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## Going too far in support of trade

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**Rich and poor countries alike look to export subsidies to enhance their presence on world markets. But they may be doing more harm than good**

THE promotion of international competitiveness has led governments down many roads that economists shudder to tread. Import substitution, with its distortion of domestic investment and its intense protectionism, has at long last fallen out of fashion. But export subsidies of all shapes and sizes seem somehow to have become tolerable stand-ins. Recent research, however, demonstrates that the theoretical basis for export subsidies is dubious, and that their empirical effects can be downright scary.

Several justifications are offered for the existence of export subsidies. They include the need to nurse infant industries; to compensate for protectionism abroad; to overcome capital-market problems faced by firms in small countries; to promote employment; and to keep trade balances positive. The subsidies can range from simple ad valorem payments to companies based on the size of their export sales, to complex systems of tax credits, loans, insurance policies and price supports.

These policies, however, bring with them some huge problems. Any company coddled by a subsidy has less incentive to improve its bottom line (and hence make the subsidy unnecessary). Tax revenues used for subsidies are distributed in a way that makes them regressive. And artificially low prices supported by subsidies may force more efficient producers in importing countries out of business. Besides harming domestic producers in poor importing countries, export subsidies may crowd out competing trade from other countries whose governments are too poor to retaliate.

Such retaliation may not be desirable, in any case. A [paper](#) by Arvind Panagariya of the University of Maryland demonstrates that a small country facing subsidised competitors should not necessarily respond in kind; although exports may expand, overall welfare may well decline. The same goes for export subsidies designed to counterbalance tariffs—if tariffs are applied at different rates for different goods, no combination of export subsidies can effectively neutralise them. Mr Panagariya accuses the World Bank and the IMF of accepting export subsidies as a substitute for true liberalisation of trade, which is always welfare-enhancing in the long run.

Even if a government seeks to promote exports (or the share of manufacturing goods in exports—a favourite of emerging economies) at all costs, export subsidies may not be successful everywhere. With the exception of South Korea, Mr Panagariya notes, developing countries that have used export subsidies have not expanded their exports faster than those that have pursued less interventionist policies. Other initiatives, such as the promotion of growth in total factor productivity, have proved more successful and less distortionary in the developing world.

## Anatomy of an American subsidy

Rich countries' subsidies are more complicated than simple ad valorem payments. New [research](#) by Mihir Desai of Harvard University and James Hines of the University of Michigan examines the perverse fusion of export incentives and corporate income tax in America. The federal government allows exporting companies to exempt roughly 15% of their profits from taxation by using offshore shelters called Foreign Sales Corporations (FSCs). Firms may also avoid taxes by allocating a share of their income to foreign sources which, under American rules, generate credits against domestic tax obligations.

The authors estimate that the combination of the two programmes is worth \$10 billion a year to American businesses. But Messrs Desai and Hines also demonstrate how sensitive markets are to FSCs by examining two events: the 1984 law that replaced FSCs' more generous predecessors, and the 1997 action by the European Union to get them banned by the World Trade Organisation (WTO).

First, a plunge of 3.1% in manufacturing exports can be traced directly to FSCs' replacement of the Domestic International Sales Corporations, which exempted 25% rather than 15% of export profits. And when Europe complained to the WTO about FSCs—a dispute that is still going on, although the WTO has so far ruled against the Americans—the share price of the average affected exporter dropped by 0.5% on the day. That exporters in a rich country should be so dependent on government subsidies is troubling.

The distorting effects of FSCs are as worrying as their contravention of the rules of international trade. Because smaller companies cannot spare the time or money needed to set up a sham foreign affiliate, big companies receive a disproportionate advantage in reaching global markets. The tax dodge using foreign-source income also favours companies that do business in high-tax countries: it is not obvious that the American government should support the treasuries of those countries (or, indeed, those of the handful of Caribbean islands where 95% of the sham firms are located).

Export subsidies in general tend to be regressive, since they take money from broad-based tax revenues and give it to corporate shareholders. But FSCs are especially bad, since they influence the collection of taxes from individuals and companies. The bigger companies that favour FSCs tend to be the richer ones, so the programme adds a regressive element to the otherwise flat corporate income tax.

Whether trade subsidies are as complex as FSCs or as simple as ad valorem payments, their perpetuation relies on the interests of industries whose scope and lifetime they have extended. Inefficiency therefore begets inefficiency. It is time for trade ministers to take a keener interest in social welfare—or in other words, to wake up and smell the artificially priced coffee.