

GENERAL AGREEMENT ON TARIFFS AND TRADE

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WORKING PARTY ON BORDER TAX ADJUSTMENTS

Interim Report 1969

1. The Working Party was established by the Council on 28 March 1968 with the following terms of reference:

Acting under paragraph 1 of Article XXV and with a view to furthering the objectives of the General Agreement, and taking into account the discussions in the Council:

1. To examine:

- (a) the provisions of the General Agreement relevant to border tax adjustments¹;
- (b) the practices of contracting parties in relation to such adjustments;
- (c) the possible effects of such adjustments on international trade.

2. In the light of this examination, to consider any proposals and suggestions that may be put forward; and

3. To report its findings and conclusions on these matters to the Council or to the CONTRACTING PARTIES.

The terms of reference and the list of members of the Working Party are reproduced in document L/3002/Rev.1.

¹For the purpose of its examination, the Working Party used the definition on border tax adjustments applied in the OECD. Thus, border tax adjustments were regarded "as any fiscal measures which put into effect, in whole or in part, the destination principle (i.e. which enable exported products to be relieved of some or all of the tax charged in the exporting country in respect of similar domestic products sold to consumers on the home market and which enable imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products)." The study of the problem of border tax adjustments concerned adjustments made either at the border or at an earlier or a later stage, depending on whether exports or imports are concerned.

2. At the twenty-fifth session of the CONTRACTING PARTIES, the Chairman of the Working Party made an interim report (L/3138), on the first five meetings, during which the Working Party conducted a preliminary examination of the provisions of the General Agreement relevant to border tax adjustments and started its study on the practices of contracting parties in relation to such adjustments.

3. In taking note of the report the CONTRACTING PARTIES underlined the importance of the task of the Working Party and recognized that the problems under its examination deserved high priority.

4. Since the twenty-fifth session the Working Party has held four constructive meetings under the chairmanship of Mr. T. Gabrielsson (Sweden). Finland and Norway have become members of the Working Party and several contracting parties are now taking active part in the work as observers. Comprehensive notes by the secretariat on these meetings have been circulated in documents L/3183 and L/3272.

Point 1(a): The provisions of the General Agreement relevant to border tax adjustments

5. The examination of the provisions of the General Agreement relevant to border tax adjustments concentrated on the legislative history of the rules and their interpretation and was conducted on the basis of a paper prepared by the secretariat. This paper, and a summary of the main points discussed are contained in a note by the secretariat (L/3039). The Working Party agreed that the main Articles it should consider were, on the import side, Articles II and III and, on the export side, Article XVI. Other relevant Articles included Articles I, VI and VII.

6. Some members of the Working Party considered that the main provisions of the GATT relevant to border tax adjustments represent an attempt at the codification of a wide range of past practices based on assumptions which are now not accepted. In particular, they felt the assumption of full shifting of indirect taxes and no shifting of direct taxes is not a reflection of economic reality. They considered that the present GATT rules favour countries which rely heavily on indirect taxes and discriminate against countries which rely predominantly on direct taxes. Further, in their view, the present rules are ambiguous and lead to differing border tax adjustment practices for similar types of taxes. They concluded that the current GATT provisions and border tax practices are not trade neutral.

7. Most members argued that there seemed to have been a coherent approach when the relevant Articles of the GATT were drafted and that there was no inconsistencies of substance between the different provisions even if the question of border tax adjustments was dealt with in different Articles. They added that the philosophy behind these provisions was the insuring of a certain trade neutrality. It was noted that the rules of the GATT had also been agreed upon by those countries

predominantly relying on direct taxes. They recalled the fact that the rules of the GATT had been in force for more than twenty years and had proved fairly adequate and easy to administer. They were also of the opinion that the present rules served the purpose of trade neutrality of border tax adjustment appropriately and that no motive could be found to change them. Some countries thought that the Working Party should not go further than a discussion on the possibilities of improvements of a technical character that could facilitate the practical handling of the GATT rules.

8. It was agreed that it was essential to continue the discussion on the relevant provisions of the General Agreement in connexion with the examination of the practices of border tax adjustments and the possible effects of such adjustments on international trade before final conclusions could be made.

Point 1(b): The practices of contracting parties in relation to border tax adjustments

9. The Working Party has devoted considerable time to a comprehensive and thorough examination of the various tax systems, and changes in those systems, of the twenty-two contracting parties, members of the Working Party and of several observer countries. The examination concerned general consumption taxes such as cascade taxes, single-stage taxes and, in particular, taxes on value added (TVA), which are or will be applied by many European countries, as well as selective excise taxes. In addition, less detailed consideration was given to certain specific problems, mainly relating to taxes on company profits and on capital. Members and observers explained their tax systems individually and replied to many detailed questions which were raised. The Working Party spent much time in collecting and clarifying the extensive information received. Extensive information on the study of practices of border tax adjustments in OECD countries has been made available by courtesy of the OECD to the Working Party.

10. The Working Party agreed that a consolidated document be drawn up by the secretariat listing all information on and discussion of the existing practices of border tax adjustments. The consolidated document, which will be distributed to contracting parties, provides a description of how adjustments at the border in various countries are made, whether these adjustments are made either at the border or at an earlier or later stage depending on whether exports or imports are concerned, at the manufacturing, wholesale or retail level, and also supplies information on the extent to which tax systems have been changed in various countries.

11. It was felt that this part of the work of the Working Party had been most useful. It constituted the fundamental basis for its further examination of the relevant rules of the GATT and the possible effects of border tax adjustments on international trade; it was agreed that the Working Party should return to this part of its terms of reference any time it should be considered necessary.

Point 1(c): The possible effects of border tax adjustments
on international trade

12. In examining the possible effects of border tax adjustments on international trade, a study has been made of the nature of indirect taxes and also to some extent of direct taxes, and their eligibility for adjustment at the border. The question was raised by some members why only indirect taxes should be eligible for adjustment at the border since the economic basis for such a clear distinction between indirect and direct taxes for border adjustment purposes has not been demonstrated. Most delegations stated, however, that in their opinion such a distinction was already justified by the fact alone that indirect taxes by their very nature bear on internal consumption and were consequently levied, according to the principle of destination, in the country of consumption, while direct taxes -- even assuming that they were partly passed on into prices -- were born by entrepreneurs' profits or personal income. On the other hand, some members stated that while forward shifting of selective excise taxes could take place under most circumstances according to micro-economic approach, forward shifting in the case of general consumption taxes was according to macro-economic approach, not possible unless one assumes either a sufficient increase in money supply or in velocity of money. Some further argued that market conditions including, for example, monopoly or imperfect competition, influenced the degree to which the shifting of taxes both direct and indirect could take place. Other members expressed their doubts about this thesis. They pointed out that forward shifting of indirect taxes is the rule and that in any case the relative importance of the degree of forward shifting of these indirect taxes in the light of the economic conditions does not constitute a determining criterion for the application of border tax adjustments.

13. The Working Party recognized that the problem of structural differences in taxation and the question as to what extent indirect taxes and direct taxes were shifted into commodity prices was full of difficulty and of a very complex nature.¹ It seemed that conclusions could not be reached. Some members felt that this part of the Working Party's examination made it clear that here further discussion was needed and that it was important that solutions should be found to ensure trade neutrality. Most other members of the Group, however, were of the opinion that the discussion rather tended to confirm that the current practices of border tax adjustments were as consistent as possible with the objectives of trade neutrality. Still some others were of the opinion that the work done so far in the Working Party was not such as to permit definitive conclusions to be drawn regarding the objective truth in the two opposing contentions.

¹See paragraphs 31-49 of document L/3272, note prepared by the secretariat on the meetings in April and June-July 1969.

14. The Working Party examined whether and to what extent changes in tax systems could affect international trade. The Working Party paid special attention to changes in border tax adjustments unaccompanied by changes in domestic rates of taxes and changes from cascade taxes or sales taxes to a tax on value added. In this connexion, special studies were made of Denmark, France, the Federal Republic of Germany, the Netherlands and Sweden, which had moved from a cascade or single-stage tax system, to a system of tax on value added (TVA). Norway informed the Working Party that the changeover to a tax system on value added would take place on 1 January 1970. Other countries, Belgium, Finland and Italy, said that they intended to prepare similar changes in their tax systems.¹ The special measures taken in November 1968 by the Federal Republic of Germany¹ and France owing to certain economic circumstances were also discussed.

15. The Working Party recognized that there were serious difficulties in the way of quantifying the possible effects of border tax adjustments on international trade, it being difficult to determine what the trade figures would have been if border tax adjustments had not been made.

16. It was nevertheless admitted that changes in border tax adjustments could in certain conditions have a favourable effect on the trade balance. Some members shared that view only with respect to changes that put an end to under-compensation. For instance, the substitution of a TVA for a cascade tax could well be advantageous to the balance of trade, if border taxes under the cascade system did not fully reflect the turnover tax paid on similar products in the home market. However, those effects would depend on the conditions in which the changes were made. Some countries explained that as a transitional measure the effect from their changeover to full compensation would be partially offset through a limited tax deduction for investments goods and stocks during the first years after the imposition of the TVA. This meant that in those years there would be still a difference in the burden between the imported product and the home product in favour of the imported product. In addition, it appeared that, at least in one case, the expected trade advantages, which would have been of a rather small percentage anyway, had been entirely obliterated by a sharp price and cost inflation after the TVA had been imposed. It was remarked that this evolution was likely to take place under certain circumstances, when a TVA is substituted for a cascade system. Some countries said that they did not share the view that it was likely that the trade advantages of such a shift could be obliterated by this phenomenon.

17. Some members of the Working Party expressed the view that border tax adjustments could have a disequilibrating impact on the world economy, if, for example, border tax adjustments which would improve a particular country's trade position were in future to be made when that country was already in a sustained balance-of-payments surplus position. The members who held this view suggested that there was a need

¹ See paragraphs 14-16 of document L/3272, note prepared by the secretariat on the meetings in April and June-July 1969.

to take this aspect into account rather than simply adopting border tax adjustments as a logical consequence of internal tax policy decisions. It was asked by these members of the Working Party whether it was correct for countries to change in all circumstances border tax adjustments to allow for fuller compensation at the border. Several countries pointed out that the rules of the GATT permitted border tax adjustments for certain indirect taxes, which was entirely justified since in the absence of full compensation, national undertakings were at a disadvantage from the aspect of international competition.

18. The Working Party examined the problem of taxes occultes. It also discussed, to a lesser extent, incentive measures that may be taken in the context of direct taxation. The view was supported that further study of the problem of taxes occultes was needed. Some countries stated that the problem of direct tax incentives also warranted some study. Some other members expressed the view that the latter problem did not fall within the terms of reference of the Working Party. Furthermore, the adjustments at the border in relation to selective excise taxes were discussed. It was noted that selective excise taxes could be applied on certain products but not other related products in order to affect international trade. It was recognized that this could be inconsistent with the General Agreement.

19. A list of products of interest to developing countries was drawn up in order to examine whether and to what extent products originating in developing countries were affected by border tax adjustments. All members of the Working Party had provided most of the information requested, except that on revenue from internal taxes on products of interest to developing countries, where not all countries had provided the information. A useful discussion was held on the practices of contracting parties in levying taxes on commodities exported by developing countries.

Point 2: Proposals and suggestions

20. The Working Party has thought it useful in this interim report to give the Council a preliminary outline of the proposals and suggestions put forward at this stage of its work as well as of the discussion of those proposals which has taken place so far. It was pointed out, however, that the proposals were made at a rather late stage of its work and that the views expressed on them by some members were only of an indicative character. They thus pertain more to the priority and the degree of importance which the Working Party felt should be attached to the problems rather than to the proposals themselves.

21. With regard to the provisions of the General Agreement on Tariffs and Trade relevant to border tax adjustments, some members stated that the rules were not neutral to trade and were ambiguous and that there was an apparent need for the revision and clarification of the rules. Most members of the Working Party felt, however, that the present rules had functioned in a satisfactory manner and that they had corresponded sufficiently closely to the objectives of trade neutrality, and consequently there was no need to amend the General Agreement. The Working Party agreed, however, to examine the rules with regard to their interpretation and clarification. This study of interpretation should concentrate initially on such matters as the terms "borne by" and "levied on" in relation to

taxes occultes and "like or similar products". Some members felt that until such an examination was completed, they could not draw any conclusion as to the need for a revision of the relevant rules of the General Agreement.

22. The Working Party agreed to examine the notifications made in the Committee on Trade in Industrial Products with regard to border tax adjustments and will report to this Committee in due course.

23. In the course of the discussion of the Working Party it was suggested that existing border tax adjustments could be subject to a complaints and consultation procedure. There was a general feeling that the contracting parties would pay attention to the policy of the GATT countries in this field and that consultations could take place concerning practices regarding border tax adjustments. Some members, however, questioned the usefulness of a special body for dealing with such complaints and referred to the existing procedures of the General Agreement. In any case, they preferred that a further study of the taxation systems should be made before new procedures could be discussed. Most members of the Working Party felt that work exercised in other competent international organizations should be taken into consideration in order to avoid duplication of work.

24. Other members were in favour of the idea that adjustments and changes in adjustments should be placed under surveillance, and some members suggested that such surveillance could be consistent with the following principles:

- (i) a country should not change its border tax adjustments without regard to the consequences for its own and other countries' trade;
- (ii) if changes in adjustments have inappropriate effects on international trade, the changes should not be made or the trade effects should be offset. Thus, a country insisting upon making a change despite inappropriate consequences on one or more other countries' trade would agree to offsetting action determined by multilateral consultation.

The Working Party decided, however, that changes in border tax adjustment practices and their harmonization should be studied by the Working Party.

25. The Working Party decided that there were several other pertinent questions to be examined such as the rules of averaging in countries applying certain forms of cumulative indirect taxation and the question whether to make adjustments at the border or at a later stage. Some members stated that the Working Party should also examine what adjustments could be made by countries in special circumstances and the extent to which taxes should be adjusted. Most members were of the opinion that this did not fall within the terms of reference of the Working Party. Furthermore, it was suggested that the question should be studied whether direct taxes also should be regarded as eligible for border tax adjustments. Some countries, however, noted that the discussion of the Working Party had shown that adjustments for direct taxes would lead to arbitrariness and they could, therefore, not agree with such adjustments.

26. Some members pointed out that the question of imposing and hence of forward shifting of internal taxes on domestic products did not arise in the case of products which were not domestically produced by developed countries. They therefore emphasized that the principle of destination regarding border tax adjustments was not relevant in the case of products of export interest to developing countries which were not produced in developed countries, and that in order to ensure trade neutrality as required under GATT rules no internal taxes should be levied by developed countries on such products.

27. In addition, these members drew the attention to the ministerial conclusions of 1963 and Article XXXVII of the GATT, which stressed that developed contracting parties should endeavour to suppress taxes on products imported essentially from developing countries and that consequently contracting parties should give priority attention to the reduction and elimination of such taxes. These members pointed out that on the contrary, as the result of recent changes in tax systems in some of the countries, the tax incidence on some of the products of interest to developing countries had tended to increase.

28. In referring to the proposal to suppress taxes on products not domestically produced in developed countries, some countries considered that it was of great importance not to introduce into fiscal policies considerations and preoccupations pertaining to trade policy. They stated that exemption of internal taxes on products of interest to developing countries would imply manipulation of the fiscal system for commercial purposes. This would create a dangerous precedent and would be contrary to the rules and basic principles of the GATT. They added that the conditions of Article III of the General Agreement could not be interpreted as forbidding the application of taxes to products not domestically produced but that they essentially aimed at preventing protection being given to national production by means of internal taxes. These conditions, therefore, did not oblige contracting parties to favour indirectly products not domestically produced by granting them tax exemption. As regards the ministerial conclusions of 1963, some countries recalled that they had not subscribed to the obligations in those conclusions, in particular those relating to taxes on products imported mainly from developing countries.

29. One member remarked that, in this connexion, the Working Party should examine the interpretation of the relevant rules of Article III in order to clarify the philosophy behind these rules when they were drafted by contracting parties. The Working Party considered that a more detailed discussion would be useful and that it should return to this subject at a later stage.

30. The Working Party recommends that it continues its work along the lines indicated above. It expects to make a report under paragraph 3 of its terms of reference either late in 1970 to the Council or at the twenty-seventh session of the CONTRACTING PARTIES.