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The Border Tax Issue Defined

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in 1966 was down to only $1,279 million. Pakistan, Korea, Taiwan and Indonesia account for over 90 per cent of this decrease. The reduction in aid to Pakistan was associated with the Indo-Pakistan conflict. Indian aid was reduced last year also, but it reached its peak in 1964 rather than 1963. Aid to Taiwan has been phased out, and aid to Korea is being reduced, since both countries are moving to self-sustaining growth. Indonesian aid was cut out in 1965 because of the impossibility of carrying out an effective program there. It was restored last year after the change in government, but it is still on a much reduced scale.

Political decisions also resulted in the virtual elimination of aid to Cambodia and Burma. Disbursements in 1966 were only $2 million in contrast to $30 million in 1963. In the case of Cambodia, the elimination of $20 million in aid (the 1963 total) appears to have cost us about $7 million in exports for a net saving of $13 million. Aid to Burma was $10 million in 1963 and it has since declined to only $2 million in 1966. This does not appear to have had any adverse impact on the sale of U. S. goods in Burma, since our exports increased from $11.8 million in 1963 to $23.6 million in 1966.

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The Border Tax System

Under the rules laid down in the original GATT and in the 1955 revision, border tax adjustments may be made only for indirect taxes, such as excise, turnover and value added taxes. Thus countries having such taxes normally will levy an import charge--or import equalization tax--designed to impose the same amount of indirect tax on the imported product as is embodied in the price of the like home-produced product. Conversely, exporters receive a rebate--or tax exemption--equal to the amount of indirect tax embodied in the price of an exported good. The intent of the adjustment system is to free world market prices completely from indirect taxation, so that prices of imported goods reflect only indirect taxes levied in the country of consumption.

Direct taxes, on the other hand, are specifically excluded from the border tax system and any border adjustment for such taxes would be viewed as an export subsidy or an import charge contravening GATT.1/ The logic behind this different treatment of the various taxes lies in the premise that taxes borne by the factors of production should reside in the country of origin and that taxes borne by the ultimate consumer should reside in the country of destination. Therefore, the entire border adjustment system is based upon the assumption that direct taxes are always fully shifted backward to the factors of production and that indirect taxes are always fully shifted forward into the final price of a good.

1/ The distinction between "direct" and "indirect" taxes is, in fact, not made explicit in the GATT regulations, but flows from interpretation of and amendments to the relevant provisions.

<u>Examination of economic logic of border tax system</u>

Under the above assumption of tax shifting, imported goods, without tax equalization charges, would be at a price advantage vis-à-vis home-produced goods to the extent that the exporting country had a lesser rate of indirect taxation. Conversely, without tax rebates a country with a relatively high rate of indirect taxation would be at a competitive disadvantage in world markets relative to countries with a lower rate of indirect taxation.

Second, without border adjustments, goods moving in international trade would be taxed doubly: once in the country of origin and once in the country of destination, both tax levies being paid by the consumer in the country of destination. Thus the foreign consumer would make a contribution to the exchequer of the country of origin. Furthermore, world market prices would be raised by the amount of the tax and the volume of trade would be likely to shrink.

Thus, if the assumption of full reflection in final prices of indirect taxes and zero reflection in prices of direct taxes holds true, the current system of border tax adjustments indeed serves to neutralize the trade effects of differential national tax systems. However, the current system is open to two basic and related questions:

1. Is the current practice of classifying certain taxes as "direct" and others as "indirect" a correct reflection of actual conditions?

and

2. Given such classification, are shifting assumptions correct?

Distinction between direct and indirect taxes

Indirect taxes are generally defined as taxes on consumption, while direct taxes are defined as those levied on income. However, the distinction on basis of these definitions has become more and more cloudy over time. The only area where there seems to be clear agreement is with regard to personal income taxes, which are classified as "direct" and retail sales taxes, which are classified as "indirect" taxes; beyond this "the classification becomes a morass."1/

Thus, it could be argued that the distinction made in international practice between "direct" and "indirect" taxes may essentially be arbitrary and that it seems to be based more on prevailing practice than on theoretical reasoning. For example, it is not at all clear whether employer contributions to social security fall into the "indirect" or the "direct" tax category, although GATT practice specifically places them with direct taxes. Conversely, value added taxes, according to GATT classification are considered to be indirect taxes. However, value added taxes fall on both costs and profits of the producer (value added being defined as the difference between the value of a firm's purchases and sales) and to the extent that they fall on profits are not always clearly distinguishable from a profits tax in their effect. Nevertheless, corporate profits taxes are classified as "direct" and value added taxes as "indirect" taxes.

1/ Richard A. Musgrave and P. B. Richman, "The Allocation Aspects of Direct vs. Indirect Taxation," Brookings Conference on the Role of Direct and Indirect Taxes in the Federal Revenue System.

<u>The question of tax shifting</u>

Given the murkiness of the borderline between "direct" and "indirect" taxes, it is not surprising that the premise of full forward shifting into price of direct and full backward shifting to the factors of production of indirect taxes has given rise to even greater uncertainties. The shifting argument is based upon Marshallian price theory which holds that, under pure competition, profits taxes will not affect prices because prices are determined by marginal producers and marginal producers have no net profits. Modern theory of shifting and incidence of taxation has moved a long way from so clear-cut a statement. For example, statistical studies can be found which support either the full backward shifting or the full forward shifting theory for some direct taxes.[1/] Basically most experts today would argue that shifting of either type of tax can and does occur in both directions and that the degree of shifting will vary with different circumstances, such as variations in demand and supply elasticities, in degree of market control and in government policies. The current border tax adjustment system, however, is solely predicated upon a general full shifting assumption and, therefore, cannot be conditional upon the structure of market forces or upon certain government actions, such as a permissive monetary or fiscal policy.

In so far as the actual extent of forward, or backward, shifting of relevant taxes cannot be determined clearly, the extent of tax neutrality brought about in international trade by the current

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1/ Full forward shifting of corporate profit taxes into prices is suggested by Marian Krzyzaniak and R. A. Musgrave, <u>The Incidence of the Corporation Income Tax</u>, Johns Hopkins Press, 1963; full backward shifting by Challis Hall, "The Incidence of the Corporation Income Tax," <u>American Economic Review</u>, May 1963.

Table 1. Balance of Trade Effects of General Taxes Assuming Fixed Exchange Rates and Unchanged Real Demand for Domestic Output1/

	Balance of Trade Effect: With Border Adjustment		Balance of Trade Effect: Without Border Adjustmen
I. Raise indirect taxes:			
a. Product prices rise	NEUTRAL		Unfavorable
b. Factor prices fall	Favorable		Neutral
II. Raise social welfare charges:			
a. Product prices rise	Neutral		Unfavorable
b. Factor prices fall	Favorable		NEUTRAL
III. Raise corporate profits taxes:			
a. Product prices rise	Neutral		Unfavorable
b. Profits fall	Favorable		NEUTRAL
	Balance of Trade Effect: Indirect Tax With Border Adj. Others Without	All Taxes With Border Adjustment	No Border Adjustmen
IV. Substitute indirect tax for Social Welfare charges:			
a. Under Ia and IIa	Favorable	Neutral	Neutral
b. Under Ia and IIb	NEUTRAL	Unfavorable	Unfavorab:
c. Under Ib and IIb	Favorable	Neutral	Neutral
V. Substitute indirect tax for Corporate Profit tax:			
a. Under Ia and IIIa	Favorable	Neutral	Neutral
b. Under Ia and IIIb	NEUTRAL	Unfavorable	Unfavorab:
c. Under lb and IIIb	Favorable	Neutral	Neutral

1/ This Table is adapted from an unpublished submission by Richard N. Cooper and Richard A. Musgrave to the Symposium of Experts on Border Tax Adjustments held by the OECD in Paris, September 1964. Effects in capital letters reflect GATT reasoning.

border tax adjustment system is also unclear. Table 1 sets out a number of examples of possible effects on trade balances of various tax changes under different shifting assumptions. Thus an increase in indirect taxes, with full border adjustments, would not affect the balance of trade only if product prices rose to the full extent of the tax (case I a), which is the case assumed by the GATT convention; if, on the other hand, factor prices were to fall, the trade effect would be clearly favorable. Thus substitution of, for example, an indirect tax, which is not fully reflected in product prices, but which is rebated in full, for a corporate profits tax, which was not reflected in prices and which was not rebatable, would have a favorable trade effect (case V a); the trade effect would be doubly favorable if the corporate profits tax was partially reflected in prices (case V b).

Since there is a substantial body of theoretical and empirical evidence which tends to contradict the view that certain taxes are always fully shifted into price, while others are always fully absorbed by the factors of production, it is most likely that the true state of affairs encompasses all and several combinations of the possibilities shown in Table 1. Consequently, in modern economies the instances of trade neutrality consistent with GATT assumptions constitute only a special rather than the general case.

Practical issues

If the current system of border adjustments neutralizes tax effects on international trade in special cases only, how serious are trade diverting effects in the remaining instances?

Trade distorting effects of existing border adjustments probably have been largely compensated by past changes in relative rates of exchange, tariffs or price levels. But, under present conditions, exchange rate or tariff changes no longer are flexible instruments of adjustment to changes in competitive position among industrial countries. Consequently, possible trade distorting effects of new border adjustments now are of much greater concern than they were in the past, although even past changes--with the greater adjustment possibilities then available--probably have produced a world trade pattern rather different from that which would have come about under systems which truly neutralized the international trade effects of differential national tax systems.

To remedy the situation one could, first, consider fundamental changes in the basic system of border adjustments. These might range from elimination of the entire practice to a broadening of the practice to include various taxes now considered ineligible for adjustment. Complete elimination of current practices clearly is not a practical possibility, partly because adjustments to earlier trade distorting effects--such as may have occurred in relative rates of exchange for example--would need to be unwound. But more importantly, in the absence of border tax adjustments, countries with a high degree of trade involvement and a close tie to world prices would find forward shifting of indirect taxes (i.e., full reflection of the tax in export prices) virtually impossible. Thus their basic tax structure might have to be modified to the extent that it relied heavily on indirect taxation.

Inclusion of a broader range of taxes, such as the corporate profits tax and social security charges, would meet with considerable administrative problems. Even if the degree of shifting, which to complicate matters may actually vary from product to product and from country to country as well as over time, could be accurately determined, it would be virtually impossible to determine the precise amount of tax embodied in the price of a specific product. This problem is analogous to that encountered in rebating cumulative turnover--or so-called cascade--taxes, where "average" rates are being rebated, which leads to over- or under-rebating in individual instances and to distortions of the competitive position among individual firms. The elimination of this problem is one of the advantages cited in favor of the value-added tax system which is to replace the cascade type systems in Germany, Italy and the Benelux countries by 1970.

In any event, as shown in Table 2, extension of border tax adjustments to virtually all types of taxes, except the personal income tax, would not redress the balance of competitive advantage in favor of countries, such as the United States, now having no or few border adjustments. This is so because the tax burden, relative to GNP, is higher in most continental European countries than it is in the United States or the United Kingdom. In this respect a truly "ideal" system of border adjustments designed to produce tax neutrality in international trade should probably take account of government expenditures also. For instance, where tax revenues are employed to reduce production

Table 2. Selected Countries: General Government Revenues and Expenditures as Per Cent of Gross Domestic Product, 1965

	U.S.	U.K.	France	Germany	Italy	Neth.
1. Indirect Taxes	9	14	18	14	12	10
2. Personal Income Taxes	9	9	4	7	n.a.	10
3. Contr. to Soc. Sec.	2	3	4	5	n.a.	3
4. Total 2 plus 3	11	12	8	12	n.a.	13
5. Corporation Tax	5	2	2	3	n.a.	3
6. Empl. Contr. to Soc. Sec.	2	2	10	5	n.a.	8
7. Total 5 plus 6	7	4	12	8	n.a.	11
8. Direct Taxes 4 plus 7	18	16	20	20	17	24
9. Other	--	2	1	2	3	3
10. Total Current Revenues	27	32	39	36	32	37

Source: National Accounts Statistics 1956-1965, Organization for Economic Cooperation and Development, Paris, 1966.

costs, countries rebating indirect taxes may actually reap a double competitive advantage. For example, if an excise tax is levied in order to fully finance a national transportation system, domestic producers would in effect have zero transportation costs on their exports, since the excise tax would be rebated at the border. If in addition, the tax is not fully reflected in final prices, a full rebate would give the exporter a second trade advantage over outside suppliers.

On the whole, it is fairly clear that it is currently not practicable to construct an "ideal" system of border adjustments. However, this does not mean that nothing can or should be done to remedy clear existing and future inequities arising from the current border tax treatment.

Impending or recent changes in taxation with definite favorable trade effects for the countries which impose them include:

1. Change from a system of cumulative turnover taxes to one of value added taxes, where tax burdens are now generally not fully compensated under the cascade system. (Such a change is now pending in Germany and the Benelux countries);
2. Change from a system of retail sales taxes or cumulative turnover taxes including investment goods and fuels (which currently are not rebatable) to a value added system which excludes these items and imposes a higher rate on consumption goods.
3. A shift from direct taxation or social security charges (which are not rebatable) to indirect taxation (which is) to the extent that the former taxes were shifted into final prices or the latter are not so shifted (such a change was effected in Italy);
4. Upward changes in adjustments for so-called "taxes occultes" (indirect taxes charged on certain inputs, such as fuel, at some earlier stage of production) or for cascade type taxes because of earlier under-rebating (such changes were effected in the United Kingdom and Germany).

The greatest promise for ironing out inequities arising from trade-favorable effects of border tax adjustments lies perhaps in treating them in a manner similar to that now applying to changes in tariffs. The recent discussions within the Organization for Economic Co-operation and Development, which aimed at a standstill on border taxes with possible countervailing concessions for changes with definite trade effects--such as those cited above--point in this direction. Such a system of countervailing concessions, broadened to not only achieve a standstill in, but perhaps also a roll-back of, border tax adjustments, would solve the problem of distorting effects on the trade patterns between two countries with different tax systems. However, beyond this there still remains the problem of trade effects in third markets, which may require further accommodation, such as possible selective waivers of GATT rules currently prohibiting export subsidies.

Appendix I. GATT and Treaty of Rome Provisions Relating to Trade Aspects of National Taxation

1. GATT provisions on border taxes and export subsidies.

a. Import equalization charge for "product" (interpreted to read "indirect") taxes as set forth in Article III:2:

> The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.

Article II prohibits import charges above rates agreed upon and bound in tariff negotiations, but a specific exception is made with respect to indirect taxes: Article II:2 (a):

> Nothing in this Article shall prevent any contracting party from imposing at any time on the importation of any product:
>
> A charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III in respect of the like domestic products or in respect of an article from which the imported product has been manufactured or produced in whole or in part;

A similar exception is made in Article VI which defines and prohibits dumping practices: Article VI:1:

> Due allowance shall be made in each case for differences in conditions and terms of sale, for differences in taxation, and for other differences affecting price comparability.

and Article VI:4:

> No product of the territory of any contracting party imported into the territory of any other contracting party shall be subject to anti-dumping or countervailing duty by reason of the exemption of such product from duties or taxes borne by the like product when destined for consumption in the country of origin or exportation, or by reason of the refund of such duties or taxes.

b. Export tax rebates and subsidies. The GATT is generally opposed to export subsidies as stated in Article XVI:2:

> The contracting parties recognize that the granting by a contracting party of a subsidy on the export of any product may have harmful effects for other contracting parties, both importing and exporting, may cause undue disturbance of their normal commercial interests, and may hinder the achievement of the objectives of this Agreement.

But there is no outright prohibition of export subsidies. Their existence for exports of primary products is explicitly recognized and condoned in Article XVI:3 which, however, deplores the practice and states that it should not be used to obtain "more than an equitable share of world trade in that product." For other than primary products Article XVI:4 holds that:

> Further . . . contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market.

Rebates of indirect taxes on exports do not constitute subsidies according to a note in Annex I to Article XVI:

> The exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy.

But remission of direct taxes or social welfare charges was defined to contravene Article XVI:4 at the 17th Session of the Contracting Parties as was overcompensation for indirect tax burdens:

> (d) The exemption, in respect of exported goods, of charges or taxes, other than charges in connection with importation or indirect taxes levied at one or several stages on the same goods if sold in internal consumption; or the payment, in respect of exported goods, of amounts exceeding those effectively levied at one or several stages on these goods in the form of indirect taxes or of charges in connection with importation or in both forms;

Under Article XVI:1, countries are required to notify each other of any practice considered as subsidies and to enter into discussions with countries feeling themselves injured by such practices. Article VI:3 permits countries injured by subsidies involving direct tax credits to impose countervailing duties.

2. Treaty of Rome provisions relating to border taxes.

The rules governing the treatment of export tax rebates and import equalization charges among Common Market countries appear to be patterned fairly closely after GATT regulations. But they specify somewhat more clearly than does the GATT that by ". . . charges . . . applied . . . to like domestic products" only indirect taxes are meant. The relevant provisions are laid down in Article 95:

> A Member State shall not impose, directly or indirectly, on the products of other Member States any internal charges of any kind in excess of those applied directly or indirectly to like domestic products.

Article 96:

> Products exported to the territory of any Member State may not benefit from any drawback of internal charges in excess of those charges imposed directly or indirectly on them.

Article 97:

> Any Member States which levy a turnover tax calculated by a cumulative multi-stage system may, in the case of internal charges imposed by them on imported products or of drawbacks granted by them on exported products, establish average rates for specific products or groups of products, provided that such States do not infringe the principles laid down in Articles 95 and 96.
>
> Where the average rates established by a Member State do not conform with the above-mentioned principles, the Commission shall issue to the State concerned appropriate directives or decisions.

Article 98:

> With regard to charges other than turnover taxes, excise duties and other forms of indirect taxation, exemptions and drawbacks in respect of exports to other Member States may not be effected and compensatory charges in respect of imports coming from Member States may not be imposed, save to the extent that the measures contemplated have been previously approved for a limited period by the Council acting by means of a qualified majority vote on a proposal of the Commission.

Source: Sidney Weintraub, "Border Tax Adjustments and the GATT," The Tax Executive, July 1965, pp. 317-320; Treaty Establishing the European Economic Community.