TAX INCENTIVE TO EXPORTS: SOME IMPLICATIONS FOR POLICY MAKERS

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Abstract. The major research question of this study is: Do American manufacturers view DISC (the tax incentive to export) as assisting them in becoming more competitive in export markets? The importance of this question was recognized by Secretary of Treasury Michael Blumenthal who included an earlier version of this study in the April 1979 Treasury Report titled “The Operation and Effect of the Domestic International Sales Corporation (DISC).” As such the study has received recognition at the highest level of policy making. This study is unique in two respects: 1) it examines the impact of the tax incentive on the firm’s total marketing and promotional efforts. Other studies have examined only the relationship between the tax incentive and change in export prices, and 2) this study expands the investigation of sample firms to include small businesses as well as multinationals. The conclusions of this study (surveying 125 multinationals and 125 small exporting firms) suggest that DISC stimulated some marketing activities for small companies and was used as a tax shelter for large multinationals. The main policy implication is that as a tax incentive DISC is helpful in attracting small firms into export marketing.

INTRODUCTION

During the years following the enactment of the 1971 legislation creating the Domestic International Sales Corporation (DISC) program a vigorous debate has emerged in an effort to assess the value of this tax incentive legislation as a public policy tool. Does the DISC program contribute a stimulus to U.S. exports? If so, does it affect large multinationals, smaller exporters, or both? Are these tax incentives employed by user firms to reduce prices in an effort to compete more effectively or to increase promotion and marketing efforts? Or do they fail to affect export behavior except to simply increase after-tax profits? Opposition to the program has centered around a belief that exports and employment have not been increased by DISC, that costs have not fallen, and that the vast bulk of the tax benefits is realized by the largest multinational corporations. Finally, policy makers have been made uncomfortable by the ruling of an international panel that the incentive is in violation of a General Tariffs and Trade (GATT) rule regarding unfair trade practices.

Previous studies to evaluate the DISC program have concentrated only on calculating the value of the program through a consideration of price elasticity. This study of DISC examines, for the first time, the impact of the tax incentive on the firms’ marketing and promotional efforts rather than simply attempting to establish a relationship between the tax incentive and price elasticity as a measure of legislative impact. In addition, this study is unique in expanding the investigation of sample firms to differentiate between impact on small businesses and multinationals with some interesting resultant policy implications.

THE DISC PROGRAM

A DISC is a U.S. corporation that has been granted a limited tax deferral on a portion of its profits from export sales of products that are manufactured in the United States. The tax incentive authorizes a DISC elector (a parent corporation) to defer

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indefinitely 50 percent of the taxes due on net income derived from export sales. DISC legislation, first enacted in 1971 as part of the Administration’s “new economic policy,” was designed to improve the competitive position of U.S. exporters in response to the increasingly alarming national trade deficit. It was designed to stimulate sales of goods manufactured in the U.S. and improve the balance of payments position, to offset tax advantages available to foreign export industries, and to discourage American corporations from investing in overseas plants by equalizing any tax advantage which might be enjoyed by foreign subsidiaries.8

The DISC Statute (Sections 991–997 of the Internal Revenue Code) and the Treasury Department regulations require that the corporation be incorporated in the United States, that at least 95 percent of its assets be related to its export functions, and that 95 percent of its gross receipts must stem from export sales or lease transactions. DISCs are typically wholly-owned subsidiaries through which corporations channel their export sales. DISCs are not themselves subject to corporate income tax, but their parent corporations are taxed on the DISC income when it is distributed to them.

The parent corporations are treated as receiving one-half of the DISC’s earnings currently, whether or not actually distributed. This amount is subject to 48 percent corporate tax. The remaining one-half of the DISC’s earnings may be retained by the DISC without, in general, liability for Federal Income Tax.

The Tax Reform Act of 1976 modified many DISC benefits in response to charges that the DISC program was exploited by large multinationals.4 Section 995 of the Internal Revenue Code applies an incremental method for the determination of DISC benefits by limiting them to profits on export sales above a base period’s average sales.

In 1975–1976 congressional task forces and committees attempted to evaluate the impact of the DISC program on the American economy. The first study was prepared by the staff of the House Budget Committee for the Task Force on Tax Expenditures.5 The study utilized the following two estimates for the period of 1971 through 1973: 1.51 export price elasticity and 1.8 percent export price reduction. The results indicated that less than 1 percent of total exports ($243 million) was attributable to DISC during that period.

A study resulting from the investigation of another task force6 estimated that $2.1 billion of export sales was attributable to DISC in 1974.7 It was also stated that the existence of tax incentives to exports would not change corporate decisions to invest (as opposed to export) overseas.

The Treasury’s annual DISC report for 1974 included information from 4,162 DISC returns and attempted to estimate exports and employment attributable to DISC.8 Although the study recognized that in explaining export performance one should take into account a number of factors (such as, corporation size, type of products, international marketing activities, and the possible offset of trade advantages induced by an initial export expansion under a system of flexible exchange rates), it did not go on to deal with these considerations.9 The study assumed DISC’s contribution to exports from 1971–1974 to be the difference between actual U.S. exports during a given accounting period and an estimate of a hypothetical level of exports sales.10 This hypothetical estimate assumed for all firms the same rate of growth as for non-DISC exporters. It estimated that exports in DISC year 1974 were about $4.6 billion higher than they would have been without DISC and, by dividing the amount of the additional exports by an average figure of output per job in the export sector, attributed 230,000 jobs in 1974 to DISC.

A Congressional Research Service study employed flexible exchange rates in its attempt to estimate DISC’s impact in 1974.11 Using estimates of export price