

## BORDER TAX ADJUSTMENTS

Report of the Working Party adopted on 2 December 1970

(L/3464)

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 adjustments;
  - (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."

2. The Working Party held twelve meetings between April 1968 and October 1970, under the chairmanship of Mr. E. Thrane (Denmark), succeeded by Mr. T. Gabriëlsson (Sweden).

3. A report of the first five meetings (L/3138) was made to the CONTRACTING PARTIES at their twenty-fifth session. A further report on the sixth to ninth meetings (L/3290) was made to the Council in January 1970, and subsequently to the CONTRACTING PARTIES at their twenty-sixth session. In presenting the report, the Chairman stated that the Working Party would continue its discussion of the practices of tax adjustments in relation to products of interest to developing countries, and would also examine notifications made in the Committee on Trade in Industrial Products with regard to tax adjustments and report to the Committee on the results of this examination.

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

4. For the purpose of its examination, the Working Party used the definition of 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)".

5. The Working Party noted that the term "border tax adjustment" had given rise to much confusion because it implies that the adjustment necessarily takes place at the border whereas this is not the case. In fact, under certain tax systems exports never become liable to tax and so no adjustment actually takes place at the border; in addition, under certain tax systems imports are usually taxed, as is home production, by the importing country at the time they are sold by registered traders to other traders or consumers, and so the adjustment takes place after the goods cross the border. For this reason it is recommended that the term "border tax adjustments" should be replaced by "tax adjustments applied to goods entering into international trade". For the sake of brevity, subsequent references in this report are to "tax adjustments".

6. The examination of the provisions of the General Agreement relevant to 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.

7. 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.

8. There was general agreement that the main provisions of the GATT represented the codification of practices which existed at the time these provisions were drafted, re-examined and completed. Some members of the Working Party considered, however, that the main provisions of the GATT relevant to tax adjustments represent an attempt at the codification of a wide range of past practices based on assumptions which are not now universally accepted. In particular, they felt the assumption of full 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 tax adjustment practices for similar types of taxes. They concluded that the current GATT provisions and tax practices are not trade neutral.

9. Most members argued that there seemed to have been a coherent approach when the relevant articles of the GATT were drafted and that there were no inconsistencies of substance between the different provisions even if the question of tax adjustments was dealt with in different articles. They added that the philosophy behind these provisions was the ensuring 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 tax adjustment appropriately and that no motive could be found to change them. The point was made that Revenue Departments, for whom many delegates spoke, had strong reason in the interest of the revenue as well as fiscal justice, to ensure, in the treatment of imports and exports, neutrality with home-produced goods: for instance in the charging of substitutes at importation and in the ensuring for exports, that too much duty was not repaid. 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.

10. The Working Party also noted that there were differences in the terms used in these articles, in particular with respect to the provisions regarding importation and exportation: for instance, the terms "borne by" and "levied on". It was established that these differences in wording had not led to any differences in interpretation of the provisions. It was agreed that GATT provisions on tax adjustment applied the principle of destination identically to imports and exports.

11. It was further agreed that these provisions set maxima limits for adjustment (compensation) which were not to be exceeded, but below which every contracting party was free to differentiate in the degree of compensation applied, provided that such action was in conformity with other provisions of the General Agreement.

12. One delegation stressed that the question of the degree of compensation, regardless of its consistency with GATT rules, was relevant to the issue in terms of the actual or potential effect on trade. For instance, trade distortions were likely to result from a country changing from consistent under-compensation to full compensation.

13. Some delegations did not share this view. GATT provisions on tax adjustments did not provide for any form of protection but rather for the possibility for governments to create equality in treatment between imported and domestically-produced goods. The various degrees of compensation practised in different countries were applied for fiscal revenue or budgetary reasons; there were no known cases of deliberate manipulation of compensation on selected products.

14. On the question of eligibility of taxes for tax adjustment under the present rules, the discussion took into account the term "... directly or indirectly ..." (inter alia Article III:2). The Working Party concluded that there was convergence of views to the effect that taxes directly levied on products were eligible for tax adjustment. Examples of such taxes comprised specific excise duties, sales taxes and cascade taxes and the tax on value added. It was agreed that the TVA, regardless of its technical construction (fractioned collection), was equivalent in this respect to

a tax levied directly - a retail or sales tax. Furthermore, the Working Party concluded that there was convergence of views to the effect that certain taxes that were not directly levied on products were not eligible for tax adjustment. Examples of such taxes comprised social security charges whether on employers or employees and payroll taxes.

15. The Working Party noted that there was a divergence of views with regard to the eligibility for adjustment of certain categories of tax and that these could be sub-divided into

- (a) "Taxes occultes" which the OECD defined as consumption taxes on capital equipment, auxiliary materials and services used in the transportation and production of other taxable goods. Taxes on advertising, energy, machinery and transport were among the more important taxes which might be involved. It appeared that adjustment was not normally made for taxes occultes except in countries having a cascade tax;
- (b) Certain other taxes, such as property taxes, stamp duties and registration duties ... which are not generally considered eligible for tax adjustment. Most countries do not make adjustments for such taxes, but a few do as a few do for the payroll taxes and employers' social security charges referred to in the last sentence of paragraph 14.

It was generally felt that while this area of taxation was unclear, its importance - as indicated by the scarcity of complaints reported in connexion with adjustment of taxes occultes - was not such as to justify further examination.

16. The Working Party noted that there were some taxes which, while generally considered eligible for adjustment, presented a problem because of the difficulty in some cases of calculating exactly the amount of compensation. Examples of such difficulties were encountered in cascade taxes. For adjustment, countries operating cascade systems usually resorted to calculating average rates of rebate for categories of products rather than calculating the actual tax levied on a particular product. It was noted, however, that most cascade tax systems were to be replaced by TVA systems, and that therefore the area in which such problems occurred was diminishing. Other examples included composite goods which, on export, contained ingredients for which the Working Party agreed in principle it was administratively sensible and sufficiently accurate to rebate by average rates for a given class of goods.

17. It was generally agreed that countries adjusting taxes should, at all times, be prepared, if requested, to account for the reasons for adjustment, for the methods used, for the amount of compensation and to furnish proof thereof.

18. With regard to the interpretation of the term "... like or similar products ...", which occurs some sixteen times throughout the General Agreement, it was recalled that considerable discussion had taken place in the past, both in GATT and in other bodies, but that no further improvement of the term had been achieved. The Working Party concluded that problems arising from the interpretation of the term should be examined on a case-by-case basis. This would allow a fair assessment in each case of the different elements that constitute a "similar" product. Some criteria were suggested for determining, on a case-by-case basis, whether a product is "similar": the product's end-uses in a given market; consumers' tastes and habits, which change from country to country; the product's properties, nature and quality. It was observed, however, that the term "... like or similar products ..." caused some uncertainty and that it would be desirable to improve on it; however, no improved term was arrived at.

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

19. The Working Party 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 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. The Working Party spent much time in collecting and clarifying the extensive information received. Information on the study of practices of tax adjustments in OECD countries was made available by the OECD.

20. A consolidated document (L/3389) was drawn up by the secretariat containing information on and discussion of the existing practices of tax adjustments. The document provides a description of how adjustments 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 present rates and the extent to which tax systems have been changed in various countries. It was felt that this part of the work of the Working Party had been most useful.

#### IV. Point I (c): The possible effects of tax adjustments on international trade

21. In examining the possible effects of 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. The question was raised by some members why only indirect taxes should be eligible for adjustment since the economic basis for such a clear distinction between indirect and direct taxes for 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 borne 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 tax adjustments.

22. 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. No conclusions were reached. Some members felt that this part of the Working Party's examination made it clear that present tax adjustment based on GATT provisions did not ensure trade neutrality and that it was important that solutions be found to this problem. Most other members of the Group, however, were of the opinion that the discussion rather tended to confirm that the current practices of tax adjustments were as consistent as possible with the objectives of trade neutrality. Still some others were of the opinion that the work done in the Working Party was not such as to permit definitive conclusions to be drawn regarding the objective truth in the two opposing contentions.

23. 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 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, Sweden and Norway, which had moved from a cascade or single-stage tax system, to a system of tax on value added (TVA).

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

25. It was nevertheless admitted that changes in 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 investment 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.

26. Some members of the Working Party expressed the view that tax adjustments could have a disequilibrating impact on the world economy, if, for example, 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 to take this aspect into account rather than simply adopting 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 tax adjustments to allow for fuller compensation. Several countries pointed out that the rules of the GATT permitted tax adjustments for certain indirect taxes, which was entirely justified since in the absence of full compensation, national enterprises were at a disadvantage from the aspect of international competition.

27. 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. Some countries stated that the problem of direct tax incentives 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 in relation to 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.

#### *Tax adjustments on products of interest to developing countries*

28. 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 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.

29. Members from developing countries drew 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 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 countries, the tax incidence on some of the products of interest to developing countries had tended to increase.

30. Representatives of developed countries considered that a distinction should be made between internal charges of a general application and selective or specific taxes, since many of the taxes imposed such as cumulative turnover taxes and the tax on value added affected all products and were, in their view, not covered by Article XXXVII:1 (c), which refers to fiscal measures applied specifically to those products in raw or processed form wholly or mainly produced in the territories of developing contracting parties. Representatives of developing countries pointed out that in the process of changeover to TVA, selective excise taxes were replaced by general consumption taxes. They therefore considered that the provisions of Article XXXVII:1 (c) were applicable.

31. It was suggested that it was not realistic to suppose that the abolition or reduction of individual excises, on which a significant element in a country's revenue depended, could be determined by the ability of the country itself to grow or to produce the commodity in question. The representatives of developing countries stated that compared to the total revenue, revenue collected from excises on products of interest to developing countries, not domestically produced in developed countries, was very significant. Revenue considerations should not therefore stand in the way of removal of such taxes, particularly as these adversely affected consumption.

32. 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 provisions 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 provisions, 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.

33. Members of developing countries stated that it should be administratively possible to exempt products from indirect taxation on a country-of-origin basis. Fiscal and trade policy were inter-related. Fiscal exemptions favouring certain imports from developing countries were therefore natural.

34. 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 tax adjustments. Most of the information requested was provided, except that on revenue from internal taxes on products of interest to developing countries, where not all countries had the necessary breakdowns of revenue data by product and by country of origin. A useful discussion was held on the practices of contracting parties in levying taxes on commodities exported by developing countries.

35. It was pointed out that some products were subject to unreasonable differential tax adjustment treatment. It was suggested that this form of differential tax treatment could be eliminated on a priority basis for developing countries by a downward adjustment of the tax rate on one product to the lower rate applied to another comparable product. However, the information so far available was not adequate for analysing this issue to the fullest extent. The representatives of some developed countries suggested that products which, according to developing countries, were subject to unreasonable differential tax adjustment, should be indicated and subsequently examined by the interested parties on a case-by-case basis.

36. It was pointed out that certain products of interest to developing countries were subject to very high and sometimes excessive rates of taxation. An example was tea, which in some developed countries was taxed at the same rate as wine. Such rates of taxation were excessive and should be reduced as these had adverse effects on consumption.

37. Representatives of some developed countries explained that most of these high taxes were specific or excise taxes that were not discriminatorily levied on tropical products, but also on other products. These taxes were mostly specific, and had remained unchanged for many years; thus, their impact on consumption had lessened with changes in real money values. It was noted that, in general, tax rates for most of the products of interest to developing countries were not high. Those that were high were imposed for special health or revenue reasons and their elimination, while depriving States of a source of income, would not lead to any appreciable increase in the consumption of the products.

38. It was pointed out that as a result of changes in tax systems (i.e. from a cascade to a TVA system) the tax incidence had considerably increased on some products of interest to developing countries. For instance, in one developed country, a cascade tax rate of 1.6 per cent on textiles had been replaced by a 12 per cent TVA tax rate. It was suggested that in these cases, tax rates should be restored to their original level. Some developed countries which had operated such changes replied that the changeover had permitted them to harmonize tax rates and to eliminate abnormal situations such as the one in textiles. Representatives of these countries said that for reasons of trade policy, exceptions to the application of uniform rates could not be maintained in new generalized systems of consumption taxes.

#### V. Points 2 and 3: Proposals and Suggestions - Conclusions

39. The Working Party examined a proposal for the establishment of a regularized system of review of changes in tax adjustments within the GATT. The proposal comprises a notification procedure and a multilateral procedure for consultation on request.

40. The Working Party does not feel that any useful purpose would be served by pursuing the examination under its present terms of reference in the present circumstances. The Working Party recognizes the continuing interest of contracting parties in the subject and in particular in future changes in taxation systems. The Working Party recommends that a notification procedure be introduced, on a provisional basis whereby contracting parties will report changes in their tax adjustments. It is understood that such notifications need not be made prior to the changes. The contents of the notifications would aim generally at reporting any major changes in tax adjustment legislation and practices involving international trade, and in particular at bringing periodically up to date the information contained in the consolidated document on contracting parties' practices (L/3389) on tax adjustments drawn up in the course of the Working Party's work. While the notifications would cover changes in centrally-controlled taxes, countries with large locally- or regionally controlled tax systems would be expected to make a special effort to report changes of a significance on a local or regional basis.

41. The Working Party took note of the particular interest of developing countries in the removal of tax adjustments on products not domestically produced by developed countries, and of the references which had been made in this context to Article XXXVII.

42. The Working Party agreed that the suggestions it makes concerning its own work should not affect the work under way in the Special Group on Tropical Products.

43. The Working Party recommends that a consultation procedure be established whereby, upon request by a contracting party, a multilateral consultation could take place on changes in tax adjustments, whether notified or not. Such consultations would be held within the scope of the relevant GATT provisions. Upon request, contracting parties should be prepared to justify the reasons for adjustment, the methods used, the amount of compensation and to furnish proof thereof.

44. It is suggested that this Working Party, because of its experience in the field of tax adjustments, is the appropriate forum for holding consultations.

45. The Working Party recommends that the Director-General should be asked to consider, at convenient intervals, on the basis of the notifications referred to above, and in consultation with interested parties, whether a review of notified changes is called for. He should also be asked to consider after an adequate period of operation, and in consultation with interested parties, whether the provisional notification procedure should be continued, modified or discontinued.

#### VI. Report on Examination of Group 5 Notifications

46. With regard to the notifications submitted to it by Working Group 5 of the Committee on Trade in Industrial Products, the Working Party referred to its Report to Group 5 (COM.IND/W/29) and considered that its task was terminated. Some members of the Working Party considered that tax adjustments that were consistent with provisions of the General Agreement could not be termed barriers to trade because they were precisely designed to ensure equal tax treatment as between foreign and domestic products.