advantage of U.S. free-trade agreements to import the foreign-made goods into the U.S. market.

The exporting of U.S. jobs is not a new phenomenon. It has been going on for several decades. Previously, however, the U.S. economy produced new, often better jobs to replace those being exported. During the Clinton years, when the U.S. economy was operating at close to full employment, it was reasonable to assume that a U.S. worker who was displaced by a low-wage foreign worker would just find another job, equally good or better. There were, of course, some legitimate concerns. In particular, some communities that lost a major employer incurred substantial dislocation costs, and some people losing a good job in the manufacturing sector lacked the training needed to take the jobs opening up in the service sector. More fundamentally, income inequality was increasing for a variety of reasons, some related to free-trade policies. Nevertheless, free trade generally made the country richer and opened up more opportunities for U.S. workers.

The creation of new jobs slowed considerably during the Bush administration. With the U.S. economy operating at well below full employment, a displaced worker may end up unemployed or employed at a less desirable job. These displaced and unemployed or under-employed workers have a legitimate complaint. Their complaint, however, is more properly directed at the policies leading to low employment levels, not at free trade.

Various explanations have been offered for the so-called jobless recovery after the recession of 2001. Almost certainly, a major reason for low job creation has been the huge budget deficits, which are being financed in significant part with foreign debt. Those budget deficits, in turn, are the inevitable result of the 2001 and 2003 tax cuts, which heavily favored corporations and well-to-do individuals.

The close link between job losses and foreign borrowing is illustrated by the following example. Assume that U.S. chicken farmers sell $10,000 worth of eggs to pig farmers in Canada, receiving in exchange $10,000 worth of bacon. That trade might reduce jobs for chicken farmers in Canada but might increase jobs for both Canadian pig farmers and U.S. chicken farmers. Since the trade is a wealth-creating transaction, the likelihood is that the new jobs will be as good as or better than the jobs lost. In real life, of course, the trade would be done using some medium of exchange rather than through barter. But so long as the money received by the Canadian bacon sellers ends up being used to buy goods and services produced in the United States, the trade should be beneficial for U.S. job creation and job enhancement.

Of course, the United States does not have the type of balanced trade illustrated in the above example. The United States runs a chronic trade deficit, especially with China and certain other countries in Asia. A significant reason for the trade deficit is the budget deficit. Foreigners selling goods here have two potential uses for the dollars they receive. They can buy U.S. goods and services, resulting in U.S. job creation, or they can buy U.S. assets, such as stock, real property, or Treasury notes. Oversimplifying only slightly, each dollar generated by imports that the foreigner ends up lending (directly or indirectly) to the U.S. government to finance the budget deficit is one less dollar used for buying U.S. goods and services. Thus, the deficit undermines the ability of U.S.-based firms to export goods and to generate good U.S. jobs.

Unfortunately, the budget deficit is increasing rather than decreasing. The repeal of the illegal U.S. export incentive, viewed in isolation, increased U.S. tax revenues. The repeal was part of a much larger tax bill, however, that will greatly increase the deficit, despite disingenuous claims that the legislation is revenue neutral. In addition, the bill contains major changes in the international income tax rules that will increase the already strong tax bias in favor of foreign production over domestic production.

The case for free trade, although robust, is not absolute. No one can argue convincingly, for example, for free trade in U.S. military secrets. In general, a country's trade policies ought to be pursued in the context of other important national policies, such as social justice, a clean and safe environment, and national security. A commitment to free trade certainly is not a commitment to the *laissez faire* economics of the 19th century. On the contrary, free trade is unlikely to benefit the majority of U.S. workers unless it is combined with strong measures to reduce income inequality—an inequality that frequently is exacerbated by free-trade policies.

IN DEFENSE OF THE INDEFENSIBLE: EXPORT SUBSIDIES IN A SECOND-BEST WORLD

by Terrence R. Chorvat, Arlington, VA

I would like to state the case for free trade somewhat differently than the way that Professor McIntyre does. There is general agreement that free trade is economically efficient. The relevant questions are, rather, what constitutes an impediment to free trade, how should we respond to existing impediments to free trade, and how does the tax system intersect with other areas of the law and the economy so as to create and reduce impediments to free trade?

The basic premise behind the efficiency of free trade is that of specialization. Individuals or groups of individuals will be more able to produce certain goods and services efficiently if they specialize in their production, and the talents or other factors that allow for more efficient production are allocated non-uniformly among the world's population. Therefore, we all gain by being able to trade as freely as possible with all producers in the world. In general, interference with free trade will reduce the efficiency of the economy, as Professor McIntyre shows. The conclusion commonly drawn from this analysis is that, to the extent that institutions such as tax systems alter the allocation of productive resources from the allocation of the market, such a reallocation will operate to reduce total welfare. Economists,

going at least as far back as Pigou, have made arguments that to the extent that taxes or other interventions are attempting to mitigate existing market imperfections, then such interventions may improve welfare. However, the general presumption is that, absent some showing to the contrary, interference with the market is bad.

Professor McIntyre gives a good statement of the first-best argument for free trade. However, we do not live in a first-best world. We live in a second- or third- or worse-best world. Countries vary not only by productive resources but also by their institutions. These institutions introduce distinctions that can interfere with efficient production. Once these distortions exist, it is no longer clear that what would be optimal in a first-best world would necessarily be optimal in the world in which we live. I am going to discuss some styled facts about the tax systems that we see in the world, and use these to argue that in fact there may be some justification for an export subsidy operated through the tax system. I will argue that even though export subsides would be inefficient in a first-best world, it is not so apparent that they are inefficient in the world in which we find ourselves. I need to be clear that I am arguing not for any particular system of export subsidies, nor do I maintain that there might not be additional facts that argue against export subsidies; I am merely arguing against the idea that export subsidies are inherently inefficient.

To illustrate the case for export subsidies, imagine a world of three countries (A, B, and C) that have the characteristics described in this paragraph. Countries A and B each have companies that compete against each other in the world-wide market for widgets. Consumers in Country C purchase widgets. Country A raises its revenue from an income tax, which is imposed on the worldwide income of firms resident in A, Country B raises its revenue from a border-adjusted VAT, and Country C, which has a low level of government services, raises its revenue from hotel taxes and casino taxes. Capital is perfectly mobile between A and B. Consumption taxes do not affect the prices charged by firms resident in Countries A and B, or to the extent they do, those taxes are borne equally by firms in both countries.

Because Country A and Country B have different tax systems, a distortion between production by Country A's firms and Country B's firms is introduced. To understand this, we must first note that this is not the same as the distortion that would be introduced by a tariff. A producer in Country A pays tax on income from selling its product in Country C. By contrast, a producer in Country B will effectively pay no tax on its product sales because of the border-adjusted VAT. Initially, one may think that because the Country A firm is subject to an income tax, it must charge a higher price than that charged by the Country B firm. Although it is true that the Country A firm is at a competitive disadvantage, the situation is more complicated than it appears. Just because the Country A firm makes a lower profit on each sale, this does not mean that it will charge a higher price. Because the point at which marginal profit approaches zero (the point at which the profit function is maximized is the point where the derivative of profit with respect to price equals zero) is unaffected by a tax applied against a constant percentage of profit, the Country A firm is not forced to raise its price despite lower profits. The firm has no incentive to shift to a different product, because any alternative use of its capital will also have a lower rate of return (assuming that the tax is uniformly imposed on income from capital in a worldwide tax system such as that imposed by the U.S.). Therefore, it would seem that there is no reason why the Country A firm would not be competitive in the Country C market.

The distortion in this case arises from the fact that because the producer in Country A receives a lower rate of return than its counterpart in Country B, the Country A producer will attract less capital. Therefore assuming that capital will increase the efficiency of labor, and effectively lower the price, or there is some similar increase in efficiency, the producer in Country A is at a disadvantage vis-à-vis the producer in Country B. As a result of the free mobility of capital, more capital will flow to the producer in Country B. So long as capital investments allow one firm to produce more efficiently, the Country B firm will enjoy a competitive advantage.

This argument can be extended to competition in Country B, by applying the Country C analysis to competition within Country B. As long as the Country B VAT applies equally to the products from the Country A firm and the Country B firm, then the Country A firm widgets must again bear both the VAT and the income tax, while the Country B firm widgets bear only the VAT. So there would still be a distinction in the after-tax rates of return on capital invested in the two businesses. The argument would not apply to competition within Country A, if Country A imposes an income tax on the profits that Country B firm made from its sales to Country A consumers; in this situation, firms would pay only the Country A income tax. The distortion would also still arise, although with lesser force if all three countries impose income taxes but rates are lower in Countries B and C than in Country A.

There are many reasons why the effect of the increase in the cost of capital may be difficult to find empirically (as Dixit and Pindick discuss in their highly readable book, Investment Under Uncertainty). Nonetheless, it is clear that even in the absence of other constraints, export subsidies may in fact be making up for other institutional inefficiencies.

It is not my intention to argue that the situation discussed above is or was a justification for the foreign sales corporation or the extraterritorial income regimes. The above argument relies on a number of assumptions, which may or may not reflect the situation at any particular time. This is an empirical question, and it could very well be that the export subsidies that we had in place until recently were inefficient. This does not mean that export subsidies must necessarily

be inefficient, given some of the stylized facts we know about the tax systems of the world. Because this is an empirical question, it must be addressed by empirical evidence, which might also change over time.

Another important point is that even if export subsidies may occasionally be efficient, it might make sense to prohibit them because there is such a large potential for mischief. But one needs to understand that getting rid of export subsidies now adds an additional argument for adopting consumption taxes, which again each of us may or may not prefer. In addition, it is not at all clear that the income tax burden of United States corporations is necessarily higher than that of corporations based in other countries. To the extent that some countries have higher taxes, but the governments of these countries provide additional benefits for businesses operating within their borders, it is not clear that the above analysis applies. ■

CLE **CALENDAR**

All programs subject to rescheduling or cancellation. For the latest information, refer to the contacts listed below.

DATE	PROGRAM	CONTACT
March 14–18, 2005	**ABA/IPT 14th Annual Advanced Sales/Use Tax & Advanced Property Tax Seminars**, New Orleans, LA	ABA Tax Section www.abanet.org/tax 202-662-8670
March 30, 2005	**"Last Wednesday" Teleconference Series: Buy-Sell Agreements for LLCs and S Corporations**	ABA Tax Section www.abanet.org/tax 202-662-8670
April 7–8, 2005	**ABA/IBA 5th Annual Tax Planning Strategies in U.S. and Europe**	ABA Tax Section www.abanet.org/tax 202-662-8670
April 13, 2005	**"Tax Link Live" Teleconference: Attorney-Client and Work Product Privileges**	ABA Tax Section www.abanet.org/tax 202-662-8670
April 21–22, 2005	**Employee Benefits in Mergers and Acquisitions**, Plaza Hotel, New York, NY	ABA Joint Committee on Employee Benefits www.abanet.org/jceb 202-662-8640
April 27, 2005	**"Last Wednesday" Teleconference Series: International Tax Topic TBA**	ABA Tax Section www.abanet.org/tax 202-662-8670
April 28–29, 2005	**How to Handle a Tax Controversy at the IRS and in Court**, Astor Crowne Plaza, New Orleans, LA	ALI-ABA www.ali-aba.org 800-253-6397
May 4–6, 2005	**ERISA Basics**, Courtyard Marriott Magnificent Mile, Chicago, IL	ABA Joint Committee on Employee Benefits www.abanet.org/jceb 202-662-8640
May 19–21, 2005	**May Meeting**, Grand Hyatt, Washington, DC	ABA Tax Section www.abanet.org/tax 202-662-8670
June 2–3, 2005	**Third Annual International Tax Institute**, Fordham University School of Law, New York, NY	ABA Tax Section www.abanet.org/tax 202-662-8670
June 9–10, 2005	**Charitable Giving Techniques**	ALI-ABA www.ali-aba.org 800-253-6397

SECTION MEETING CALENDAR

2005	**MAY MEETING**, **May 19–21**, Grand Hyatt, Washington, DC
	JOINT FALL CLE MEETING, **September 15–17**, Park Hyatt & Hyatt Regency, San Francisco, CA
2006	**MIDYEAR MEETING**, **January 19–21**, Sheraton Center, New Orleans, LA
	MAY MEETING, **May 4–6**, Grand Hyatt, Washington, DC
	JOINT FALL CLE MEETING, **September 28–30**, Location TBA
2007	**MIDYEAR MEETING**, **January 18–20**, Westin Diplomat, Hollywood, FL
	MAY MEETING, **May 10–12**, Grand Hyatt, Washington, DC
	JOINT FALL CLE MEETING, **September 27–29**, Hyatt Regency and Fairmont, Vancouver, BC