Tax Harmonization in Europe
And U. S. Business

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Foreword

The European Economic Community member countries, West Germany, France, Italy, Belgium, the Netherlands, and Luxembourg, are scheduled to adopt a common value-added tax system by January 1, 1970. The value-added tax has been discussed in a previous Tax Foundation publication, Federal Non-Income Taxes, An Examination of Selected Revenue Sources.

The purpose of the present study is to analyze the effect European tax harmonization is expected to have on U.S. business. The United States, which for over thirty years has been working to reduce barriers to international trade, faces a particularly difficult problem of non-tariff barriers in the form of European border taxes. The border tax issue requires detailed work and discussion in the choice of U.S. policies that might effectively offset trade distortions resulting from European tax harmonization.

Dr. Guenter Schindler, Senior Research Analyst, had primary responsibility for drafting this study.

The Tax Foundation is a private, non-profit organization founded in 1937 to engage in non-partisan research and public education on the fiscal and management aspects of government. Its purpose is to aid in the development of more efficient and economical government. It serves as a national information agency for individuals and organizations concerned with problems of government expenditures, taxation, and debt.

Tax Foundation
August, 1968
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I. Introduction

T. V. A. no longer is used exclusively with reference to the "Tennessee Valley Authority." In more recent times T.V.A. has often been used to designate the French tax system of "la taxe sur la valeur ajoutée."

The "value-added tax" has repeatedly received special attention from leading statesmen and from economists throughout the world as well as in the United States. In recent years this tax system has been considered as a possible alternative to the present corporate tax system by U.S. Congressional committees, businessmen, and tax economists.

In the United States, excise taxes are the only indirect taxes applied on the Federal level. In Europe, on the contrary, national governments make extensive use of indirect taxes in the form of general turnover taxes. By reason of the existing international trade rules to be explained later, countries relying heavily on indirect taxes can gain competitive advantages to the detriment of those countries not sharing in this practice.

Generally levied upon the transfer of commodities, turnover taxes can be compared to sales taxes. Present day turnover taxes may be classed into two major groups: the multiple stage and the single stage taxes. The value-added tax, which represents a third form, has some characteristics of each, while being distinct from both in that it includes in its tax base services rendered in the production process.

In 1950 value-added taxation was proposed to Japan by the Shoup Mission under Professor Carl S. Shoup of Columbia University. However, Japan failed to adopt the proposed tax reform. The state of Michigan between 1953-1967, and France since 1953, have had practical experience with value-added taxation. Whether or not value-added taxation seems unsuitable for the United States, as officials of the U.S. Treasury Department have repeatedly declared, it is vital for Americans dealing in foreign markets to know more about this new tax system. The European Economic Community, one of the foremost trading partners of the U.S., by decision of the Council of Ministers of the E.E.C. has decided to adopt the value-added tax system as the common indirect tax for the entire European Common Market. The date at which the common tax system is to become effective has been fixed at January 1, 1970.

Western Germany, on January 1, 1968, adopted a value-added tax system of its own, thereby replacing its former cascade type turnover tax. This was an important step, not only doing away with the inconveniences and disadvantages of Germany's multi-stage turnover tax.

1. Cascade type turnover taxes are applied each time a product changes hands; it is a tax on tax insofar as the tax base includes the tax paid on the previous turnover.
sales tax system, but also decisively moving in the direction of the Common Market tax harmonization. Germany thereby followed the proposal of the Neumark Commission, a special commission of experts on tax harmonization, which had recommended a two-stage procedure for the harmonization of indirect taxes.

The Netherlands will follow suit on January 1, 1969, at which time they will also replace the existing turnover tax system by a national value-added tax. Italy, Belgium, and Luxembourg committed themselves to join the other Common Market member states in the adoption of the common value-added tax by January 1, 1970.

When this new tax law goes into effect, fiscal and tariff frontiers inside the Common Market can be removed with the adoption of a uniform value-added tax rate. At the same time, however, increased border tax adjustments affecting international trade with the outside world will emerge as a consequence of this change in European tax legislation. Exception is made for France, which will have to reduce its border tax adjustment when the Common Market value-added tax rates become effective. These border tax adjustments, while favoring Common Market exports, will discourage imports from third countries. The resulting trade distortions are likely threats to the U.S. position with regard to its competitiveness in the European Common Market. “Border taxes”, a term virtually unknown until very recently, play an increasing role in foreign economic policy of governments and the thinking of American businessmen.

Tax harmonization is well within the logic of an economic union. The removal of all barriers to the free flow of labor, capital and goods is one of the conditions proposed by the Treaty of Rome, which is the legal basis on which the European Economic Community is constructed.

Section II discusses the development of the European Economic Community and the place tax harmonization has within such a union. Section III deals with the implication to foreign business of the changeover to the new tax. Section IV considers some of the different courses of action open to the United States to offset the resulting distortions of international trade.

Appendix I presents a discussion of the E.E.C. Directives introducing the common value-added tax system. The new German value-added tax law, its rates and mechanics, are presented in Appendix II. Appendix III summarizes some of the most noteworthy features of the value-added tax.
II.

The European Economic Community

Purpose, Organization and Tax Harmonisation Objectives

The catastrophes of World War II and the dilemmas of the post World War II era motivated European statesmen charged with the establishment of peace and with the reconstruction of their economies, to revitalize old, and to make new, proposals for the unification of Europe. Various attempts to unify the European nations had resulted in the establishment of institutions such as the Organization for European Economic Cooperation in 1948, the Council of Europe in 1949, and the Coal and Steel Community in 1952. Finally in 1957 the groundwork was laid for the establishment of the European Economic Community.

In March 1957, France, Western Germany, Belgium, the Netherlands, Italy, and Luxembourg agreed to sign the Treaty of Rome. It is the legal groundwork for an organization that was to exceed by far the scope of the earlier institutions. In the treaty, the member countries agreed not only to remove internal tariff and quota barriers but also to equalize external tariffs according to an established time schedule. Besides providing for the establishment of a common external tariff, the Treaty of Rome calls for common policies for agriculture, social affairs, transport and energy — common rules that would ensure fair competition and the harmonization of fiscal and monetary policies.

The primary objective set forth in this treaty is the creation of a single market among the member countries of the European Economic Community, permitting labor, capital, and all factors of production to move about freely within the Common Market area, while assuring high levels of employment, stability of income, and sustained economic growth throughout the entire area.¹

Fiscal Harmonisation and Common Market Objectives

Fiscal harmonization—and in particular tax harmonization—is closely involved with the objectives outlined above. The term “tax harmonization” came into the vocabulary of the tax economist only recently. It denotes the mutual adjustment of national tax systems to achieve certain objectives which are common to the member countries. With regard to fiscal policy, the Treaty of Rome establishes only a broad legal framework permitting interpretation of the needs and mechanics by which tax harmonization can be achieved at a later date. Articles 95-99 reflect this approach.²

Articles 95-97 forbid the use of differential taxation or tax rebates as protective devices against imports from other member states. At the same time these

². Ibid., p. 87.
articles together with Articles 101 and 102 provide for the elimination of any "disparity existing between the legislative or administrative provisions of the member states (which thereby) distorts the conditions of competition in the Common Market." Only Article 99 specifies directly the need for the harmonization of indirect taxes.

The harmonization of direct taxes is the object of Article 100; however, this article bears a lesser degree of compulsion than that of Article 99 with regard to the harmonization of indirect taxes. Since the Council of Ministers is authorized only to issue "directives" with regard to direct taxes, the choice as to the form and method of achieving the desired results is left to the Member States.

As the issue stands, the European Economic Community permits the maintenance of different tax systems by each nation as long as no distortion of competition between Member States results. The Treaty of Rome specifically provides for the preservation of differences in the national fiscal system which express significant variations in social and economic philosophies of the member countries except for indirect taxes which are to be harmonized. These include differences in concepts of individual equity, the size of the public sector, and so on.

Hans von der Groeben, member of the E.E.C. Commission, defines the tax harmonization as desired by the Common Market as follows:

Harmonization does not mean the tax systems must be made uniform, but only that they must be mutually adapted to the extent that this is necessary to make them neutral from the point of view of competition and thus to bring tax systems into line with the competition system of the Community. Three factors call particularly for consideration: differences in the burden of taxes in the Member States, differences in the distribution of the tax burden between direct and indirect taxes in the various Member States, and the difference in the tax structure of the Member States.4

**Why the Need to Harmonize Indirect Taxes**

Harmonization of indirect taxes within the European Economic Community is one of the prerequisites of economic integration. At the time the Common Market was created, there existed in all countries but France a general turnover tax on sales. Each time any finished or semifinished product was passed forward, the turnover tax was imposed. Even though these tax rates were generally low, the total yields were usually substantial because of multiple application.

Table I shows the kind of turnover tax and the rates applied by the Common Market Member States before 1968.

The turnover tax has often been criticized because it induces vertical integration, that is to say, producers could avoid the payment of some turnover taxes by joining together so that products in the process of production would no longer have to move from one hand into another. The non-integrated producer is thereby left with a higher tax burden than the bigger and integrated producer, limiting as a consequence the competi-

---

3. The text of Article 99 reads as follows: "The Commission shall consider in what way the law of the various Member States concerning turnover taxes, excise duties and other forms of indirect taxation, including compensatory measures applying to exchanges between Member States, can be harmonized in the interest of the Common Market." Article 100 reads as follows: "The Council, acting by means of a unanimous vote on a proposal of the Commission, shall issue directives for the approximation of such legislative and administrative provision of the Member States as have a direct incidence on the establishment or functioning of the Common Market." Treaty establishing the European Economic Community and connected documents.

Table I
Turnover and Value-Added Taxes in the Common Market
Calendar Year 1967*

<table>
<thead>
<tr>
<th>Country</th>
<th>Type of tax</th>
<th>Standard tax rate</th>
<th>Rate for luxury goods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>Multi-stage turnover</td>
<td>7%</td>
<td>up to 23%</td>
</tr>
<tr>
<td>Germany</td>
<td>Multi-stage turnover</td>
<td>4%</td>
<td>4%</td>
</tr>
<tr>
<td>Italy</td>
<td>Multi-stage turnover</td>
<td>4%</td>
<td>6.4 - 23.3%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>Multi-stage turnover</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Multi-stage turnover</td>
<td>6%</td>
<td>15 - 25%</td>
</tr>
<tr>
<td>France</td>
<td>Value-added tax**</td>
<td>20%</td>
<td>25%</td>
</tr>
</tbody>
</table>

*This table does not take account of special tax rates applied to a limited number of products, e.g., automobiles, trucks, etc.
**In France, the tax base includes the tax itself, thereby raising the effective rate to 25 and 33 1/3 percent respectively, (compared to the nominal rate of 20 and 25 percent).

The tax element in costs is likely to vary when cascade type turnover taxes are applied because of differing degrees of integration. As a consequence, tax rebates to exports and import compensating taxes are set at standard rates by class of traded commodities. These standard rates may, however, fall short or exceed the actual amount of the turn-

tiveness of small producers. The General Agreement on Tariffs and Trade (GATT) permits rebates of indirect taxes for products leaving the country and the imposition of equalization taxes on products entering a country to compensate for the indirect tax charged on domestic items.5

Turnover taxes qualify as rebatable indirect taxes according to the rules of GATT, but the correct rebates for exports, and the right amount of the equalization taxes on imports is next to impossible to estimate under the cascade type turnover tax. Such estimates require correct information about the number of stages of production each product passes through and information about the tax rates applied at each stage.

The tax element in costs is likely to vary when cascade type turnover taxes are applied because of differing degrees of integration. As a consequence, tax rebates to exports and import compensating taxes are set at standard rates by class of traded commodities. These standard rates may, however, fall short or exceed the actual amount of the turn-

5. General Agreement on Tariffs and Trade, Basic Instruments and Selected Documents, Vol. 3.

GATT rules with regard to the rebate of indirect taxes to exports.
Article VI: 1 dealing with dumping, this article sets forth the general rule that dumping may be considered to be taking place when the same product is being sold for less in the export than in the domestic market, but then adds: "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."

Article VI: 4 similarly seems to relate to indirect but not to direct taxes: "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."

GATT rules with regard to the taxation of imports.
Article III:2 reads as follows: "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:2 with regard to border tax charge on imports: "Nothing in this article shall prevent any contracting party from imposing at any time on the importation of any products, a charge equivalent to the 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."
over tax paid. If the border tax adjustment is below the effective rate applied to domestically produced goods, then imports are given a competitive advantage and exports are penalized. If, on the other hand, the border tax adjustment is greater than the effective domestic tax rate, imports are discriminated against and exports subsidized. When border tax adjustments are altered, the change has effects similar to a change in tariffs and in export subsidies.

Presently, among the Common Market countries, France and Germany alone use value-added taxes, which permit the exact assessment of turnover taxes paid at each stage of production. Since the TVA rates are precisely determined for each product, a full and accurate tax rebate is afforded to exports. Similarly on imports, compensating tax at the same value-added rate will effectively equalize the tax on imported and domestically produced goods.

The removal of custom barriers within the Common Market also calls for the removal of fiscal frontiers. The European Economic Community has recognized the dominant role of turnover tax harmonization so that fiscal frontiers in the form of border tax arrangements can effectively be removed within the Community. The Common Market thereby chooses the complete adoption of the country-of-origin principle for the application of turnover taxes.

Countries applying cascade type turnover taxes or no turnover tax at all suffer a competitive disadvantage relative to countries applying value-added taxes. Border tax adjustments resulting from the different tax systems express this point. In May of 1961 a ton of French steel rods cost $111.50 f.o.b Thionville (France). At the same time, a ton of German steel rods cost $108.25 f.o.b. Oberhausen (Germany). Exports of the French steel to Germany can be calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic price f.o.b. Thionville, France</td>
<td>$111.50</td>
</tr>
<tr>
<td>less: Turnover tax rebate at French frontier 20%</td>
<td>$22.00</td>
</tr>
<tr>
<td>equals: French export price</td>
<td>$89.50</td>
</tr>
<tr>
<td>plus: German border adjustment tax</td>
<td>$5.00</td>
</tr>
<tr>
<td>Freight charges Thionville-Oberhausen</td>
<td>$6.25</td>
</tr>
<tr>
<td>equals: Price of imported French steel in Oberhausen</td>
<td>$100.75</td>
</tr>
</tbody>
</table>

Conversely, the export of German steel to France may be shown as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic price f.o.b. Oberhausen, Germany</td>
<td>$108.25</td>
</tr>
<tr>
<td>less: Turnover tax rebate at the German border</td>
<td>$6.50</td>
</tr>
<tr>
<td>equals: German export price</td>
<td>$101.75</td>
</tr>
<tr>
<td>plus: French border adjustment tax</td>
<td>$25.50</td>
</tr>
<tr>
<td>Freight charges Oberhausen-Thionville</td>
<td>$6.25</td>
</tr>
<tr>
<td>equals: Price of imported German steel in Thionville</td>
<td>$133.50</td>
</tr>
</tbody>
</table>

6. The country-of-origin principle tax places jurisdiction with the country in which the products are produced.
Since value-added taxes are completely removed from products leaving the country, France gives greater tax relief—around 20%—to its exports than any of its neighbors. At the same time that France gives these high rebates to exports it imposes an equally high level of border taxes on products entering the country. Other Common Market countries presently find themselves at a competitive disadvantage since their border tax adjustment does not equal that of France.

The adoption of a uniform turnover tax system within the Common Market will do away with these inequalities. It is expected that the Common Market will fix the uniform value-added tax rate soon after January 1, 1970. The uniform turnover tax system permits the change-over to the country-of-origin principle. If all member countries apply this principle, no more border adjustment would be applied to inter-community trade and definite administrative economies will result from the removal of inter-community custom and border controls. Only with the total removal of fiscal borders can a tariff union be fully realized. For as long as different border tax adjustments exist between member nations of the Common Market, custom facilities and inspections must be maintained even for inter-community trade.9

The Value-Added Tax

The advantages of the French value-added tax system, which permits the correct assessment of taxes paid at any stage of production, explain the Common Market preference for this tax. Based on two directives of the E.E.C. Council of Ministers, the change-over to the value-added tax is to be carried out in two phases.10 The first phase calls for the replacement of the existing cascade type turnover tax by a national tax on value added. The second phase, which is to begin by January 1, 1970, calls for the introduction of value-added taxation in all member countries and for the application of common rates and common exemptions to be fixed thereafter. While West Germany had adopted a value-added tax by January 1, 1968 with rates and exemptions suited to national considerations, France has paralleled Germany’s decision by taking legal measures to reduce its tax rates from 20 to 16% percent thereby bringing its own value-added tax system more into line with the E.E.C. directives.11

The Council of Ministers directives with regard to the harmonization of turnover taxes reflect the logic of the Neumark Report. This report was submitted to the Common Market in 1962 by a committee of experts under the chairmanship of Professor Fritz Neumark of Frankfurt University. This committee studied the basic questions of tax harmonization in the Common Market, re-confirmed the urgent need for fiscal harmonization, and proposed the value-added tax as the common tax system.12 In 1970, when all Economic Community member countries are scheduled to have adopted the common value-added tax, internal border tax adjustments within the Common Market are to be removed.

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8. Except, of course, for trade with countries outside the Common Market which do not apply border tax adjustments.
Before Germany adopted its value-added tax system in the beginning of 1968, only France was in a position to rebate all turnover taxes on exports and to tax all imports in the same way domestically produced goods were taxed.

Given the difficulty of estimating the correct amount of turnover tax charges under the multi-stage turnover tax system, border tax adjustment rates vary greatly depending on the turnover involved in the production and in the retail of any given product. Frequently the border adjustment tax fails to reflect the correct amount of turnover tax charged to a domestically produced product, thereby resulting in over- or undercompensation. Table II shows border tax adjustments that were applied throughout the Common Market before 1968.

Generally speaking, a border tax arrangement is said to favor exports and to discourage imports. As long as border tax adjustment rates were relatively low within the Common Market area, they have not aroused many objections by countries not practicing border tax adjustments. But with a value-added tax of about 15 per cent, the Common Market border tax adjustment can no longer be ignored in the interest of fair and equitable conditions for international trade. A rebate of 15 per cent to products leaving the Common Market and an equally high tax on foreign products entering the Common Market will place countries not utilizing border tax adjustments at a competitive disadvantage. In the United States only state and local retail sales taxes bear a resemblance to European border tax adjustments in that they increase the price of the product. Retail sales taxes in the United States average

### Table II

<table>
<thead>
<tr>
<th>Country</th>
<th>range</th>
<th>average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>up to 12%</td>
<td>5 - 6%</td>
</tr>
<tr>
<td>Germany</td>
<td>0 - 10%</td>
<td>5%</td>
</tr>
<tr>
<td>Italy</td>
<td>up to 8%</td>
<td>4 - 5%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>up to 12%</td>
<td>5 - 6%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>3 - 12%</td>
<td>5%</td>
</tr>
<tr>
<td>France</td>
<td>20%</td>
<td>20%</td>
</tr>
</tbody>
</table>


At the same time that border taxes will be removed within the Common Market area, new border adjustment tax rates for trade with the outside world will go into effect. These rates, reflecting the rate of the common value-added tax, are expected to be in the neighborhood of 15% for most products. This action will increase the border adjustment tax rates presently applied in most of the Common Market countries. As mentioned earlier the General Agreement on Tariffs and Trade permits border tax adjustments with regard to indirect taxes. It is therefore understood that turnover taxes paid will be remitted on products exported, while foreign products entering a country will be charged a border adjustment tax reflecting the domestically applied turnover tax.

**Border Tax Adjustments**

The Common Market countries which still apply the multi-stage turnover tax have border adjustments averaging from 3-7 percent. Before Germany adopted its value-added tax system in the beginning of 1968, only France was in a position to rebate all turnover taxes on exports and to tax all imports in the same way domestically produced goods were taxed.

about 3 per cent and thereby do not share the importance of the European value-added tax.

An example illustrates how the adoption of the uniform value-added tax system is expected to affect prices in a Common Market country.

Assuming that an Italian knit dress is produced by the retailing house itself, as often is the case with Italian knitwear producers, the total of turnover tax under the present cascade type system amounts to only 3 per cent.14 Under the value-added tax system, with a rate of 15 per cent, the price of a $100 dress will be raised to $115, against the previous sales price of $103. A similar price increase will be imposed on a product entering Italy from abroad, since the 15 per cent value-added taxes will be applied in the form of border taxes.

With regard to exports, turnover tax rebates granted to Italian products leaving the Common Market area will also change from 3 to 15 per cent, thereby freeing export products completely from all turnover taxes.

Consequently, prices in Italy rise, due to an increased tax burden, while Italian products abroad remain at their original price. A change of price of Italian products will only occur whenever over- or undercompensation of turnover taxes was given to exports.

The European Economic Community has so far defended the fairness of the system since border tax adjustments put foreign and domestic products on the same competitive level. But the United States, together with many other countries, relies much more heavily on direct taxes than it relies on indirect taxes; and the rules of the General Agreement on Tariffs and Trade do not allow the practice of border tax adjustment15 for direct taxes, but only for indirect taxes.16

14 Not considered in this example are turnover taxes paid with the purchase of raw materials and capital goods.

15 GATT rules with regard to direct taxes: The exemption or the remission of direct taxes in connection with exportation generally would be considered to be a subsidy under the GATT rules. Article XVI:2 explicitly outrules subsidies. "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 disturbances to their normal commercial interests and may hinder the achievement of the objectives of this Agreement." General Agreement on Tariffs and Trade, op. cit.

Excluded from this rule are, however, primary products, e.g., agricultural products.

16 In national income accounting and under GATT rules, corporate taxes are considered as direct taxes. A forthcoming Tax Foundation study of the corporate income tax suggests, however, that corporate taxes can logically be classified as indirect taxes, since they are not applied to income received by individuals.
III.
The American Balance-of-Payments Situation and Border Taxes

One result of the Common Market value-added tax as it goes into effect will be the tax impediment to the free flow of goods.

At the same time, the U.S. will be confronted with a challenge to its international competitive position large enough to be potentially serious. Under the present rules, as established by GATT, and given the degree of U.S. reliance on direct taxes, no tax rebates can be granted to American export trade. No taxes, other than duty charges, can be levied on goods entering the United States, with the exception of U.S. excise taxes which are limited in scope. In view of its persistent balance-of-payments deficits, the United States can no longer ignore the disadvantages for American trade resulting from the European border tax adjustment.

It should be noted that European border tax arrangements will not hurt American businesses established within the Common Market. These American producers will not only share all the advantages of the value-added tax harmonization but they will gain an additional advantage with regard to the free choice of locations for their European production centers. The adoption of the common value-added tax system by the Common Market will do away with the existing inequalities in the tax treatment among Common Market countries.

The United States has incurred deficits in its balance of international payments every year, with a single exception, since 1950. Until 1958 the deficits were small, ranging between $0.3 billion and $2.1 billion a year, averaging $1.1 billion. In 1958 the deficit increased to $3.5 billion, and since then it has ranged between $3.1 billion and $4.2 billion annually.

By the close of World War II the United States had accumulated about three-fourths of the world’s monetary gold. To enhance their very thin gold reserves European countries turned to the use of dollars to complement their gold holdings. Keeping these reserves on deposit in American banks helped make the United States the world’s principal reserve banker.

The deficits in the American balance of payments up to 1960 and a little thereafter were in a sense necessary because gold production was not sufficient to meet the demands of economies that needed international reserves. But the situation has now changed. Other countries no longer want to increase their dollar holdings, so the deficit in recent years can not be justified on grounds that it is necessary to supply international reserves. In recent years foreign governments, central banks, and official monetary institutions have preferred to redeem some of their dollar
holdings in gold, even at the cost of losing interest they could get on deposits. The outflow of gold is therefore the consequence of the persistent balance of payment problem. The result of this outflow is a relative deterioration in the liquidity position of the United States as the ratio of its reserve assets (e.g. gold) declines relative to its liquid liabilities (e.g. dollars held by foreigners).

The constantly diminishing American gold holdings have spread uneasiness among European nations and foreign bankers. At the core of their concern is not only the strength of the dollar but also the stability and efficient functioning of the international monetary system.

The balance of payments deficit has only become a real problem in recent years, when foreign investment, aid, and overseas military expenditures far exceeded the earnings from trade surplus and investment earnings abroad in spite of many steps taken since 1960. The costs of the Vietnam war and the inflation since 1965 have aggravated the problem of deficits and have thereby presented a threat of disruption to the international monetary system.

Actions to solve this persistent balance-of-payments deficit are urgently called for. Nevertheless fear exists that a complete elimination of the U.S. deficit would dry up the flow of dollars abroad, thereby precipitating a shortage of monetary reserves which would have a deflationary effect. It is because of the dollar's role as the world's big reserve currency that deficits in the U.S. balance of payments have acquired such great international importance.

The problem of the balance of payments and the problem of the weaknesses of the international monetary system are therefore inextricably linked together. Neither of these problems can be solved fully in isolation from the other. It is however clear that the problem of the international monetary system cannot be solved as long as the American balance-of-payments deficits remain as large as they have been.

On January 1, 1968, President Johnson delivered a message to the nation on the balance of payments situation. The essence of this message was that the U.S. balance of payments must be restored quickly in order to safeguard the U.S. economy and to prevent the breakdown of the international monetary system. The objective of this program is to achieve an improvement of $3 billion in the balance of payments in 1968.

The program for 1968 includes a reduction of $1 billion in U.S. direct investment abroad. It requires a return of $500 million to this country through a reduction of bank loans to continental Europe. Furthermore, it envisages a reduction of nonessential travel outside the Western Hemisphere. Also included in this program are further restraints on government spending abroad. Finally, it proposes measures to encourage a larger increase in U.S. exports as the principal means of restoring the long-run payments position.

With respect to the improvement of the American trade position, President Johnson's program called for discussions with the Common Market countries concerning the difficulties caused to U.S. trade by the rebates on exports and border charges on imports.

President Johnson emphasized the success of the Kennedy Round as a major effort to reduce international tariff barriers. Declaring that the liberalization of world trade would remain the basic policy of the United States, President
Johnson turned to the problem of non-tariff barriers by saying:1

We must now look beyond the great success of the Kennedy Round to the problems of non-tariff barriers that pose a continued threat to the growth of world trade and to our competitive position.

American commerce is at a disadvantage because of the tax systems of some of our trading partners. Some nations give across-the-board tax rebates on exports which leave their ports and impose special border tax charges on our goods entering their country.

International rules govern these special taxes under the General Agreement on Tariffs and Trade. These rules must be adjusted to expand international trade further.

Discussions have been initiated which will examine proposals for prompt cooperative action among all parties to minimize the disadvantages to our trade which arise from differences among national tax systems.

Border tax charges (as will be discussed later) as applied by European countries are non-tariff barriers of particular concern to American exporters. The President's action program indicates the realization on the part of the American administration of the need to come to a solution in this matter.

The Common European Value-Added Tax and Border Taxes

The harmonization of turnover taxes in Europe leads to the adoption of the country-of-origin principle as compared to the country-of-destination principle with regard to the tax treatment of inter-community trade. With the adoption of the country-of-origin principle, fiscal frontiers within the Common Market area will be eliminated. For the purpose of taxation this action would effectively create a common or domestic market between the six member nations.

For inter-community trade as a result of the country-of-origin principle, together with a uniform value-added tax rate, prices paid by consumers for a given product should be the same in all countries, aside from transport costs. Much of the discussion concerning the adoption of a common turnover tax system has centered on the question of destination versus origin principle.2 Broadly speaking, the essential difference between these two principles lies in the answer to the question of which country is to have tax jurisdiction over the value added by the various factors of production. Under the country-of-origin principle, tax jurisdiction lies with the country in which the value originates while under the country-of-destination principle the tax is levied where the product is finally utilized or consumed. Where the destination principle is applied, sales made abroad are exempted from taxation by means of refund of taxes prior to export. The importing country then may impose the compensatory tax rate equivalent to the turnover tax charged on similar domestic products and may also charge its own tax rate on subsequent transfers within the country.

This system insures that goods and services whether from within or from outside the E.E.C. are subject to equal amounts of taxes imposed by the country in which they are finally consumed, regardless of the country in which they