Prepared Testimony
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U.S. Senate Committee on Finance
"The Role of the Extraterritorial Income Exclusion Act in the International Competitiveness of U.S. Companies"

Mr. Chairman, Senator Grassley and distinguished members of the Committee:

My name is Pierre Chao and I am a Managing Director with the equity research division of Credit Suisse First Boston, a global financial institution. As part of my everyday job I am required to assess the impact of economic, financial, political, and technological events on corporations and their stock values. At CSFB we have analysts and economists that follow practically every sector of the economy, although my particular area of expertise is the aerospace/defense industry.

Thank you giving me this opportunity to discuss the real impact on U.S. industry of the proposed repeal of the Extraterritorial Income Exclusion/Foreign Sales Corporation (ETI/FSC) provisions of the U.S. tax code.

Allow me to begin by stating that I am approaching this issue with a belief that capitalism works, that open trade is beneficial to an economy, that trade and international competition should occur on a fair and level playing field, and that the United States should abide by the rulings of the WTO. That being said, we are all aware there are distortions in the international market place, some deliberate and some unintended. The irony of this current discussion is that the ETI/FSC rules were put into place to offset an existing distortion in the market place – the fact that countries whose tax laws are based on territoriality do not tax or significantly lower their taxes on exporters, thereby putting U.S. companies at a direct disadvantage when competing in third-party markets. A U.S. and a foreign company could be identical in every respect, with the exception of location, and the U.S. company would be forced to keep its prices higher in order to make up the tax hit or accept lower margins. I was constantly surprised that this very common sense element was often missing in the WTO debate.

Nonetheless, the WTO has made a ruling and the ETI/FSC must go away. The Congress has heard quite a bit of expert testimony over the last few years on this topic. Economists and tax specialists have discussed how economies and firms theoretically respond and adjust. I would like to bring us to the real world and the here-and-now. The repeal of the ETI/FSC will act as an instant tax on U.S. exporters – hitting industries such as agriculture, electrical equipment, aerospace/defense, manufacturing and certain parts of high technology particularly hard. Without relief, I believe the companies will have little ability to respond in the very near term, which will serve to increase their effective tax rates and lower earnings per share. All else being equal, a decline in earnings per share will impact the stock prices/market capitalization of these exporters in a fairly rapid

fashion. The mathematics are simple – same pretax income, higher effective tax rate based on removing the ETI/FSC exclusions, a lower earnings per share, using the same price-to-earnings multiple equals a lower stock price. Some quick calculations based on 2001 earnings reveal that, all else being equal, key exporters like Boeing and United Technologies could lose $3-3.5 billion of market capitalization; Caterpillar, Deere and Walt Disney could lose around $1 billion of market capitalization; Archer Daniels Midland and Dupont around a $0.5 billion of market cap; and Harley Davidson and Tyson Foods could lose a few hundred million dollars. Not to mention the estimate that the impact on General Electric's and Intel's market capitalization could be as high as $15-20 billion. That's quite a kick in the teeth to battered investors who have already suffered a stock market meltdown. This is a time when I believe we should be reassuring investors and trying to get them to invest in solid American firms, not giving them a reason to flee.

Naturally, management teams will have to respond. Their options are limited. Either raise prices to offset the impact of the increased tax (making them less competitive internationally), accept lower margins and earnings (thereby impacting their ability to attract capital) or lower costs to offset the increased tax rate. Lowering costs in this world often translates into laying people off, moving work to lower cost areas (which are often offshore) or fundamentally restructuring how a company operates its factory floor (also known as "lean" efforts, which again usually results in firing people and takes time). The fact that the ETI/FSC repeal disproportionately hits key, good-wage, high value-added U.S. exporting industries like aerospace, manufacturing and high technology is particularly disturbing. I would submit to you that finding a WTO-compliant replacement to the ETI/FSC exclusion is critical, worthy of taking the time and, in the end, a matter of fundamental fairness.

I would be more than happy to elaborate further during the questioning period.