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Market reactions to export subsidies ☆

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Abstract

This paper analyzes the economic impact of export subsidies by investigating stock price reactions to a critical event in 1997. On November 18, 1997, the European Union announced its intention to file a complaint before the World Trade Organization (WTO), arguing that the United States provided American exporters illegal subsidies by permitting them to use Foreign Sales Corporations to exempt a fraction of export profits from taxation. Share prices of American exporters fell sharply on this news, and its implication that the WTO might force the United States to eliminate the subsidy, which happened in 2004. The share price declines were largest for exporters with high profit margins and those whose tax situations made the threatened export subsidy particularly valuable. This evidence suggests that export subsidies do not merely benefit foreign consumers, but also improve the profitability of exporters, particularly those earning rents in imperfectly competitive markets.

Keywords: Export subsidies; Foreign sales corporations; Tax incidence

JEL classification: F12; F13; H87; H25; D43

1. Introduction

The tantalizing prospect of stimulating exports has led many policymakers to ignore the simple textbook logic that export subsidies benefit foreign consumers at the expense of domestic taxpayers. Why do countries persist in trying to subsidize exports? A popular explanation is that interest groups, particularly exporters, successfully lobby governments to obtain trade policies from which the groups believe they will benefit. Identifying the extent to which exporters actually benefit from subsidies can be difficult, as the magnitude and distribution of rents associated with export subsidies are functions of market conditions. This paper uses stock price movements to assess the value to American exporters of a major U.S. export subsidy, thereby providing evidence of the underlying features of American export markets.

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On November 18, 1997, the European Union declared its intention to bring a complaint before the World Trade Organization (WTO), accusing the United States of violating the rules prohibiting WTO members from subsidizing exports. Europe maintained that the ability of American firms to route their export sales through tax-avoidance devices known as Foreign Sales Corporations (FSCs) provided them with export-contingent tax subsidies of roughly $4 billion a year. The European Union argued that European firms were thereby unfairly disadvantaged in competition with American firms in foreign markets, and requested that the WTO require the United States to discontinue its export subsidy or else face sanctions and penalties. Negotiations between the United States and Europe proved fruitless, and the WTO in due course ruled against the United States twice, as a result of which the United States repealed the export subsidy in October 2004.[1]

This paper investigates the extent to which share prices of American exporters capitalized the threatened removal of export subsidies. For asset price reactions to convey such information, it must be the case that market participants considered the European challenge to be an unanticipated and significant development. U.S. news accounts on November 18, 1997 and during the following weeks included extensive coverage of the details and (large) magnitude of the subsidy; journalists described American officials as "stunned;" and the chief of staff of the U.S. Congress Joint Tax Committee later publicly commented, "frankly, we've been somewhat surprised by this development." There was virtually no mention of the U.S. export subsidy in major news outlets in the weeks prior to November 18, 1997, the only coverage being sporadic humdrum accounts of the use of the tax subsidy.[2] Clearly, the European announcement on November 18, 1997 was a surprise, and contemporaneous share price movements therefore can be expected to embody market valuations of losses from possible future repeal of the export subsidy.

The evidence indicates that shares prices of American firms whose sales were dominated by exports fell sharply on November 18, 1997. These price movements were greatly attenuated for exporters with net operating loss carryforwards, for whom tax subsidies are less valuable than they are for others. Similarly, the stock prices of firms with foreign income taxed at high rates reacted less sharply than did other stock prices, reflecting the existence of a generous alternative export subsidy available only to firms with heavily taxed foreign income. It is telling that share prices of Japanese firms, who were not directly affected by the events of November 18, 1997, exhibited none of the same price movement patterns as American firms, suggesting that the American share price reactions reflect considerations that are specific to U.S. taxpayers rather than exporters generally.

Two aspects of the share price movements on November 18, 1997 reflect the significance of imperfect competition in export markets: first, that share price declines were concentrated among firms earning significant market rents, and second, that share prices declined at all. Since the export subsidy was available to any American exporter, the values of firms in perfectly competitive markets should not be affected by its removal. The loss of the export subsidy in perfectly competitive markets would be compensated by market exit that reduces costs and raises prices to the point that remaining exporters earn the same normal after-tax rates of return as they did prior to removal of the subsidy.

The inability to adjust capital stocks quickly, even under perfect competition, can allow unanticipated short-run changes in after-tax prices to influence stock market valuations. Indeed, Grossman and Levinsohn (1989) find such effects in their empirical study of the effects of quarterly U.S. import price movements on firms in six competing domestic industries. Fortunately, the November 18, 1997 episode is distinctive in that the announcement did nothing immediately to affect U.S. export subsidies, nor was it anticipated to take effect quickly. Indeed, it did not ultimately make a material difference to the use of these subsidies for another seven years. World Trade Organization dispute resolution is a very slow process, particularly when applied against a major U.S. policy. Consequently, there was ample time for investment and capital stocks to adjust to the future removal of the subsidy. The stock market revaluation of American exporters therefore likely reflected a revaluation of their intangible capital associated with market power

[1] In February 2000 the WTO ruled that the FSC program represented an illegal export subsidy. In November 2000 the United States passed legislation eliminating FSCs, but simultaneously introducing a new tax exemption for extraterritorial income that had almost exactly the same export-subsidy effect as the former FSCs. Europe balked at this purely formal change, challenging the revised U.S. provisions before the WTO; the WTO in January 2002 again found the United States to be in violation of its rules, and in August 2002 authorized the European Union to impose up to $4 billion a year of retaliatory tariffs on the United States, which led to the removal of the export subsidies in legislation passed in October 2004.

[2] For journalistic accounts of American reactions, see Gordon Platt, "U.S. To Fight For Foreign Sales Corporations," *Journal of Commerce*, December 2, 1997 and Judith Burns, "Treasury's Lubick Says Can't Rule Out Action Vs. EU," *Dow Jones News Service*, December 12, 1997. An electronic search of "FSC" and "Foreign Sales Corporations" in major media sources for the two weeks following November 18, 1997 produces scores of hits, whereas the same search for the period between November 1, 1997 and November 17, 1997 produces just two, describing the use of FSCs by individual companies.