MEMORANDUM

SUBJECT: Foreign Value Added Tax (VAT) Systems Unfairly Disadvantage U.S. Automakers and Their Parts Suppliers

In the wide-ranging debate about the bailout of the Big Three American automakers, unfair foreign trade practices have scarcely been mentioned. So many are so anxious to blame American businesses and American labor first – without ever looking at the broader picture and the very un-level playing field on which the U.S. government forces our domestic producers to compete today and for decades past.

Unfair foreign trade and economic practices are not an "oversight," or "just a different way of doing business," but are conscious policies intended to ***distort markets*** and give foreign firms a ***competitive advantage over their American rivals***. These practices – which range from currency manipulation, to outright subsidies, to R&D assistance, to theft of American intellectual property, to transfer pricing and other tax avoidance, to the export subsidies provided by Value Added Tax systems – ***cost our producers literally hundreds of billions of dollars a year***. For decades Congress and the Executive Branch have failed to stop these practices. Yet we criticize our producers, in this case the Big Three -- and the UAW, for not being competitive.

I would like to draw your attention today to just one of these unfair practices, Value Added Tax systems, which are used to discriminate against American cars, trucks, and auto parts, as well as thousands of other domestic products, by over 150 of our trading partners.

Most of America's trading partners raise a substantial amount of their tax revenues from a Value Added Tax. This tax is levied at each step of the production process – whenever value is added to a product and that product is passed up the assembly chain. The VAT is ultimately incorporated in the final price of the product and paid by the end-consumer. However, if the product is exported, the producer gets a big break: the tax is rebated. In effect, the VAT functions as an ***export subsidy.*** It thus becomes part of offshorers' calculations to move overseas – why not produce for the U.S. market in an overseas location and avoid paying American or foreign taxes. The VAT is also a bar to entry to the foreign market because it is added to the cost of American exports coming into that market. So American producers get hit coming and going.

One way to think about VAT systems is that taxation is a cost of government, i.e. taxes are what enable governments to operate and provide services to their populations – like education, clean water, clean air, medical care, unemployment insurance, first responders, and national defense.

Under the VAT system, if a German-made product is not sold in Germany, then it does not bear the cost of German government – because the tax is rebated at the border upon export. But there is a problem – because the product was produced in Germany and in a sense "took advantage" of all the benefits provided by the German government – from schooling of the workforce, to unemployment insurance, to health care, etc. So it should bear some of the costs of the government that allowed it to be produced in the first place. But under the VAT system, it does not.

This problem with the VAT is then compounded when a VAT-country product comes into a non-VAT country – like the United States. (When VAT countries trade with each other, there is no problem. Each VAT country rebates the VAT for its exported products and imposes the VAT on imported products. So there is rough parity on the products – depending on the amount of VAT each individual country rebates/imposes. But in general, there is no free ride.)

However, in the United States, there is a ***free ride for foreign products*** produced under a VAT system. We do not levy a VAT at the border – so that the incoming product does not bear the cost of American government. And the cost of the foreign government has already been rebated upon export. American-made, domestic products sold in our market do bear the cost of our government – since the companies that make them pay our taxes. So they are forced to compete in their home market against products that do not carry the cost of taxation within their prices.

This disparity in the two systems means that foreign VAT-country products are competing in our market without the cost of any government – either their own or ours, thus making them cheaper against American products bearing the costs of U.S. taxation, thus making them more expensive.

A similar disparity exists when American products enter a VAT country. They already bear the cost of American government, since our taxes are not rebated at the border – and then they are saddled with the VAT tax when they are imported into the foreign country. So they carry the costs of two governments – ours and the foreign government – while the foreign product in its domestic market only bears the cost of its own government. Again the comparable American product is more expensive.

This VAT disparity exists on cars, trucks, and auto parts imported into the United States, which compete with the Big Three and domestic parts makers in our market with the help of the VAT export subsidy from their home countries.

They also benefit from the fact that they are not charged a VAT or equivalent tax upon entry to the United States. The sales in America of, for example, Japanese, Korean, German, Swedish, French or Italian cars, or Chinese and Indian auto parts, are given a big boost by their respective countries' VAT systems, which create enormous price advantages. These price advantages can range up to 20 percent or more. Maybe we should look at this disparity more closely before we beat up on the Big Three, the UAW, and domestic parts makers as uncompetitive solely due to their own incompetence or greed.

Please look closely at the attached graphics comparing a German and American car, each offered to the consumer in its respective home market for $20,000. When the German car is exported to the United States, the VAT taxes are rebated and it costs $17,885 here – a price advantage of roughly 10 percent due to the difference in tax systems alone.

The VAT gives the German automaker a tremendous advantage. This is the fault of the Congress and the Executive Branch – and has nothing to do with competitiveness of the Big

Three. In fact, if the Big Three could take advantage of the same tax savings as the German import, they could significantly upgrade the quality of their cars and be vastly more competitive against the imports and "transplants." (The transplant assembly plants and their parts suppliers rely heavily on high value-added imported parts for their U.S. assembly operations. So although they claim to be American-built, that claim is highly doubtful. They also engage in transfer pricing as a U.S. tax-avoidance technique and take advantage of large state subsidies, including tax holidays, to locate their plants in specific states.)

Please note that in the same example, the $20,000 American car exported to Germany is saddled with the VAT at the border – which is imposed not just on the base price of the car, but the shipping and insurance costs as well – and winds up costing $25,792 in Germany, while the German car remains at $20,000 in its home market. Small wonder that Detroit cannot export effectively from the United States but must set up foreign operations to counter the effects of the VAT (and currency manipulation and many other unfair foreign trade practices).

In sum, in competition with a foreign VAT country product, the American-made product winds up more uncompetitive in its home market, as well as in the foreign VAT country market. This disparity is reliably estimated to place an **extra $290 billion burden on American manufactured goods and $85 billion on U.S. services - or roughly half our yearly trade deficit.** (Please refer to the attached VAT World Map and the list of VAT countries to see a graphic depiction of the problem.)

This problem was created by blundering American trade negotiators in the late 1940s when the rules governing the current world trading system were first established. Our government allowed the disparity to be created between VAT and non-VAT systems of taxation.

At the time, few countries used the VAT and the rates charged and revenues raised through the VAT were minimal. But no sooner was the loophole created than foreign governments began to switch wholesale to VAT systems to create an advantage for their exports – especially those to the United States. Three generations of American Presidents and Congresses have tried to correct this anomaly but failed. It is high time that this unfair competitive advantage was eliminated – along with its constant damage to our auto companies, as well as other domestic producers, and our tax base.

The United States is not going to scrap its income tax system in favor of a VAT or even a mixed system. And while American firms would like to have their tax burdens lifted significantly, that cannot be done in the face of today's enormous budget deficits. Nor are we going to persuade our trading partners to abandon their VAT systems. Thus, the only practical solution is to impose a VAT equalization surcharge at our border to level the playing field.

The border adjustment surcharge would be in a modest 15-25 percent range, matching the rate of the country-of-origin of the imported good. In other words, it would merely be reciprocal – not punitive. But when levied on the $1 trillion of goods and services we import each year, it would almost immediately begin to help domestic producers, as well as with the large deficits created by the current economic crisis.

The Executive and the Congress must place the Big Three – and in fact all domestic producers – on a more equal tax footing. American firms would take back some of their lost market share here at home, expanding the domestic economic base to generate more jobs (with good benefits), profits, income – and tax revenue. A surcharge that promotes domestic economic growth while raising needed revenue is a win-win for the country, and is needed to keep America competitive both at home and overseas.

It is high time that Congress and the Executive act in concert quickly and effectively to eliminate the unfairness of the VAT and the competitive advantage it provides foreign rivals. U.S. trade diplomats have tried but failed for about 40 years now. This simple step would go a long way to assisting the Big Three and their parts suppliers become more competitive both at home and abroad. And not only wouldn't it cost the taxpayers a dime, but it would also raise additional tax revenues that could be used to enhance American international competitiveness elsewhere in the economy.