness in services in industrial countries could undermine reform efforts in developing countries, and even trigger a costly spiral of retaliatory protection. It is conceivable that this threat of retaliatory protection is restraining protection in the industrial countries.

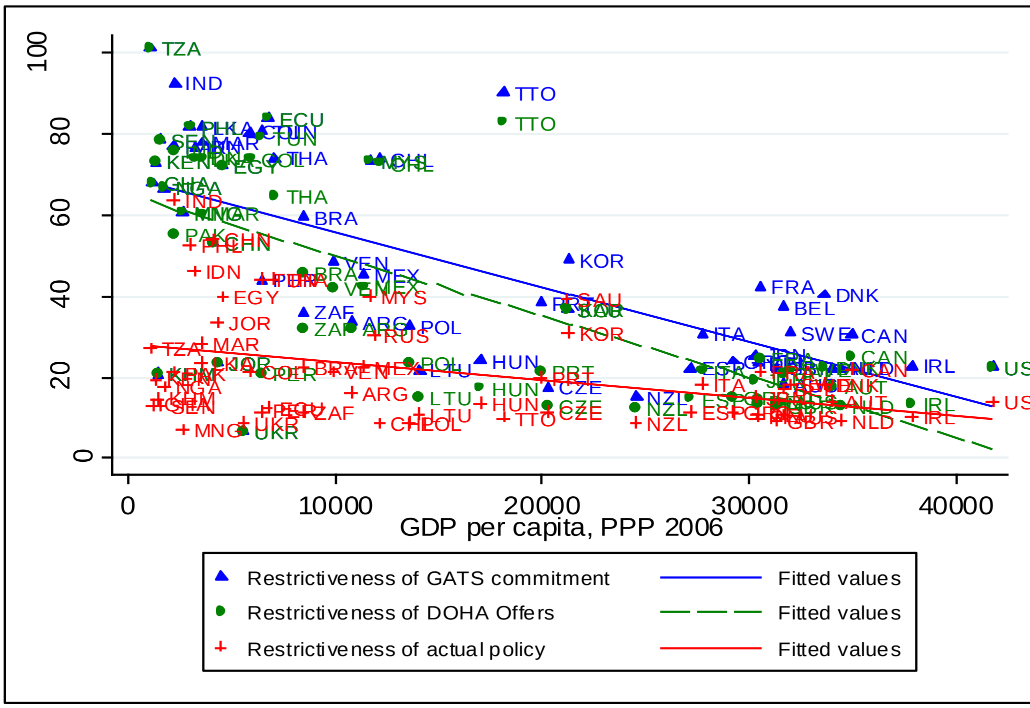
IV. MULTILATERAL DISCIPLINES ON PROTECTION: WHITHER DOHA?

How far is protection constrained by existing international rules and commitments? Gootiiz and Mattoo (2009) survey applied trade policies in the major services sectors of 56 industrial and developing countries. Figure 4 compares these policies with these countries' Uruguay Round commitments in services and the best offers that they have made in the current Doha negotiations. The paper finds that Uruguay Round commitments are on average 2.3 times more restrictive than current policies. The best offers submitted so far as part of the Doha negotiations improve on Uruguay Round commitments by about 13 percent but remain on average 1.9 times more restrictive than actual policies. Figure 5 makes the same point from a sectoral point of view, showing that in all major sectors there is substantial scope to limit market access without violating commitments. Hence, current commitments can claim only limited credit for restraining protectionism, even in the US and industrial countries where the gaps between actual policy and Uruguay Round commitments are narrower.

In any case, rules and commitments in international agreements only preclude government measures that discriminate against foreign services or service providers (i.e. violate national treatment commitments) or impose quantitative limits on services or service providers (i.e. violate market access commitments) (last column of Table 1). Government procurement in services has been excluded from the scope of the WTO's General Agreement on Trade in Services (GATS) but is to some extent covered by the plurilateral Agreement on Government Procurement which has 40 mostly OECD signatories. Thus, there is today no multilateral rule against discrimination in procurement against developing countries.

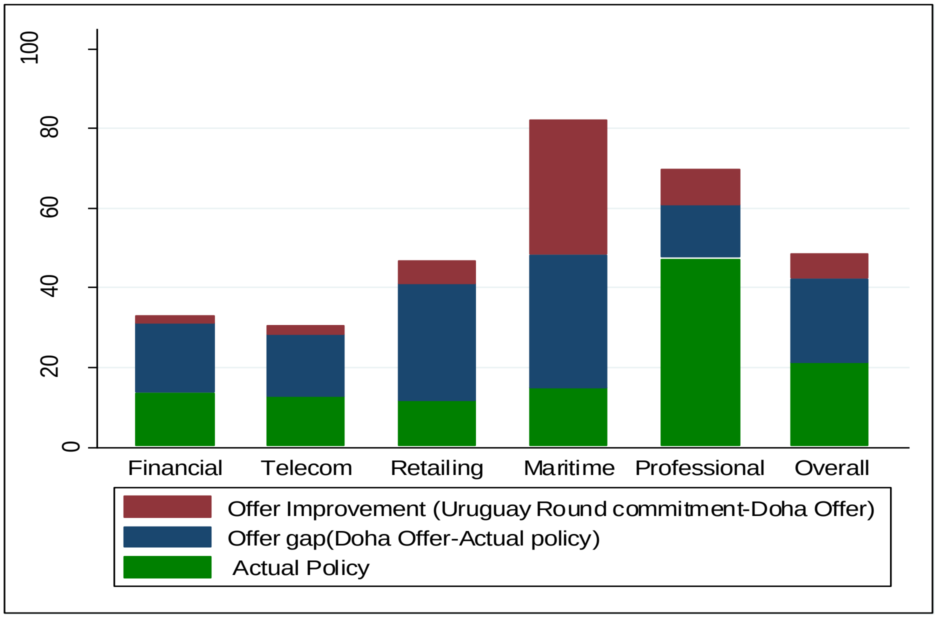
More seriously, most rules only apply to "measures" taken by the government. There is nothing to prevent a state-owned entity from deciding to (re)locate all its economic activities domestically rather than abroad. Also, there is nothing to prevent "political and social" pressure – which does not take the form of a government "measure" – from inducing private firms to buy, employ or locate nationally. Finally, since the GATS has no rules on exports of services, there is also nothing to prevent a government from requiring its banks to lend locally. Hence, a whole range of implicit protectionism that does not take the form of "measures affecting imports" is currently beyond the scope of multilateral rules.

Figure 4: Global Services Trade Restrictiveness, by Country



Source: Gootiiz and Mattoo (2009).

Figure 5: Global Services Trade Restrictiveness, by Sector



Source: Gootiiz and Mattoo (2009)

V. LOOKING AHEAD

Even though there has so far been limited recourse to protectionism in services, it would be wrong to be complacent. We suggest, first of all, greater efforts to monitor protectionist actions in services – which have so far largely escaped WTO scrutiny (with the exception of financial bailouts). Second, the Doha negotiations must aim to lock-in existing policies in at least the major trading countries. Third, there is need for greater discussion on how to address the possible home-market bias created by the widening boundaries and increasing influence of the state.

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Annex 1: The Obama Administration's proposal for "curbing tax havens and removing tax incentives for shifting jobs overseas"

Certain sources have called the Obama plan "protectionism" (e.g. Heritage Foundation). In this appendix we briefly summarize the Administration's proposal and show that it does not entail any measures that would impact in a protectionist way on services trade or outsourcing. The Obama Administration's plan, advanced on May 4, 2009, entails three changes:

First, a reform of deferral rules: US taxes on profits earned abroad by US-headquartered companies are usually not due until those profits are brought back to the US. Nonetheless, expenses supporting those overseas investments can be deducted immediately to lower US tax returns. The proposal would simply bring in sync the levying on taxes and the tax deductibility of expenses, such that deductions cannot be claimed until taxes have been paid on offshore profits. Thus, the proposal would harmonize the rules for tax benefits for investing domestically and abroad, yet the existence of the deferral system as such means that the proposal would still not fully neutralize the incentives because deferral is not an option for domestic investment.

Second, a reform of rules on foreign subsidiaries: so-called "check the box" rules have allowed US parent companies to make their foreign subsidiaries "disappear" for tax purposes. Income shifted between any overseas subsidiaries has to be reported as passive income by the US parent company and is subject to US taxation. By checking out those subsidiaries, the ensuing taxes due in the US disappear as well. The proposal would require foreign subsidiaries to be considered separate legal entities for US tax purposes. The current legal situation (pre-reform) is a device for shifting income from one overseas investment (the productive one) to a so-called tax haven. Since under current law only offshore subsidiaries may "disappear" (but not US subsidiaries), this indeed creates an advantage for investing overseas as compared to producing domestically. The proposal would remove discrimination against US non-multinational companies (in 2004 the effective tax rate for multinational companies was 2.3%, compared to a statutory 35%). Clint Stretch of Deloitte estimates that the tax burden would increase by 8% *but much more for multinational companies*. After all, nearly one-third of all profits reported in 2003 by US companies come from just 3 small countries: Bermuda, Netherlands, and Ireland.

Third, a reform of rules to claim tax credits for taxes paid overseas against taxes due in the US. Usually foreign tax credits are only available for taxes paid on income that is taxable in the US, however certain rules make it possible to claim tax credits for taxes paid on foreign income that is not subject to current US tax. Abandoning this rule would primarily eliminate an advantage that US multinationals previously enjoyed over US domestic companies.

It is also worth pointing out that the proposal outlined above does not call for an end to the deferral scheme as such. Specifically, to the extent that deferral of both deductions and taxes confers a net benefit as compared to paying taxes net of deductions immediately, the playing field is not yet level between domestic and international investment decisions. Moreover, the plan does not propose any changes regarding rules on transfer pricing, which is believed to be the most widely used tactic for multinational companies to reduce taxes they owe to the US.

It is true to some extent that the plan would disadvantage US multinationals that compete with multinationals from other jurisdictions, as most countries have a territorial tax system which subjects only profits realized within its territory to taxes, whereas the United States is part of a dwindling minority of industrialized countries that in principle taxes corporate profits on a global basis, which in turn necessitates double-taxation agreements and deferral rules. If other tax systems offer more lenient treatment to multinationals, then there is an incentive to locate headquarters outside the US. The plan takes a step towards neutralizing the incentives to invest abroad and at home. But the effect on employment in the US is unclear.

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Annex 2: The composition of US services trade