The submission by the European Communities of 1 July 1969 is a useful addition to the border tax adjustment discussion. The Community's paper recognizes that border tax adjustments under the present rules can lead to trade diversion, but we believe the paper unduly minimizes these effects. The United States' position is that this Working Party should identify trade effects resulting from the rules to arrive at possible reforms. In addition, the submission by the Communities raises a number of points which require further exploration.

A fundamental point requiring additional examination is the argument in the EC presentation that the price effects of selective and broad-based sales taxes are the same. In fact, the economic and price effects are normally quite different. The individual entrepreneur, operating at the micro-economic level, views any tax levied on his product as a cost which he attempts to recover. However, the individual entrepreneur knows that there are some conditions under which he can increase prices to cover costs (and make his increase stick) and other cases where he must narrow his profit margin, be firmer against the wage and other demands of his employees, and resist price increases by his suppliers. That is, the entrepreneur alone does not make his market. There are factors beyond his control and there is a decisive macro-economic framework in which he operates and that governs his prices and profits.

If each entrepreneur is able to incorporate a general sales tax, under any name, into his selling price while maintaining his sales volume, the general price level will be higher by the amount of the tax and full shifting will have occurred. However, unless the velocity of circulation of money happens to be sufficiently elastic -- with the existing money supply -- not all producers will be able to incorporate the full amount of the tax in the price of their product. Unless the money supply is allowed to increase to a level which supports the higher price level, higher product prices will merely cause fewer goods to be sold -- and factors of production will effectively have had the tax shifted backwards onto them through unemployment or lower returns.

Although after a time the effects of a high-rate general tax (such as most TVAs) become difficult to measure, the tax can be fully shifted forward only if the monetary authorities allow an appropriately large increase in the money supply. A low-rate tax can usually be shifted to a greater extent than a high-rate tax as the necessary accommodating increases in velocity of circulation and money supply
are more likely to be achieved. A small increase in prices is also more likely to be tolerated by consumers. Certainly, the EC does not mean to suggest that large and permissive inflation is the standard case. Members of the Working Party have explicitly recognised (L/3272) that "indirect taxes were normally increased by the Government in inflationary conditions to offset a budgetary deficit and to act as a stabilizer of the economy". To the extent that the money supply is not increased sufficiently to permit full passing on of the tax, some or all entrepreneurs will have an additional incentive to export because of the higher return on export sales that can occur when border tax adjustments for the full amount of the tax are made. The amounts of rebate they receive in excess of the amount of tax they could shift forward in sales to the domestic market can be effectively a subsidy for them.

In contrast to the macro-economic approach for general taxes, a selective tax can be examined by micro-economic tools. If a tax affecting one or relatively few products is imposed or increased, it is possible for the price of those products to rise by the full amount of the tax without any increase in the money supply and without a significant decrease in quantity demanded. It should be recognized, however, that the price of some other products will fall if the money supply is not changed. The significance of this distinction between the effects of a general tax and a selective tax is that the case for adjustment of a selective tax is much clearer than for a general tax.

The EC submission places considerable stress at several points upon the intent of the legislator, i.e., that he is "really seeking to ensure that the actual burden will be borne by the final consumer and will fall entirely on him". We recognize that such is often legislative intent. Many legislatures place the legal incidence of the tax on the consumer. Sometimes fines are imposed on any retailer who announces that he absorbs the tax burden himself. Yet it must be clear that the wording of a law cannot by itself control the economic effects of a tax, which also depend on other factors, nor does a separate listing of the tax imply that the sales price is higher than it otherwise would have been by the amount of the tax. The history of legislation in many fields shows that it is easier to pass a law calling for a desired effect than to obtain the desired effect.

The EC submission also refers to the incompressibility of indirect taxes. Although an indirect tax cannot be legally avoided, economic necessity may require that gross price not be equal to the price net of tax plus the amount of tax. To the extent that the tax cannot be fully added to the price, factor costs or profits must be compressed. Similarly, importers must reduce their profits in order to maintain prices or are forced to raise prices and thereby lose sales.

It is difficult to accept the EC contention that foreign producers should bear the consequences of a partially shifted domestic tax. According to previous EC arguments, the border tax adjustments are intended to effectuate the destination principle in which goods are taxed at the point of consumption. However, a tax that is not fully reflected in price has many of the characteristics of a tax
for which no adjustment is permitted under current GATT provisions. The full adjustment on imports for a partially shifted tax reduces the incentive to export to the country imposing the border adjustment. The foreign producer competing in third country markets with exported goods benefiting from the full border adjustment is also disadvantaged. While the exporter in the country making the adjustment is given a profitable alternative to producing for the domestic market, the foreign producer finds that his competitors are in a stronger position because of the subsidy-like effect of the full export remission. Examined in this light, it is clear that the so-called burden of partial shifting, when combined with full border adjustments, in fact provides a positive advantage to the adjusting country, to the detriment of its trading partners.

The Community also asks what method should be chosen to offset the trade effects of full adjustment when less than full shifting occurs. It is clear that the assumptions of 100 per cent shifting at all times implied by the GATT rules are arbitrary. It would be no more arbitrary to use a lower figure and provide for less than full adjustment. An example of the feasibility of less than full adjustment at the border is provided by the November 1968 action by the Federal Republic of Germany which effectively reduced border adjustments by approximately 4 percentage points on industrial products without a change in domestic tax rate.

The Community has suggested that the value added tax (TVA) is uniquely designed to insure that full shifting occurs and that the TVA is equivalent to a single-stage tax. Although the total value of a good is equal to the sum of the value added at each stage of production, strict theoretical assumptions are required in order to be able to maintain that a value added and single-stage tax are equivalent. Due to operational characteristics and the realities of economic processes, the economic effects of each tax will in fact be different. The accounting system used to monitor the TVA results in one particular definition of value added. Another possible accounting system would provide a different definition. For example, the tax on capital goods is presently deductible as soon as it is purchased. This provides a cost saving over the economic life of the capital good since the cost of the capital goods is deducted immediately while depreciation is permitted over an extended period. By deducting the tax immediately rather than after it is fully depreciated (i.e., consumed) the tax saving is greater, and the resultant definition of value added is smaller, than if the other deduction technique were used. Furthermore, the single-stage tax almost always includes products which are not pure consumer goods. The tax therefore differs from the pure single-stage tax which is necessary for comparison with a pure TVA.
Another difference between these two sorts of taxes is that TVA requires economic decisions by a great many more individuals than does a single stage tax. As such there is greater likelihood of effects of contradictory assessments of economic conditions and of relative strength of buyers and sellers. Thus a different interplay of competitive forces would occur than with a single stage tax. The price effects of a TVA system will not be the same as with a single stage tax.

The operation of the TVA system has direct financial implications for a firm's operations (i.e. a firm often pays substantial sums for prior stage taxes for which it only belatedly receives credit). Denmark attempts to compensate for financing costs on importers by imposing a lower TVA at the import stage. This provides an immediate tax saving, although the tax is later made up by the crediting mechanism.

In its discussion of the possible trade effects of direct taxes and the feasibility of making border adjustments for such taxes, the Community raises several questions. For example, the Community suggests that the ability to shift direct taxes depends on market conditions and that as a rule conditions conducive to direct tax shifting do not exist. In contrast, the Community asserts that the market conditions necessary for indirect tax shifting will normally exist.

Virtually all countries have both direct and indirect tax and existing market conditions affect each. The conditions of monetary ease that are required for forward shifting of a broad-based indirect tax can also permit firms to recover a part of their income taxes through higher prices. Furthermore, so long as an economy has both a corporate and a non-corporate sector, the existence of a corporate tax will reduce returns to capital, in the corporate sector, adversely affecting investment decisions in that sector and lead to some forward shifting of taxes on it. A degree of market control also leads to forward shifting of both direct and indirect taxes. Under these circumstances, the logic of the extreme difference in treatment of direct and indirect taxes in the GATT rules is questionable.

When direct taxes are reflected in prices, producers in countries which rely primarily on these non-adjustable taxes for revenue can be disadvantaged in international trade, particularly when countries relying primarily on indirect taxes are able to adjust fully for taxes that are not completely reflected in prices.

The section of the EC paper entitled "The Thesis of Divergencies in Tax Structures" consists of material which is unrelated to the border tax adjustment issue. We are concerned with divergence in tax systems to the extent that any set of rules differentiates at the border among different types of taxes without adequate regard to the price effects of different taxes. The ratio between taxes that cannot be offset and those which can be is important only as a rough indicator of the magnitude of the problem of devising a set of rules equitable to all countries irrespective of their tax systems.
The EC analysis concentrates exclusively on the revenue side of the fiscal equation and ignores the micro-economic effects of Government expenditures—that is, the use of the revenues generated by the fiscal system. Full analysis of the effects of border adjustments requires not only a look at the ratio of direct to indirect taxes in the various systems (i.e., the ratio of taxes adjusted for to those not adjusted for) but requires a look at total tax burdens and Government expenditures. A large part of general tax receipts finance Government services and transfer payments. When such tax revenues are rebated to an exporting producer who has benefited from the Government services or transfer payments, the micro-economic effect is equivalent to a direct reduction in his production costs. An equivalent producer in a country which (a) does not provide as high a level of tax-financed services and transfer payments and/or (b) cannot rebate as high a percentage of taxes under current GATT rules is at a competitive disadvantage. A similar micro-economic effect is seen on the import side, where the foreign product may bear certain production costs twice—once at home where these costs are not returned at the border (especially if the Government does not render some of the same services) and again at the foreign border where effectively a charge is levied for services not received in that country.

The EC paper asserts that the trade effects stemming from a change in border tax adjustments to remove "under compensation" and not accompanied by an identical change in domestic taxes are fully justified. This Working Party is concerned with the trade effects of border tax adjustments. To state that an increase in the border offset payments occasioned by a shift in form from one tax system to another merely "eliminates the previous disadvantages suffered by domestic products" ignores the immediate trade balance effects. There has in effect been a devaluation of the domestic currency on trade account.

Conclusion

The EC paper recognizes that "no perfect fiscal balance between States exists or can be attained". It argues that under the current rules "these differences of fiscal origin are unlikely to give rise to more than very slight disturbances in international competition".

We have provided sufficient information and analysis to demonstrate that the effects of the current rules are not so small. In some respects international competition and trade patterns may be severely distorted. These effects cannot be demonstrated by a simple measure such as the persistence of trade deficits or surpluses. A deficit or a surplus position is a sum of many factors and the distortions caused by adjustments made under the current border tax rules are only one of them.

We note with interest the EC statement that "from the point of view of general economic theory, it might be asked why among all the many constituents of a cost price, the indirect tax should be singled out as the marginal element when the possibilities of passing on charges are considered". Indeed, a good
case could be made that among all the factors comprising relative and absolute advantages in international trade, there is no reason to single out indirect tax for adjustment.

As to the question raised by the EC about how an overall assessment would be made of the part of the indirect tax burden which is not passed on, we recognize that any solution would have to be somewhat inexact. It could only reduce inequities and not eliminate them.

The United States has no desire to see a system that would interfere with any country's fiscal sovereignty. Our desire, to the contrary, is to see removed the encouragement to certain types of taxes given by the present border tax rules.