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WORKING PARTY ON BORDER TAX ADJUSTMENTS

Note by the Secretariat on the Meetings of 23 to 25 April and 30 June to 3 July 1969

This Note has been prepared by the secretariat for the convenience of delegations.

1. The Working Party held its seventh meeting from 23 to 25 April and its eighth meeting from 30 June to 3 July 1969. At its seventh meeting it welcomed the participation of Finland and Norway as full members.
2. The Working Party had before it the consolidated document (Spec(69)49/Add.1) prepared by the secretariat summarizing the information acquired during the examination of practices of contracting parties in relation to border tax adjustments under point 1(b) of its Terms of Reference. Also before the Working Party, for its internal use, were copies of the OECD reports on the consultations with the Netherlands and Belgium (TC(68)21 and 22).
3. Members of the Working Party who were to complete their own submissions or to reply to specific questions put to them during the discussions of point 1(b) were requested to transmit such information to the secretariat for incorporation in the relevant parts of the final version of document Spec(69)49.
4. The Working Party noted that information concerning taxes levied on products of interest to developing countries had been circulated in Spec(68)134 and Addenda 1-12. It was agreed that it would be helpful if delegations could provide information on revenues derived from consumption taxes imposed on products of interest to the developing countries so as to permit a useful discussion of this issue. It would also be useful if the information contained in Spec(69)49 regarding border tax adjustments on products of interest to less-developed countries which were not produced by importing countries could be completed. Adequate representation of the less-developed countries at the eighth meeting would help to conduct a meaningful discussion of this question.

5. It was agreed that it would be useful if delegations could provide a bibliography of recent literature on border tax adjustments in addition to that which appeared in the OECD publication "Border Tax Adjustments and Tax Structures in OECD Member Countries" 1968. A bibliography of recent literature on the subject, so far received, is listed in the Annex.

6. The Working Party conducted a preliminary examination of possible effects of border tax adjustments on international trade as called for in point 1(c) of its Terms of Reference. This examination concentrated on trade effects of changes in border tax adjustments, tax shifting and structural differences in taxation. The Working Party also discussed the effects of taxes occultes and the trade effects of selective excise taxes.

7. A summary of the main trends of the discussion follows below. The full texts of the general statements which were made in connexion with the examination of point 1(c) have been circulated in Spec(69)53-59, Spec(69)67, Spec(69)89 and Spec(69)91.

I. TRADE EFFECTS OF CHANGES IN BORDER TAX ADJUSTMENTS

8. It was generally recognized that some changes in border tax adjustments could have an effect on the trade and the balance-of-payments position of the implementing country. Under certain circumstances a change in a country's fiscal structure would influence its principal macro-economic factors and thereby would also affect its foreign trade at least temporarily.

9. It was recognized that to quantify in precise terms the trade effects of border tax adjustments was a very complex matter. Neither the information nor the analytical techniques necessary to measure in any exact way these effects was available. Furthermore, it was not possible to determine what the trade figures would have been if border tax adjustments had not been made. However, although trade effects were difficult to quantify, it did not follow that further discussion on the basis of reasonable estimates and tendencies could not be productive.

10. A distinction was made between changes that occurred simultaneously with domestic tax changes of an equal amount, and changes that occurred without a change in the domestic tax level. It was pointed out that those countries that altered their border tax adjustments without corresponding changes in their domestic taxes could improve their balance of payments significantly. Even changes in the range of 1 to 3 per cent ad valorem, as was the case for some countries, were worth considering when such apparently small figures involved total trade or even substantial segments of total trade. These changes were also compared with the results of past tariff negotiations where the average rate of duty cut would also appear to be a small figure, but one which was sometimes worth years of negotiation.

11. Many countries stated that there did not exist sufficient evidence that present border tax adjustments had been the cause of any major trade disruptions. Changes in the level of border tax adjustments did have an incidence on foreign trade, but this incidence was no doubt modest in comparison with that of other more important factors prevailing in various economies. Countries who increased border tax adjustments without increasing internal rates of tax did so only because of previous minor under-compensation to rectify a competitive disadvantage. However, it should not be forgotten that over-compensation had also been rectified. Some countries did not find that the comparison between changes in border tax adjustments and negotiated tariff reductions was valid. Border tax adjustments were in accordance with GATT rules, since they were not of a discriminatory character while tariff reductions were the results of concessions legally negotiated within the framework of GATT.

12. It was further noted that most of the changes which had taken place were made at a time when the countries involved had no balance-of-payments difficulties. In practice the reasons for change from a cascade system to a TVA were that the cascade system discriminated against non-integrated firms and it did not permit the calculation of exact border tax adjustments but involved averaging. In some cases the adoption of the TVA system was the result of a directive issued with the purpose of furthering an economic integration process.

13. It was felt that the examination of the recent experience of some countries present at the meeting, with regard to changes and adjustments in their economic policy, would be helpful in understanding and solving the foregoing problems. Consequently, the Working Party first discussed the special measures taken in November by the Federal Republic of Germany and France, and then discussed the changes in the tax systems of various other member countries, all in the context of the information in Spec(69)49.

14. When considering the recent policy of the Federal Republic of Germany, the Working Party gave most of its attention to the special measures taken by this country in November 1968. It was recalled by another country that these measures had been introduced with the purpose of substituting for an appreciation of the exchange rate and that they had been publicly announced as a "downward adjustment of border tax". A survey indicated that every other exporting firm in the Federal Republic of Germany had increased its prices as a result of the new taxation measures and there was evidence of differential shifting.

15. In the opinion of the representative of the Federal Republic of Germany the discussion of his country's measures of November 1968 exceeded the Terms of Reference of the Working Party. These measures were not intended to adjust border taxes to internal taxes, nor to affect the border tax adjustments laid down in the existing GATT rules. His country's measures were equivalent to a subsidy on imports and a tax on exports in order to safeguard the external balance and bore no relation to the internal taxation. Detailed information on the import subsidy and the export tax adopted by Germany could be found on page 122 of Spec(69)49.

16. However, since this point deserved further exploration the representative of the Federal Republic of Germany volunteered information on the trade effects of the measures taken by his country in November. Regarding the price effects of the special tax on exports, he noted that the official index of export prices (1962:100) had gone up from 105.8 in November 1968 to 109.0 in February 1969 and even further to 110.3 in May 1969. Therefore, from November to May the export price index had increased by 4.5 points, i.e. by 4.2 per cent. Since the average

rate of the export tax for all German products was of about 3 per cent it seemed to be clear that the export tax had been almost completely shifted into prices. Thus the competitive position of German exports had been worsened by the amount foreseen by his Government. It was difficult to see the effects of the import subsidy on imports since the amount of the bonus given to importers did not figure in the official index of import prices. Nevertheless, this import subsidy seemed to have had its effects on imports since from January to May 1969 German imports had risen by 21.3 per cent (DM 6.9 billion) over the same period in 1968. However, he came to the conclusion that though the German trade surplus would be reduced by about DM 3 billion during the whole year, this was lower than the 4.5 to 5 billion that had been estimated. This was due mainly to the fact that the expectations, as to the development of demand and prices in other countries, did not materialize to the full extent.

17. The special measures taken by France in November 1968 involved first, the suppression of the wages tax and, secondly, an increase in the rate of the TVA. It was asked whether, given the nature of the suppressed taxes, there was any real price effect resulting from this change, since about the equivalent amount of revenue had been taken by the upward adjustment of the TVA, and if in fact this could not be considered as a border tax adjustment which was not accompanied by an equal increase in the domestic rates. It was asked what had been the effects of these measures on foreign trade.

18. The representative of France explained that the intentions of his country were to ensure a return to equilibrium of the general economy following the May-June events in France. The general wage raise that followed increased the costs of production considerably. It was then necessary to lift some of the burden off the shoulders of industry by suppressing the wages tax. The suppression of this tax was not discriminatory and was compatible with GATT rules: semi-finished imports which still required processing in France before marketing benefited from the suppression. Regarding the effect of the suppressed tax on trade it should have been felt immediately since it reduced costs automatically. However, there was no evidence to support this hypothesis. An analysis of French exports from October until March did not point to any outstanding increase.

19. Referring to the increase of the TVA, he said the reasons for its implementation were purely internal. As a result of the general increase in wages it was necessary to curtail consumption. This tax affected imported and domestic production alike. Balance of trade figures supported the contention that imports had not suffered.

20. Some representatives pointed out that one could not deduce that because there was no improvement in the French balance of trade the measures adopted in November 1968 had not had a favourable effect on France's trading position. The true comparison was with what would have happened had the changes not been made. Up to November 1968 there was an unfavourable trend in the balance of trade of France. Without the changes, a trade deterioration would have been even more manifest.

21. The representative of France answered that in October and November there had been nothing alarming about his country's balance of trade. As a matter of fact there had been a significant improvement in the months of July and August 1968 and in October and November the prospects were very hopeful.

22. It was pointed out that information on the effects of the French measures on their trade with other countries could be useful. Though reservations were made as to the usefulness of isolated trade figures the representative of the Netherlands reported that Dutch exports to France from January to April 1969 had increased by 38 per cent compared to the same period in 1968.

23. The representative of Belgium informed the Working Party that the tax on value added would be adopted by his country on 1 January 1970. The rate of compensation and the rate of alleviation under the actual system covered from 85 to 90 per cent of the real fiscal charge as expressed in terms of the normal rate of the transmission tax which was 7 per cent. One per cent was then the actual amount of under-compensation (15 to 10 per cent of 7 per cent tax = 1.05 to 0.70 per cent). In principle the remaining 15 to 10 per cent of this tax would be compensated when the tax on value added system came into force. The maximum rates that had been proposed for the tax on value added were of 6, 14, 18 and 25 per cent. These rates had not yet been definitely decided upon nor the lists of products they would affect.

24. The representative of Denmark said that on 3 July 1967 the wholesale sales tax had been replaced by a value added tax which was applied to all goods and many services. The rate of the tax on value added was calculated in such a way that the tax incidence on the industrial sector should be the same as the wholesale tax applied before which implied that the amount of the tax occulte was approximately the same after the changeover to the tax on value added. Therefore the question of adjustment at the border was a simple one. While the tax on products, not formerly subject to tax, had been fully shifted into prices, producers had not in addition taken the opportunity to increase their profit margins. No changes had taken place in the border tax adjustments rules governing selective excise duties. Neither had the new adjustments been made where adjustments had not been made before.

25. The representative of Finland said that the present sales tax used in his country was not considered satisfactory by a governmental committee report considering the adoption of the TVA. This was because the hidden tax element was 4.5 per cent on average, and its abolishment consisted of the main argument in favour of a changing of the present sales tax. To that end the committee suggested the adoption of the TVA. The tax rate recommended by the committee is 11 per cent, which also is the present sales tax rate. The adoption of the TVA would include a certain widening of the selection of taxed objects, that is mainly services, but would also carry out the removing of the present hidden tax on investments. Thus, there would be no remarkable rise or reduction of State revenues as a consequence of the adoption of the TVA. It has been estimated, however, that there would be an increase of 2 per cent of the general price level. It was too early to predict whether or not Finland would adopt the TVA system since the Finnish Government had not yet discussed the expert committee report. However, the purpose of the planned introduction of the TVA would be not to disturb the present balance between direct and indirect tax.

26. The representative of Italy informed the Working Party that on 20 June 1969 the Council of Ministers approved a draft law giving the Government the necessary powers to carry out a reform of the fiscal system in relation to both direct and

indirect taxation. Concerning indirect taxation the most important part of the reform will relate to the replacement of the actual general turnover tax by a tax on value added which will have a general rate of 10 per cent. This part of the reform was the result of the obligations Italy had undertaken in the framework of the European Economic Community. The introduction of a tax on value added system in Italy would also bring about the elimination or reduction, as the case may be, of certain minor indirect taxes such as the stamp tax. Also a complementary consumption tax levied at rates ranging from 1 to 20 per cent will replace actual consumption taxes collected at local levels. The fitting-up of the new fiscal system should be effected by 31 October 1970. However, since the tax on value added is part of a larger form, all the legislative measures that need to be taken to put into force the whole fiscal reform will be adopted on 1 January 1972. He pointed out that the fact that the proposed reform of the fiscal system was only at the draft law stage meant that any discussion of the question would be premature.

27. The representative of the Netherlands said that before the changeover from a cascade tax system to a value added tax system in his country, it was expected that prices would rise by about 1.3 per cent, but the actual increase was of about 5.9 per cent. The reason for this was that merchants and industries had taken the opportunity to increase their profit margins which, consequently, led to a general rise in the cost of living therefore forcing industries to give special cost-of-living allowances. As a consequence the expected favourable effect from full compensation had not taken place. He also noted that export prices had risen by only 1 per cent this year, therefore much less than the general increase in prices. This was probably due to the facts that export industries wished to remain competitive in export markets and that these industries are more capital intensive than others and therefore were less affected by the necessity to grant special cost-of-living allowances.

28. The representative of Norway said that two laws, one on the tax on value added and the other on investment tax, had been dealt with by Parliament in June 1969. It was his Government's intention that these laws should enter into

force in January 1970, with a general rate of 20 per cent for the tax on value added and a rate of 12.5 per cent for the tax on investments. The Parliament still had to formally adopt these two tax rates late this autumn. The tax on value added will also be collected on imports, but exports of goods and services will be exempted from this tax. The introduction of the tax on value added was part of a general tax reform and as such the proposed turnover tax rate would be increased from 13.64 per cent to 20 per cent with the coming into force of the tax on value added. The increased State revenue that would result from this increase would be balanced out by the simultaneous reduction of direct taxation and increased rates for governmental social security services. The Government did not expect significant balance-of-payments effects resulting from the reform. The exact field the investment tax was to cover had not yet been decided upon, however, it would be borne by industry without any compensation at the border whether it be for exports or imports.

29. The representative of South Africa said that last year South Africa had given details of its tax system to the Working Party in Spec(68)88/Add.1. Since 26 March 1969, a sales duty had become payable on a number of finished goods. The change in the tax system was based on the findings and recommendations of the Commission of Enquiry in Fiscal and Monetary Policy in South Africa. It found that the share of direct taxes in total tax revenue in South Africa was exceptionally high. The high marginal rates of income tax had a detrimental effect on the work effort of some groups in the labour force and encouraged tax avoidance. The Commission accordingly proposed relief in respect of the income tax on individuals which would result in a total loss of tax revenue of approximately R 140 million per year, and recommended that this loss of revenue be recouped from indirect taxations in the form of a selective sales duty, and from company-taxation. This would have the effect of reducing the share of direct taxation in the total tax revenue to 53 per cent on the basis of 1967 revenue statistics. The Commission's recommendations in this regard have been accepted by the Government. The new sales duty is an internal duty on selected commodities with a countervailing duty at the same rate on imported goods of the same class. It is collected at one stage only, i.e. on the removal from the local factory or in the case of imported goods on clearance for home consumption. The duty is ad valorem duty with only three rates, namely 5 per cent, 10 per cent and 20 per cent.

30. The representative of Sweden informed the Working Party that the transition from a single-stage tax system to the value-added tax system had taken place on 1 January 1969. This change-over was essentially a technical matter based on internal motivation. No problem of under or over compensation was involved. The tax on value added rate was the same as the rate of the old turnover tax. Previously in the turnover tax system there had been a tax on capital goods which was not rebateable. This tax had now been replaced by a wage tax which was equally not rebateable on export. The total tax burden on consumption and on enterprises was thus planned to be and did in fact remain unchanged.

II. TAX SHIFTING

31. This discussion of this issue was centred on the question of the extent which indirect and direct taxes might be shifted into the prices of goods.

32. As regards indirect taxes, it was argued (a) that they were not always fully shifted forward and in the circumstances there should be no more adjustments at the border in respect of these taxes than was warranted by their impact on prices (paragraphs 33-35), (b) that as a general rule these taxes were shifted forward, it being possible for this shifting to be greater or smaller than the mechanical incidence of the tax change depending on the economic content of the moment, and that therefore full adjustments at the border were justified (paragraphs 36 and 37) and (c) that even if not fully shifted, indirect taxes should be fully compensated (paragraphs 38 and 39).

33. A distinction was drawn between selective excise taxes and general consumption taxes. When taxes on particular products were increased with the purpose of re-allocating resources by dampening demand for certain products, the effect of such taxes on prices could be properly approached from a micro-economic point of view. When, on the other hand, a general consumption tax was increased, such an increase had macro-economic effects on income, employment, consumption, investment and general price levels and that without an increase in the monetary supply, or other offsetting governmental resources, the tax cannot be fully shifted.

The ability to shift the tax fully in prices would depend, inter alia, on the monetary authorities' willingness and ability to permit the needed increase in the money supply or the government's willingness to increase expenditure by the amount of new tax takes. The price of goods could not automatically increase by the full amount of the tax; such increase required action to permit the rise. Thus it was pointed out for a large portion of the tax to be shifted, a combination of certain economic conditions and measures would be necessary; the likelihood of these occurring was certainly very slight. This was so particularly when anti-inflationary measures would be undertaken simultaneously with a change in tax level. Certain countries gave particular examples of instances where indirect taxes were not fully shifted.

34. The view was also expressed that there might never be full shifting of indirect taxes even in the long run, after macro-economic adjustments had been fully played out.

35. It was argued that, if the tax was not fully shifted into the prices of goods sold on the domestic market, the full exemption of exports from the domestic indirect tax burden would permit the exporter to export below the domestic sales price without having export profits less than the profits on domestic sales, thus improving his competitive position on world markets. Alternatively, the exporter could receive export profits which were greater than the profits on domestic sales thus having an incentive to export.

36. On the other hand, the view was expressed that indirect taxes were normally fully shifted. It was pointed out that these taxes were normally increased by the government in inflationary conditions to offset a budgetary deficit and to act as a stabilizer of the economy. The view was expressed that the money supply would be likely to increase at such time and any increase in the tax would be fully or more than fully shifted into commodity prices. Against this it was argued that if a tax increase designed to combat inflation were to be accompanied by increase in the money supply it would be the increase in the money supply that would be the cause of the price rise.

The point was also made that even in the absence of an increase in money supply, the general price level could increase somewhat owing to a rise in the velocity of circulation which would permit full shifting.

37. The point was made that any price change which was related to a change in indirect taxes was the result of the inter-action of the tax change and the market situation previously existing, and that the forward shifting could be either greater or, on the other hand, less than the mechanical incidence of the tax change, depending on whether the economy as a whole, and the economic sector or the undertaking concerned in particular was expanding or contracting. Moreover, business circles tended to confirm that full shifting was the general rule, despite exceptional cases and temporary situations where it would not appear that the full amount was shifted.

38. It was also argued that in the tax on value added system, the shifting into prices was of a special character. The tax did not constitute an element of the price at stages preceding the retail level. This, however, was equally true of a retail sales tax and under both systems falling demand caused by tax increases might compel producers and retailers to reduce their net of tax prices.

39. With respect to the argument that indirect taxes should be fully compensated even if they were not fully shifted, the point was made that the amount of forward shifting in relation to the retail and wholesale taxes, depended on the degree of competition in a particular sector. In cases where there might be some backward shifting of wholesale or retail tax to the manufacturer, the latter might be prepared to take a lower profit than previously. But this should not be a reason for suggesting that the tax on the imported product should be abated by the amount of the reduction in the profit of the home manufacturer, since the foreign supplier should be expected to take an equivalent cut in his profit. Another important consideration would be the extent to which a given firm's production was exported. Moreover, it seems difficult to accept that if the national producer had to bear part of the tax burden, the legislator would relieve a third supplying country from this same burden. Sound competitive policy required that the basic conditions at the outset should be identical.

40. It was, however, argued that if the business absorbed a consumption tax it must then be considered as having effects similar to that of a tax on business and such taxes were not normally eligible for border adjustments.

41. Leaving aside arguments about shifting, doubt was expressed as to the feasibility of limiting the scope of border tax adjustments to the degree of shifting since, from the technical point of view, it would be extremely difficult to determine either globally or for groups of individual products and, for each individual transaction, what proportion also of the indirect tax burden was not shifted. Furthermore, the abandonment of the destination principle for indirect taxes would result in major changes and distortion in international trade.

42. As regards direct taxes, it was argued that corporation income taxes were, to a certain extent, shifted into the prices of goods. To the extent that they were shifted, these taxes should likewise be eligible for border adjustments.

43. In supporting this view, it was pointed out that the arguments for the non-shifting of direct taxes were based on a number of assumptions on how firms behaved in the case of perfect competition. In practice, however, industry generally did not operate under conditions of perfect competition and firms used administered pricing and profit mark-up techniques. Firms often followed average cost pricing which would generally include a factor of net profits; the profits tax thus became a cost factor shifted into prices. A corporate income tax altered adversely the return to capital in the corporate sector and tended to drive some capital to the non-corporate sector until the rates of return were equalized. The higher price for capital must ultimately be reflected in higher prices for the output of the corporate sector.

44. It was also pointed out that direct taxes on certain utilities were fully shifted; the rates were set generally by reference to the after-tax return to the capital employed. It was, however, argued against this that in case of utilities the market structure was a complete monopoly and this situation should not be equated to the general experience of corporations which operated in a different environment.

45. If direct taxes were so shifted, it was argued that if countries had different levels of effective direct taxation and/or direct taxes were shifted unequally, additional trade effects could result. The relative increase in prices for the country with the higher direct taxes or greater direct tax shifting would place that country at a competitive disadvantage in both its own domestic market and in export markets.

46. On the other hand, the point was made that in view of the market conditions and the short-term economic outlook, it would be a mistake to refer in very general terms to the possibility of shifting into prices of direct taxes without taking into account the technical characteristics in every instance of this tax. Obviously the only direct taxes that could be considered relevant to border adjustments would be those actually borne by business undertakings, i.e. taxes on profits and assets. In view of the fact that the object of these taxes was not the delivery, still less the consumption of products, the legislator was not interested in the price of the products sold, nor in the origin or the destination of the goods, but solely in the net profit achieved by the producer or trader, whether the latter operated at national or international level. The territorial factor came into the picture only in the context of international law on double taxation. Thus, it was argued there was no correlation between the field of application of the profits tax and the conditions of taxation of products entering into international trade. Having regard to the character of these taxes, it seemed logical that the rules of international law in force did not, as a matter of principle, afford any right to offset the burden of these taxes in the field of international trade. Market factors generally imposed tight margins on undertakings which by no means made it always possible for them to incorporate these taxes in production costs and prices.

47. Apart from this, any adjustment of such taxes at the border would encounter virtually insuperable obstacles from the technical point of view. Because of the very nature of these taxes, their incidence differed from one undertaking to another, and might even become nil in the event of loss. The profits tax base was established only subsequently to the operations which would give rise to compensation. It seemed, therefore, impossible to effect such compensation in a

satisfactory manner. Finally, it was to be feared that the introduction of such adjustments might distort competition and international trade, because they could not be carried out adequately. It was therefore questioned whether, in matters of direct taxation, the problem of incidence was of notable importance.

48. It was observed that business circles in some countries tended to confirm that as a general rule, indirect taxes were fully shifted while direct taxes were hardly shifted. In particular, reference was made to the work of the Richardson Committee¹ and more specifically to the passage where it was stated that: "It was overwhelmingly clear from the replies of the business organizations approached that they would regard a value-added tax and the profits tax as very different types of tax and would react differently to them. None of the witnesses had any doubt that liability to a value-added tax would be regarded as a charge or cost and that businesses would aim to recover it in prices, either immediately or in their next review of costs and prices. On the other hand, almost all our witnesses said that they did not, or did not directly, take the profits tax (and income tax) into account in prices. Most of them said, without reservation, that profits taxation had no effect at all, either on their home market or on their export prices: and most of the others who expressed reservations about some possible indirect effect did not take their reservations very far." Reference was also made to the report of BIAC of the OECD countries which observed that "the process of shifting a direct tax is a complex one. If he has a degree of market control the producer will do so by trying to achieve a certain after tax return on his capital and pricing his products accordingly. This is a complex calculation based on the assessment of the demand situation for his product, and the actual degree of shifting that would be achieved is uncertain. According to market conditions there may be a failure for a time to shift profits taxes at all, or alternatively full shifting may be accomplished over a particularly favourable period."

¹Report of the Committee on Turnover Taxation (H.M.S.O. Cmd. 2300, 1964).

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that what would otherwise be offsetting effects of a fiscal payments measure were not felt with indirect taxes but persisted when direct taxes were employed for this purpose. Thus, the mere composition of fiscal systems had trade effects beyond the shifting question.

53. It was pointed out that the concept of tax structures underlying the aforementioned arguments was based on overall tax revenue figures instead of on a selection and comparison of the tax data relevant to each individual case. Secondly, this concept generalized the economic effects of all types of direct taxes and indirect taxes. Among the various types of direct taxes, there were only a few that, in certain conditions, could have a significant influence on production costs and prices. Thirdly, it did not take account of the fact that it was not only the type of the tax that caused the relation between revenues, from taxes which were offset and from those that were not, to vary from one country to another, but also a large number of other factors. Thus, a given tax system with identical rates and collection modalities would yield revenues, the structure of which would vary widely from one country to another depending on the degree of economic development and the relative importance of the various branches of activity within the national economy. Conversely, if the objective was to achieve identical revenue structures - and such an objective was probably unattainable - the tax systems of the various countries would have to vary greatly.

54. Apart from these considerations, the direct taxation element inherent in social security schemes and the relative importance of external trade differed greatly from one country to another. If it were to be admitted that undertakings located in a country where the burden of direct taxes was relatively heavy were at a disadvantage as compared with undertakings liable to lower direct taxes in other countries, then it was essential to ascertain whether there existed any considerable disparity between the various contracting parties to GATT in the burden of taxes on revenue and capital. Some of the available information indicated that the burden of taxes which could not be offset was not on the whole very different as far as the major trading nations were concerned. It was, therefore, argued that since there were no essential differences it might be

concluded that, whatever one thought about the shifting of such taxes into prices, the absence of border tax adjustments in respect of these taxes would not affect trade or impair international competition although some specific differences might arise from time to time when a government relied on special tax measures in order to attain specific objectives. Even if the differential in rates between two countries was twenty points - and such a difference must be considered exceptional in the rate of taxes on corporate profits - in the event of a net profit of, say 5 per cent, the difference in terms of rebate per exported product as between the two countries would amount to only 1 per cent.

55. It was also stressed that it was important to distinguish between taxes on business organizations and those on private persons. Inflation should not be tackled by increasing a corporation tax but only by increasing the taxes on private persons, either by way of a consumption tax or by way of a personal tax.

56. The question of whether differences in the rates of profits tax in the major countries were significant was also raised. The view was expressed that if account was taken of effective rates and the different tax treatment of distributed profits, the variations in rates between countries were substantial.

57. The point was made that apart from the fact that the tax structure might differ from country to country, different kinds of enterprises were hit differently by the same type of tax. This depended on their economic structure, that is to say if they were capital-intensive or labour-intensive.

IV. SELECTIVE EXCISES

58. It was mentioned that selective excise taxes might be used in such a way as to produce trade distorting effects. For example, selective excises had been imposed, in a certain case, on goods which were imported in meaningful quantities as well as home-produced goods with imported components to discriminate against imports from a specific country. The possibility was also open to vary excise taxes on imported products according to origin. It was questioned whether GATT rules should be modified to prevent this.

59. In this respect it was pointed out that although this might occur it was normal practice to look at the trade effects when imposing or increasing selective excise duties. It was maintained, however, that any such practice was inconsistent with the GATT rules which prohibited the use of these taxes with a view to affording protection to domestic production.

60. It was pointed out that selective excise taxes were more likely to be shifted forward than general consumption taxes because the existing demand level might support a higher price for certain products within the general structure of consumer prices.

V. TAXE OCCULTE AND DIRECT TAX INCENTIVES

61. It was suggested that the Working Party should consider the effects of the varying border adjustments made for "taxe occulte" and the possibility of reaching a generally acceptable definition of "taxe occulte". It was observed that the issue of "taxe occulte" was difficult to separate from the broader issues raised by other tax measures which affected the trade competitive position of a product.

62. Practices regarding border adjustments in respect of "taxe occulte" varied from country to country and this had led to differences in the way the relevant GATT rules should be interpreted. The rules were so unclear that some countries continued practices which others considered illegal. Consequently, it was stressed that it would be quite useless to study the problems at hand only in general terms. A narrow legal interpretation of GATT rules was necessary if any understanding of the problems was to come about. In this connexion reference was made to GATT document L/3039.

63. The view was expressed that border adjustments for "taxe occulte" were inconsistent with the GATT as were adjustments for any taxes not incorporated in the product itself when such a product moved into international trade, that was, adjustments for any taxes not borne by or levied on the product. It was suggested that for simplicity, fairness and administrative ease, they should be eliminated. Countries differed in their interpretation of what were legitimate border adjustments in relation to the question of "taxes occultes". It was

therefore essential to define more precisely, and agree on uniform interpretation of what was meant by "taxes occultes" in general and in particular: a charge equivalent to an internal tax; in respect of a like domestic product; in excess of those applied, directly or indirectly, to like domestic products; and taxes borne by or levied on. Some countries took advantage of these ambiguities to gain trade advantages by making excessive border adjustments.

64. It was noted that, from the examination of practices, some countries in establishing their levels of adjustment at the border included adjustments for what would normally be considered as "taxe occulte".

65. The point was also made that the introduction of the TVA system did not automatically eliminate all adjustments for "taxe occulte". It was observed that, despite its method of collection, the TVA was like a sales tax which normally affected only the final consumer.

66. It was noted that the definitions and practices of the EEC varied as between internal transactions amongst the member States on the one hand and external transactions with third countries on the other hand.

67. It was pointed out that in recent years a growing number of countries had introduced and extended special tax incentives for stimulating exports or encouraging investment in import-competing and export-competing industries. When the issue of these incentives came up in the Industrial Products Committee, the Committee referred it to this Working Party.

68. The question was raised as to whether tax measures affecting trade should be construed to include direct tax measures as well as those which were indirect since the same issues of what was borne by or levied on the product arose.

69. It was suggested that direct tax incentives should be dealt with separately from the question of "taxe occulte".

VI. Problems relating to developing countries

70. As had been agreed at the seventh session, the Working Party devoted part of its eighth session to the question of border tax adjustments as they related to the special interests of developing countries.

71. Part of the exercise took the form of a discussion on the information supplied by developed countries, members of the Working Party, on taxes levied on products of interest to developing countries and reproduced in documents Spec(68)134 and Addenda 1-12. This part of the discussion has been reproduced in document Spec(68)134/Add.13.

72. On the basis of an interpretation given by Articles II:2(a) and III:2 of the General Agreement, it was stated that inasmuch as an imported commodity was not the same as, or similar to, a domestically-produced commodity in the importing country, it should not be subject to a border tax adjustment. Border tax adjustments were only justified provided they were not in excess of the exact amount of tax borne by the same, or similar, domestically-produced commodity. Since domestic production was not put at a disadvantage by the importation of products not domestically produced, border tax adjustments for such imports could and should not be considered trade neutral because the question of tax shifting did not arise; and therefore any border tax adjustments generated adverse trade effects on exports of products which were not domestically produced by importing countries. Such adverse effect on developing countries' exports would arise irrespective of the nature of indirect taxes, selected sales tax or general consumption tax levied by importing countries. It was emphasized that this economic argument was concerned with the adverse trade effects and not with the objectives or motivation behind the imposition of indirect taxes on products not domestically produced. To offset the adverse trade effects, it was suggested that imports which were not domestically produced should be exempt from internal levies. Such exemption would not be tantamount to giving subsidy to certain exports from developing countries, but would merely remove the present discrimination against certain exports of developing countries. Such an exemption would be administratively feasible as it had been demonstrated by recent fiscal measures taken by

developed countries to favour imports. Any loss of budgetary revenue to the importing country due to such an exemption could be made good by taxing other sources.

73. It was pointed out that some changes in indirect taxes in the past few years, particularly in those cases where a cumulative turnover tax system had been replaced by a tax-on-value-added system, had led to increases in tax incidence on products from developing countries. These changes in indirect taxes were contrary in general to Part IV and in particular to Article XXXVII of the General Agreement which enjoined developed contracting parties to refrain from imposing new fiscal measures on imports from developing countries. Moreover, the Ministerial Conclusions of 1963 stressed that industrialized contracting parties should suppress taxes on products imported essentially from developing countries. Where such taxes existed, developed countries should give prior consideration to their reduction and eventual elimination. In view of the complexity of the subject it was suggested that an expert analysis be undertaken on the incidence of changes in border tax adjustments on exports of developing countries so that the full implication of these measures be understood. Members interested would discuss an outline for the study with the secretariat.

74. It was remarked that border tax adjustments which fully compensated exporters in one developed country could also hurt the exports of developing countries to third countries. For example, if a country applying the tax-on-value-added system imported silk from a developing country and made silk shirts from the raw material, it could export the shirts to a third country and fully compensate the exporter through a border tax adjustment. Such an adjustment would have the effect of an export subsidy and would adversely affect the exports of silk shirts by developing countries into the third country's market.

75. On the other hand, other speakers maintained that the conditions of Article III could not be interpreted as forbidding the application of tax adjustments at the border or at another stage, in the case of products which were not domestically produced, particularly when it was a matter of adjustments corresponding to taxes, such as general taxes on sales, cumulative taxes or the

tax on value added which were applied in a general and uniform manner to large categories of products. It did not appear that there was any contracting party which refrained from applying to all the products which were not manufactured locally the fiscal adjustments corresponding to such general taxes. The fiscal provisions of Article III were aimed at preventing protection being given to national production by means of internal taxes, but it by no means obliged the contracting parties to favour indirectly products manufactured exclusively abroad by granting them tax exemption.

76. In fact, according to those members of the Group, the essential purpose of Article III was to avoid the abuses which result from the application of particularly heavy taxes which would affect mainly the goods which were not produced domestically. If the provisions of Article III meant that no internal tax was to be levied on imported goods which were not identical with or analogous to goods produced within the country, such a principle would deprive the developing countries of substantial budgetary revenue, for in those countries such revenue was based to an appreciable extent on consumption taxes on goods which were not produced locally. On the other hand, the developed countries, particularly the large economic entities, which produced nearly all kinds of goods, would derive very definite advantage from such a rule.

77. Those members of the Group considered that it was of the utmost importance not to introduce into fiscal policies considerations and preoccupations pertaining to trade policy. To exempt from internal taxes products of interest to developing countries would be to manipulate the fiscal system for commercial purposes, which would create a dangerous precedent. One special case would lead to another, and consumption taxes would soon be being used to influence international trade, which would be contrary to the rules and basic principles on which the General Agreement was founded.

78. It was also pointed out that Part IV of the General Agreement, in particular Article XXXVII, was directed against fiscal measures "which would hamper ... significantly the growth of consumption of primary products, in raw or processed form, wholly or mainly produced in the territories of less-developed contracting

parties, and which are applied specifically to those products", which showed that the Article applied to taxes which were selective in character. As regards the Ministerial Conclusions of 1963, certain speakers recalled that they had not subscribed to the obligations in those Conclusions, in particular those relating to the taxes on products imported mainly from the developing countries.

79. On the subject of the example of silk shirts, it was observed that the practice of exempting exports from consumption taxes could not be regarded as an export subsidy, and that this was specifically stated in the report prepared on the occasion of the Declaration of 1960 forbidding subsidies for products other than basic products.

80. On the question of selective and excise taxes on tropical products, it was stated that during the past ten years a certain number of them had been eliminated in the markets of some developed countries. Since the attention of developed contracting parties had been drawn to this issue no new cases of selective taxes had been reported. Moreover, since most of these taxes were specific, their incidence had been considerably reduced by the general rise in prices and standards of living in the developed countries over the past ten years.

81. Regarding the changeover from a cumulative turnover tax system to a tax-on-value-added system, the changes in tax rates corresponded to changes in the method of collection and not to the amount of tax collected. Consequently, it was inappropriate to generalize on whether taxation had increased as a result of the changeover. Regarding recent measures taken by a developed country to favour imports and discourage exports, it was stated that such measures should be examined in the context of commercial policy since they could not be regarded as fiscal measures, but rather as measures to subsidize imports and tax exports, made effective through and administratively rely upon the mechanism of indirect taxation.

VII. Proposals and suggestions

82. The Working Party then embarked upon point 2 of its Terms of Reference to consider proposals and suggestions being made in the light of the preceding discussion. It was, however, understood that discussion on the preceding points of its Terms of Reference could still be resumed.

83. Several members of the Working Party seemed to consider that border tax adjustments were in practice normally not being applied with a view to solving international trade balance problems, and that likewise they had no significant impact on trade. Such effects could make themselves felt, but neither the maintenance of existing systems nor the changeover to new systems involved such a degree of advantage to domestic production that they could entail significant trade distortions. They felt that the question of stability in any shifting models seemed to indicate that it would be extremely difficult, if not impossible, to translate such varying shifting into practical GATT terms. In this context, it was mentioned that the extent of shifting varied as between products, markets and periods, and from one type to another. No conclusions could be arrived at from the concept of tax structures as to the effect of existing rules and practices on border adjustments on international trade. It was not likely that full fiscal neutrality in international trade could be achieved and the present GATT rules could be regarded as generally well suited and easy to administer. They maintained that under the present circumstances a change in the rules of the General Agreement was not warranted. On the other hand, GATT could provide a useful forum for study, discussion and possibly consultations with regard to the practical implementation of border tax adjustments.

84. Others felt that the impact of border tax adjustments on the balance-of-payments position as well as on the competitive position of domestic industry was obvious and that GATT should study the monetary implication of all taxes levied at the border. They claimed that recent changes in the taxation system as well as in the level of border taxes continued to create an imbalance. The present GATT rules gave a competitive advantage to countries relying more heavily on indirect taxes. Full forward-shifting into the prices did not always take place. The situations had been aggravated by countries making up for under-compensation. Furthermore, the varying border adjustments made for tax occulte gave rise to trade effects; acceptable definition was therefore needed. The present GATT rules did not reflect a satisfactory approximation of reality.

85. It was pointed out that further discussion was still needed before the Working Party could reach any consensus on the points that had been examined. To this end various delegations submitted papers to the Working Party stating in summary form their views on border tax adjustments and the points that had been discussed. The EEC submitted their statement in document Spec(69)89, Switzerland in Spec(69)100 and the United States in Spec(69)98. The Nordic countries referred to their statement made at the seventh meeting and reproduced in Spec(69)55.

86. It was agreed that these statements, along with others that members might wish to submit, should be carefully studied in the different capitals of members of the Working Party before the next meeting. These statements would prove useful when the Working Party would report its findings and conclusions to the Council or to the CONTRACTING PARTIES.

87. Members whose governments had adopted the tax-on-value-added system, or intended to do so, were requested to submit short papers on possible effects of the new tax before the next meeting or give oral statements at the next meeting.

Other

88. The Working Party came back to point 1(a) of the Terms of Reference to examine the provisions of the General Agreement relevant to border tax adjustments, taking document L/3039 as a basis for further discussions. It was felt that discussion on this point should be taken up after proposals and suggestions were considered under point 2 of the Terms of Reference and before reporting to the Council.

89. The Chairman informed the Working Party that the Industrial Committee had referred the notifications listed in document Spec(69)79, which had been extracted from section F of document Spec(69)71/Add.1, to the Working Party for examination by fiscal experts. It was agreed that the Working Party would discuss this point at the next meeting after members had the time to study the relevant documents.

90. Reference was made to the study being prepared in the OECD on the use made of instruments acting on international trade flows for balance-of-payments adjustment purposes. The study was expected to be completed in September. One

member asked whether the secretariat could request the OECD Council to make the study available for the internal use of the Working Party. In this context another member did not feel that the balance-of-payments problems fell within the Terms of Reference of the Working Party.

Date and agenda for next meeting

91. The Working Party agreed to hold its next meeting from 30 October to 4 November.

92. The Working Party should then:

- consider any comments on the proposals made and any new proposals put forward, as called for under point 2 of the Terms of Reference;
- continue the discussion on: (a) the effects of the changeover to the tax-on-value-added system in certain countries since this system would have been in force for a period of time long enough to enable assessment of these effects; (b) the problems facing the less-developed countries; (c) the interpretation of GATT rules relevant to border tax adjustments; (d) and any remaining points;
- consider, in the light of its examination, how to deal with the presentation of its report to the Council or the CONTRACTING PARTIES.

ANNEX

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