were produced. In other words, the consumer cannot avoid contributing to the public expenses of his own country by purchasing a commodity abroad, provided, of course, that the country in which the consumption takes place also applies turnover taxes.

The two main reasons why sales-taxing countries exempt exports and tax imports are: first the general belief that these taxes fall as burdens not on business firms, but on consumers; hence the country in which the consumer resides should obtain the tax revenue. This can be termed the "benefit to consumers" argument.

The second argument for exempting exports and taxing imports can be termed the "competition argument." A country levying a high rate of turnover tax on its products going abroad will place its producers at a competitive disadvantage with regard to those in countries charging low turnover tax rates. By rebating the total of turnover taxes charged to products exported, the price is lowered and products can more readily find a market abroad. At the same time, however, importing countries are permitted to levy the equivalent of their turnover tax on foreign products entering at the frontier.3

The United States Government imposes no turnover tax, and hence has no occasion to exempt exports and to tax imports. American border tax arrangements are only used with respect to excise taxes, which are applied to a limited number of products only, such as cars, tobacco, and alcoholic beverages. Most of the American indirect taxes are applied on the state and local level. Table III compares the reliance on direct and indirect taxes in seven countries. The table clearly shows the contrast between indirect taxes applied in the United States and the greater reliance on indirect taxes in Europe. Consequently,

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Table III
Taxation as a Percentage of Gross National Product in 1966

<table>
<thead>
<tr>
<th>Country</th>
<th>Total Taxation per cent</th>
<th>Direct Taxes per cent</th>
<th>Indirect* Taxes per cent</th>
<th>Social Security Contributions per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>38.6</td>
<td>6.5</td>
<td>17.7</td>
<td>14.4</td>
</tr>
<tr>
<td>Netherlands</td>
<td>35.8</td>
<td>13.3</td>
<td>10.4</td>
<td>12.1</td>
</tr>
<tr>
<td>West Germany</td>
<td>34.9</td>
<td>10.5</td>
<td>14.2</td>
<td>10.2</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>31.3</td>
<td>11.6</td>
<td>14.9</td>
<td>4.8</td>
</tr>
<tr>
<td>Belgium</td>
<td>31.2</td>
<td>9.1</td>
<td>13.2</td>
<td>8.9</td>
</tr>
<tr>
<td>Italy</td>
<td>29.1</td>
<td>6.6</td>
<td>12.6</td>
<td>9.9</td>
</tr>
<tr>
<td>United States</td>
<td>28.2</td>
<td>14.3</td>
<td>8.9</td>
<td>5.0</td>
</tr>
</tbody>
</table>

*Includes real estate and land taxes.


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a definite disadvantage results for the United States with regard to its competitive position in Europe because the United States does not tax imports and gives no tax rebates to exports.

The Border Adjustment Problem

When the European economic community adopts its common value-added tax system with rates of about 15%, the origin principle will be applied to inter-community trade. Community trade with the outside world will continue to be treated according to the destination principle, thereby leaving the latter subject to border tax adjustment.

It is the current and virtually universal practice among countries to treat turnover and excise taxes as costs that are uniformly passed on in the price of the product. The existence of a border tax adjustment embodied in the rules of GATT reflects this approach. The border adjustment tax as applied to imports will charge foreign products the equivalent of the domestically applied indirect tax. On the export side GATT rules provide for the complete rebate of all indirect taxes charged to products leaving the country. Not eligible for border tax adjustment are, therefore, income taxes, profit taxes, payroll taxes, property taxes, and social security taxes. Given these GATT rules, the adoption of a common value-added tax system of about 15 per cent will bring new foreign trade advantages to the Common Market, advantages which are not shared by the outside world because of the tax system applied in the different countries.

As a result of the new border tax adjustment, the Common Market’s balance of trade should be favored. Common Market products will be cheaper abroad and foreign products will suffer price increase upon entering the Common Market area. The changes in the European turnover tax system is likely to cause the United States international trade position in Europe to decline. Since border tax adjustments are feasible only when indirect taxes are applied, exporters from countries like the United States will have no means of compensating for the emerging European border tax adjustment.

The United States responded to the prospect of increased European export rebates and higher import taxes by bringing the matter before the Organization for Economic Cooperation and Development. The OECD is the principal international forum that could review the issues involved. The United States urged a standstill agreement, under which the status quo on border tax adjustments would be maintained while the justification for border tax adjustments could receive a thorough re-examination. Behind this position is the feeling that the theory of tax incidence reflected in the GATT rules is open to question. Many attack directly the belief that indirect taxes are always shifted forward in price while direct taxes are never shifted. The United States challenges the principle on which the GATT system has rested ever since it was created in 1947. In March 1965 a working party of the OECD Council was set up to consider the questions raised by the issue.

Special emphasis was given by the working party to the tax shifting controversy. This controversy has centered on

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the relative degree of shifting of consumption taxes (which are eligible for border tax adjustment) on the one hand, and profit taxes (which are not eligible for border tax adjustments) on the other. Generally speaking, the working party of the OECD challenged the basic assumption that indirect taxes are always treated as costs and shifted forward to the final consumer.

It was argued that in specific cases the producer will prefer to bear part of the tax burden himself to avoid prices from rising to the point at which the quantity of demand will decline enough to reduce net profit. Thereby the total of turnover tax would no longer be shifted forward to the final consumer. The producer selling in his domestic market, having sacrificed a share of his profit by paying part of the turnover tax himself, will find the expansion of his export business very attractive relative to domestic sales. On exports he will not have to bear any of the tax costs as he does in absorbing tax on domestic sales, but he will receive the full rebate of all turnover taxes charged on to the product. In other words, while the value-added tax seems carefully structured to pass the tax along in an accounting sense, no guarantee is provided that the economic effects follow the accounting structure and assumptions.

If the tax is not fully shifted forward in an economic sense, the international trade position of the country applying the tax will tend to be favored regardless of the accounting structure. To estimate correctly the portion of indirect taxes not shifted forward in prices poses an impossibly difficult problem. The issue is closely linked to the impact of a tax change on prices. Arguments suggest that a rise in such taxes may sometimes lead to an even greater rise in prices than the rise in tax itself. (For example, the initial influence of an increase in indirect taxes on prices will involve wage increases which will increase costs, resulting in further price increases. Producers, it is argued, tend to take advantage of tax increases to put prices up additionally to cover other rising costs.)

Further complications arise because shifting of indirect taxes will vary from article to article, depending upon the elasticity of supply and demand, according to the state of the economy, and the government's monetary and pricing policy.

A problem of equal difficulty is posed by the analysis of the effect of business profits taxes on prices. It has often been assumed that corporate income taxes were not shifted forward in prices, but were borne in total by the producer. This assumption which is reflected in the rules of GATT was contested empirically by the findings of Krzyzniak and Musgrave who hold that direct taxes are shifted forward fully in price in the short run. These findings have been repeatedly criticized by other leading tax economists and the subject therefore remains controversial. The arguments in favor of a particular view in the shifting of these taxes are abstract and verification of the facts is complicated, for it goes beyond the estimate of the effects of tax changes on the price of goods.

7. Ibid., p. 9.
The border tax adjustment controversy has not received much attention in the past, because of the scarcity of information concerning the shifting of direct and indirect taxes. It was argued that with the existing low rates of border tax adjustments the distorting effects on international trade could only be slight, since over the years changes in exchange rate and general price levels would have offset these distortions. However, with the European Economic Community increasing its border tax adjustment, countries interested in the foreign trade position can no longer ignore the effects of border tax adjustments. It is evident that the immediate effect of the adoption of common value-added tax rates will lower prices of Community exports, while prices for products entering the European Economic Community will be increased. This effect can be compared to a devaluation of Common Market currency, as was pointed out by Professor Prest in connection with the German changeover to value-added taxes.

It can justly be feared that the emerging Common Market border tax adjustment will nullify some of the reciprocal tariff reductions negotiated during the Kennedy Round.

The OECD working party failed to make any firm policy recommendation. It limited itself to consultation with regard to general policy implications concerning the international trade and payment effects of border tax changes.

IV.
The U. S. Courses of Action to Compensate for European Border Taxes

The renewed concern with the border tax issue caused by the expected change in the European indirect tax structure is closely connected with the American balance of payments deficits. Export expansion is one of the most promising avenues for improvement in the U.S. balance of payments.

In February 1968, the National Export Expansion Council, in its advisory capacity to the Secretary of Commerce, suggested administrative and legislative action favoring the expansion of exports by proposing to study: (a) the possibility of a change in GATT rules to allow rebate payments for direct taxes; (b) the possibility of substituting a value-added tax as a source of some of the revenue now raised by the corporate income tax; and (c) the adoption of a system of border taxes and rebates on exports based on existing indirect taxes imposed by state and local governments, as well as the Federal government.1

The American balance of payments deficit situation in recent years has been contrasted with an overall positive balance in its foreign trade accounts. Table IV reflects the positive balance the United States has enjoyed in its trade with the European Economic Community.

This positive balance of foreign trade with the European Common Market might be said to confirm the argument that present border adjustments really have no effect on international trade. However, international trade problems are likely to result from the Common Market adoption of the uniform value-added tax system.

Given the favorable balance of foreign trade that the United States has maintained in past years, caution is indicated, in order not to respond to the European border tax increase in a fashion that might jeopardize, instead of further improve the American international trade position in Europe in the long run. Some of the repeatedly suggested policy measures will be summarized briefly

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and analyzed to consider their possible adverse effects.

1. The United States might wish to negotiate changes of GATT rules with regard to the justification of border tax adjustments for indirect taxes only, in view of existing controversy with regard to the shifting of direct and indirect taxes.

2. GATT could be asked to approve border tax adjustments for direct taxes. This would be in direct violation of present GATT rules, but changes of these rules could possibly be negotiated.

3. Another solution might be a change from heavy U.S. reliance on income taxes in favor of the adoption of turnover taxes. If the United States cannot lick the system, perhaps it should join it.

4. Finally, one other suggestion, which is less drastic but possibly more in keeping with U.S. international obligations, is for the U.S. to rebate certain indirect taxes presently not rebated.2

Asking GATT to change its rules with regard to border tax arrangements has a definite appeal to many countries concerned. Before any decision in this direction could be taken, much detailed work on the question of the shifting of direct and indirect taxes would be necessary. It would be unreasonable to expect countries presently practicing border tax adjustments to cease to do so arbitrarily. However, an acceptable solution to the problem might be found through functional modifications of the present system. To bring about these modifications the United States might seek a standstill arrangement with the Common Market countries introducing the increased tax adjustment until firm decisions in this matter could be taken. If it were found that the principles underlying the present system are not fully valid, future border tax adjustments could be limited to the effects of taxes on prices.

That the European Economic Community is willing to discuss the border tax issue with the United States was pointed out by Mr. Jean Rey, President of the Commission of the European Economic Community in a speech before the National Press Club.3

A reconsideration of the principles on which the present GATT rules rest might also lead to the acceptance of border tax arrangements for direct taxes. This solution might not accomplish much for the United States, in that corporate income tax rates in the U.S. do not differ much from corporate income tax rates applied in major European countries. The OECD gathered statistics which indicate that the total tax burden of the United States is lower than that of either the United Kingdom, France, Germany, Italy, or the Netherlands, in terms of general government expenditures as a percentage of gross domestic product in 1965. Thus the case is made that because Europeans rely also to a great extent on direct taxes, the border tax adjustment for direct taxes would reflect this situation and the advantages gained for the United States would consequently be slight. This effect would be emphasized even more with regard to

3. Curtis, op. cit. Mr. Rey expressed at that occasion the Common Market's view that the U.S. balance of payments problem was not a balance of trade matter but a matter of domestic economic policy. He said that the EEC considers the GATT to be the correct measure of its conduct on the border tax issue, and he said that the adverse effects of border taxes on U.S. foreign trade had not yet been proven. He also said that Americans had for years known about the border tax system that was being formulated in the EEC, and had taken no action until the present "emergency".
third nations, since they would also be permitted to apply border tax adjustments. It thereby becomes probable that border adjustment for direct taxes, if instituted at all, would not radically alter the relative border adjustment magnitude of the United States and most other important trading countries. Finally, even if one were to permit adjustments for direct taxes, such a course would meet with considerable administrative problems, for it would be virtually impossible to determine the precise amount of direct tax embodied in the price of a specific product. This difficulty would exist 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.

Should the United States then change its tax structure and apply turnover taxes? It is yet unclear how an emulation of the European tax system would affect American exports, since the precise relationship between the level of indirect taxes and exports is still uncertain. A recent study by Robert Z. Aliber and Herbert Stein has attempted to show how a change in the mix of U.S. taxes might affect the international competitiveness of U.S. products abroad. In view of the complexity of this type of analysis, which should include possible changes in wages, interest, and other costs, only rough indications of the likely magnitude of the improvement in different circumstances is given. On the whole, however, it appears that a change in the tax mix would affect prices only slightly. A conference of experts sponsored by the Brookings Institution and the National Bureau of Economic Research in late 1963 held a similar view on this subject. The issue cannot be separated from the question of the degree to which indirect taxes are shifted forward and direct taxes are shifted backward, e.g., how much of corporate income tax reduces net yield to capital here and abroad. The ramifications of a changeover to indirect taxes from the domestic standpoint would be much more significant than its international aspect. Congress, having only recently eliminated many consumer excises, might be very hesitant to adopt a general turnover tax.

The final suggestion, which has actually received more attention than all other proposals, calls for the rebate of certain indirect taxes presently not rebated by the United States. Besides levying excise taxes on a limited number of products which are actually rebated on exports, the United States makes considerable use of indirect taxes which could also be rebated according to GATT rules. These indirect taxes have not been rebated so far; with the exception of property taxes, they are usually levied at the state and local level in the form of retail sales taxes. The levy at state and local level complicates their use as a sales stimulant of American products abroad. While it has been estimated that the average of these indirect taxes is about 2 per cent of export sales prices, the impact on product lines differs with the range running from 1½ per cent to 4 per cent of export sales prices. The rebate of these tax costs and a similar import charge, administered through

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5. See Aliber and Herbert Stein, Ibid.
the customs organization, would reflect an approach that corresponds to the principle applicable under the value-added and turnover tax. This approach, if adopted by the United States, would reflect the principles and practices underlying the treatment of indirect taxes in Europe.

It should be considered, however, that the adoption of a border tax adjustment in the United States will immediately create new trade obstacles with such countries as Canada, Britain, Japan, and Australia. Some of these nations presently do not practice border tax adjustment. However, they could be led to do so if the United States decided to go ahead on this issue.

At the beginning of 1968, the American delegation to GATT asked for the creation of a special working party on border tax adjustment. This request expresses the belief that a general review and possible revision of GATT rules is necessary with regard to Articles II, III and XVI which govern the border adjustment.8

The Working Party on Border Tax Adjustments met for its first session from April 30-May 2. The representatives of the United States in their opening statement welcomed the possibility of a general review of GATT rules, and expressed their hopes that the question of border tax adjustments would find a constructive and expedient re-examination. The rules were drawn up more than two decades ago, and the economic environment present at that time has changed drastically. Levels of indirect taxes were much lower then and existing practices and simple assumptions with regard to tax shifting seemed acceptable at that time. Little attention was paid to questions of what might be harmful to the U.S. payments position, since the need was to assist other countries to overcome the so-called dollar-gap and meet the requirements of post-war reconstruction.

The border tax adjustment controversy is not an isolated problem. The GATT working party on border taxes has placed this issue in the context not only of the balance of payments question as a short run concern, but also in the context of equity requirements for international trade in the long run. In the light of these considerations the working party agreed to proceed to:

a. Analyze and re-examine how the present GATT rules came about.

b. Gather information about the practices of GATT members with regard to border tax adjustment.

The U.S. representatives made clear the belief that the problem is one for the long term, but also directly related to the amplitude of recent and prospective tax changes in Europe and the U.S. balance of payments.

It is expected that new and basic information about the question of tax incidence will be gathered by this working party, so that equitable international trade rules can be established. Clearly, several months of highly technical discussions are required before a workable solution can be found. American officials are hopeful that GATT rules can be revamped so that trade distortions resulting from emerging European border taxes can be avoided.

8. General Agreement on Tariffs and Trade. Basic Instruments and Selected Documents, Vol. 3
The harmonization of turnover taxes by the member nations of the European Economic Community brings about an important rise in European border taxes. Real concern exists in the United States about the trade distorting effects of the emerging border tax adjustments. In an environment of international trade liberalization and reciprocal tariff reduction, resulting from the recent Kennedy Round negotiations, an increase in European border taxes seems to contradict free trade objectives.

The General Agreement on Tariffs and Trade allows for a rebate of indirect taxes to exports and for the application of indirect taxes to imports. Countries relying heavily on indirect taxes, e.g., the Common Market member nations, enjoy a comparative advantage over countries relying more heavily on direct taxes, since no border tax adjustments are permitted for direct taxes.

In the presence of these GATT practices equitable conditions for international trade could only prevail if all countries applied the same taxes and rates of taxes. This is evidently not the case and may not be feasible. If this is not feasible, what is needed then is revision of GATT rules with respect to border tax adjustments. A special working party on border tax adjustment has been created within GATT. Having met for the first time in April-May of this year, the special working party on border taxes has opened discussions on this problem.

GATT has played an important role in liberalizing international trade through the removal of tariffs. It is hoped that GATT will parallel its past efforts by the effective removal of non-tariff barriers to international trade.
Appendix I

THE E.E.C. DIRECTIVES INTRODUCING
THE COMMON VALUE-ADDED TAX SYSTEM

At a meeting held in Brussels on February 9, 1967, the Council of Ministers of the European Economic Community adopted two directives on the harmonization of turnover taxes in the six member states. The first directive foresees the removal of the cascade type turnover tax system in all member countries and the adoption of a common value-added tax system. While the first directive defines the essential principles on which this system is to be based, the second directive makes detailed arrangements for the application of this common system. The main provisions of the first directive are as follows:

1. The common TVA system will come into force on January 1, 1970, at latest. The national laws required to bring this about must be promulgated early enough for this deadline to be complied with.

2. Before the end of 1968, the Commission is required to submit to the Council proposals indicating how and by what date the harmonization of turnover taxes is to achieve its ultimate aim, the abolition of all taxes levied on imports and of all tax drawback on exports in trade between Member States. The Council will, if possible, take its decision on these proposals before January 1, 1970.

The second directive concerns the method of application of the TVA system, which each Member State is to follow. The following are the main points:

1. The TVA will be a general tax on consumption levied, in principle, at all stages of the economic process and in such a way that it falls only on the value added at each stage. The method of collection is as follows: the tax for the total turnover is calculated, and from this amount the total tax on purchases (previous tax) is subtracted, the difference being paid over to the tax authorities.

2. TVA is to be paid on merchandise and services supplied within the country, and on merchandise imports.

3. In principle, TVA will be charged on deliveries of goods up to and including the retail stage. Until the date on which fiscal frontiers are abolished, the Member States will, however, be free to limit the area of application of TVA to stages up to and including the wholesale stage.

4. Taxation on services is only compulsory when they have a marked direct or indirect effect on the prices of goods. A list of these services is given. It includes the assignment of patents and trade marks, freight transport and warehousing, but not

Border adjustment taxes will therefore continue to be applied to imports entering the Common Market, and tax rebates will continue to be given to exports leaving the Common Market area. The rate of border adjustment tax to be applied to Common Market trade with the outside world will correspond to the value-added tax rate applied within the Common Market. This rate has not yet been fixed and will be the object of future Common Market Council directives. It is generally assumed that the common value-added tax rate will be about 15 per cent.


banking services. It is left to the Member States to impose such taxes as they may deem appropriate in respect of the large group of services not included in the list (e.g. those supplied by doctors, hairdressers and others who usually supply services only to private individuals).

5. The place where the service is taxed is to be the place where the service in question is used or exploited. The Council, acting on a proposal of the Commission, may however make special provisions departing from this rule.

8. Previous taxes imposed on deliveries of merchandise, on services or on merchandise imports are deductible from the TVA payable on the relevant turnover. Normally, previous taxes may be deducted in full and directly. In order to alleviate difficulties connected with the changeover to the new system, Member States may, however, during a transitional period, make partial deductions for capital goods each year (deductions pro rata temporis) or exclude capital goods either wholly or partially from the system of deductions.

In addition, the Member States are free, after consultation within the Community, to bar deductions in respect of capital goods, either wholly or in part, for reasons connected with the current business situation.

7. Although Member States are free, until fiscal frontiers are removed, to determine tax rates and exemptions independently, the directive sets certain limits to their discretion in this field. Where exemptions are concerned, deduction of previous tax will normally not be allowed. Reduced rates may not be cut below a certain minimum. Until fiscal frontiers are removed, both these rules may, however, be waived for precisely defined social reasons for the benefit of final consumers. The total effect of these waivers may, however, not exceed the total effect of reliefs previously granted within the framework of social policy.

8. The directive provides for a special procedure in exceptional cases where a Member State considers it necessary to introduce special measures designed to simplify the collection of taxes or prevent fraudulent practices.

9. Each Member State may at its discretion apply to small firms, with respect to which the application of the normal TVA system would encounter difficulties, such special arrangements as it may deem most suitable in the light of national requirements and resources.

10. With regard to taxation of agriculture, the Commission is called upon to submit to the Council as soon as possible proposals for common implementing procedures relating to trade in agricultural products.

Point 10 of the second directive of the Council of Ministers indicates that a special arrangement for the taxation of the agricultural sector will be applied. The Commission of the European Communities in February 1968 submitted to the Council a proposal for a third Council directive on the harmonization of turnover taxes with regard to the agricultural sector.

The proposed directive will include the agricultural sector in the common value-added tax system, permitting agriculture to integrate itself into the general economy but avoiding discrimination among the different producers within the community. It is anticipated that the provisions concerning agriculture can go into effect by January 1, 1970, the date at which the Common Market is to adopt its common value-added tax system. The proposed directive foresees that deliveries and imports of agricultural products shall be subject to a common low rate. It is expected that the Council will fix the rate to be applied to agricultural goods at about half the normal rate of tax on value-added.

3. First and Second Directives of the Council of Ministers, op. cit.
Appendix II

THE GERMAN LAW ON VALUE-ADDED TAXES

It should be understood that the change brought about by this new law is actually a preliminary step in the direction of the common value-added tax. While it is expected that the Netherlands will also adopt a national value-added tax system, it is unlikely that Belgium, Italy, and Luxembourg will devise a value-added tax system of their own before adopting the communal value-added tax system by January 1, 1970. The German value-added tax law as put into effect by the beginning of 1968 replaces the former cascade type of turnover tax. This new tax applied to all deliveries of goods, including self consumption and delivery to self, as well as services and imports. Taxable persons are those who engage in transactions within the scope of industrial, crafts, commercial, or professional activity. Only small businesses whose annual turnover does not exceed the equivalent value of $5,000 are exempted from this tax. The tax base is the sales price of products, while the method of determining value added is the deduction method, allowing for a credit for the amount of tax paid at previous stages of production. The accumulation of capital goods is exempt from value-added taxation. There are two tax rates, the normal rate of 10 percent which is to be increased to 11 percent by June 30, 1988, and the special rate of 5 percent which is to be applied to certain sectors of the economy, for example agriculture. This special rate will be raised to 5 1/2 percent by June 30, 1988. These are also the rates that will be imposed on foreign products entering Germany. The German value-added tax law allows few exemptions. The principle ones are banking, communication, waterborne transport, and the leasing of real estate.

The following shall present a brief summary of the major provisions expressed in the German value-added tax law. Subject to the tax are all deliveries and services, including those to self and self consumption as well as imports. The exemption from value-added taxes are described in Articles four through nine. Exempted from the value-added tax are exports, services and sales abroad, services rendered by insurance companies for clients established abroad. Postal transactions and internal navigation are also exempted from value-added taxes, as well as certain foreign exchange and capital transactions. Occasionally, the option to renounce the right to exemption is granted by the law, as in the case of internal navigation and leasing or renting of land and similar operations. Further exemptions from value-added taxation are granted to health and social services.

The tax base, which in principle is the price of the product or service excluding the turnover tax as defined in Article 10; however for imports that tax base will be the value declared for customs purposes (Article 11) plus customs duties and any special consumption tax, excluding turnover tax.

The tax of 10 percent is fixed by the law as the normal rate. It applies however to the net price so that the actual tax rate charged amounts to 9.09%. A reduced rate of 5 percent is applied to a limited number of operations connected with specific products (In reality the rate applied is 4.76%): a. agriculture, b. operations connected with the exercise of a liberal profession as defined in Article 18, paragraph 1, item 1 of the income tax law. As pointed out earlier, the present rates are to be short lived. The German Bundestag has already enacted an amendment increasing the tax rate to 11 percent and 5.5 percent respectively.

6. Ibid., Articles 1, 2, 3.
7. Ibid., Articles 4, 5, 6, 7, 8 and 9.
8. Ibid., Article 10.
9. Ibid., Article 12.
10. The law considers a liberal profession to be any independent activity of a scientific, artistic, literary, instructional, or educational nature; the independent professional activities of doctors, dental surgeons, veterinarians, lawyers and notaries, patent agents, surveyors, engineers, architects, chemical engineers, auditors, tax experts, economic experts, public accountants, tax advisors, medical orderlies, dentists, remedial gymnastic supervisors, translators, marine pilots, and similar professions.
Imports will be charged value-added taxes of equal rates as applied to domestically produced products by means of border tax adjustments.12 On the other hand, exports are not subject to the new tax, for value-added taxes are refunded in full on exports.

The tax liability for deliveries and other performances of the entrepreneur include self consumption and delivery to self.13 Article 14 gives the express provision making the issuance of invoices compulsory. At the same time included in this article is specific information to be contained in each invoice.

In total, the German Value-Added Tax Law covers 33 articles, dealing with the different aspects connected with the changeover to value-added taxation. The articles 15-33 are of a more general nature concerned with the requirement to keep books establishing the tax period, and the taxing of entrepreneurs with low total turnover, etc.

Exceptions are made for the articles concerned with long-term adjustments as called for by the changeover to this new turnover tax system.

Article 15 of the German Value-Added Tax Law calls for the complete deduction of turnover taxes on capital assets by January 1, 1968. However, the economic ramifications of this approach were not feasible. Inevitably, it would have resulted in business decisions to forego new investments until 1968. Furthermore, it would have resulted in a heavy drain on government revenues. The law takes a different approach which in effect provides for a step by step deduction over a five year period.14 However, all further fixed asset additions through 1972 will be subject to a quasi investment tax. This tax, levied at an 8 per cent rate in 1968, declines gradually to zero.15 Similar adjustments were necessary with regard to long-term contracts. Contracts entered into prior to October 1, 1967, which were to be fulfilled, whether in whole or in part, subsequent to the effective date of the new tax had to be reconsidered. Should the added-value tax be higher than the former cascade turnover tax, the supplier will be at a disadvantage were the contract price to remain the same. If the value-added tax were lower, the purchaser would be at a disadvantage. The new law provides for readjustment of the contract, where the total tax burden increases or decreases materially.16

The licensing agreements in effect before the value-added tax also had to be re-evaluated.17 As licensing agreement royalties are subject to turnover taxation and, further, as there is generally only one transaction, the new tax could result in a substantially greater burden to the licensor. Moreover, the German licensee will have the right to deduct this tax from the tax payable by him on his own sales. In order to alleviate changes resulting from the changeover to value-added taxes long-term contract readjustments are worked out.18

Considering the effects of the new value-added tax on prices, it is very difficult to make any valid observation as of yet. The switch to the new tax in Germany has not been an easy one, and it will take months before things will settle down again. Some firms have taken advantage of the changeover to a new tax system to raise prices sharply, perhaps because they did not know how the new tax would work, or because they were unable to calculate its impact correctly. Some businesses simply raised the old prices by 10 percent, although the old prices already contained former turnover tax charge. Presumably, both the present slow pace of the West German economy and existing competition will limit unrealistic price rises. Bigger and more sophisticated producers have refrained from increasing prices, knowing how much the old turnover tax had affected prices. The leading car manufacturers, for example, have kept their price list unchanged, as have most book and newspaper publishers. Industrial buyers of such products in fact find them cheaper, as they will be able to charge the tax element in the price against their own tax liability.

It should actually be possible for the prices of many types of food to go down, as the reduced rate of only 5% is applied to those items. Whether in fact the price of food will be lowered remains to be seen, and will depend above all on local competitive situations between retail outlets.

11. Bundesgesetzblatt, Teil 1, October 18, 1967. (Added value tax law.)
12. Commerce Clearing House, German Added Value Tax Law, Article 11.
14. Ibid., Article 15.
15. Ibid., Article 30. The rate is 8% of all additions made in 1968; 7% of all additions made in 1969; 6% of all additions made in 1970; 4% of all additions made in 1971; 2% of all additions made in 1972 and zero thereafter.
16. Ibid., Article 29, point 2.
18. Commerce Clearing House, German Added Value Tax Law, Article 29.
By the end of last year, the German American Chamber of Commerce published the results of a study undertaken by the Association of German Consumer Organizations, giving a broad outline of the effects of value-added tax on prices. The Association found:

- Food (which accounts for about 34% of the money spent by an average worker's family) will mostly be cheaper;
- Manufactured goods (about 30%) will stay about the same, with small price reductions on some products being offset by increases on others;
- Services (about 15%) will be somewhat costlier;
- Utilities and gasoline (combined, about 6%) will gradually rise in price over the next six months.

The Association's report includes the following table (some items appear in more than one column because the information was gathered from many sources in different localities).

A second, unrelated study made by a major market research organization supports the Association's conclusions. The market research firm found that consumer goods prices will decline by a weighted average of 1.5%, with extremes of −2.9% and +1.3%. Even after July 1, 1968 when TVA rates are to be increased from 10% and 5% to 11% and 5.5%—consumer prices should still average 0.8% below current levels. The research organization noted, however, that utility costs will rise almost 6%, hotel prices about 5%.

It is still unclear just what effect the new tax will have on prices for imports and exports. Common Market tax experts point to a combination of short-run and long range factors as the reason why an immediate appraisal is impossible. The answer to this question is complicated, because the former turnover tax, being both cumulative and hidden within the gross selling price of products, cannot easily be compared with the new tax system.

Nevertheless, occasional increases of charges against imported products have been observed. It is claimed, however, that these increases result from their having been undercharged in comparison with domestic goods before January 1, 1968.

Present evidence indicates that the change-over to the new tax system for both imports and exports may give some items a competitive advantage they did not formerly enjoy. Others have lost their former advantages while still others are not affected at all.

20. For more discussion on the effects of value-added tax on foreign trade see:

<table>
<thead>
<tr>
<th>LOWER</th>
<th>UNCHANGED</th>
<th>HIGHER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of services</td>
<td>Vacations</td>
<td>Commuting</td>
</tr>
<tr>
<td></td>
<td>Rail tickets</td>
<td>Dry cleaning</td>
</tr>
<tr>
<td></td>
<td>Commuting</td>
<td>Hair care</td>
</tr>
<tr>
<td></td>
<td>Telephone calls</td>
<td>Inns and hotels</td>
</tr>
<tr>
<td></td>
<td>Postage</td>
<td>Manual trades</td>
</tr>
<tr>
<td></td>
<td>Hair care</td>
<td>Health Resorts</td>
</tr>
<tr>
<td>Cost of utilities</td>
<td>Water</td>
<td>Water</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Electricity</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Gasoline</td>
</tr>
<tr>
<td>Cost of consumer goods</td>
<td>Lingerie</td>
<td>Chinaware</td>
</tr>
<tr>
<td></td>
<td>Stockings</td>
<td>Major appliances</td>
</tr>
<tr>
<td></td>
<td>Umbrellas</td>
<td>Used cars</td>
</tr>
<tr>
<td></td>
<td>Shoes</td>
<td>Tires</td>
</tr>
<tr>
<td></td>
<td>Appliances</td>
<td>Records</td>
</tr>
<tr>
<td></td>
<td>Soaps, detergents</td>
<td>Cameras</td>
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<tr>
<td></td>
<td>Cosmetics</td>
<td>Outerwear</td>
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<tr>
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<td>Drugs</td>
<td></td>
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<tr>
<td></td>
<td>Records</td>
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<td></td>
<td>Books</td>
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<td></td>
<td>Sporting goods</td>
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<td></td>
<td>Shirts</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Furniture</td>
<td></td>
</tr>
</tbody>
</table>
Appendix III

THE VALUE-ADDED TAX

The consumption type of value-added tax can be described as a retail sales tax.

The base to which this tax applies is the total of sales receipts of a firm less the payments made to other firms for goods and services. Alternatively, the tax base or the total of value added is equal to the sum of wages, interest and rent payments to individuals, plus profits.

The value-added tax explicitly grants credit for all taxes paid at earlier stages of production. The advantage of correct tax assessment at each stage of production is however combined with the administrative complexity of multiple tax application.

With regard to capital accumulation, the value-added tax system as applied in Europe allows for the complete deduction of all capital expenditures from the tax base in the year of purchase. Total deduction of capital expenditures is said to be the consumption type of value-added tax, as compared to the income type of value-added tax which allows for depreciation of capital equipment in the years it is used.

An example will illustrate how value-added taxes were applied in France before 1968.

The manufacturer deducts from the total tax of $58 the $31 which were included in the price of the materials he bought. The producer therefore renders only $25 of taxes to the tax authorities which is the tax of the value added by him. The retailer will be charged the total amount of value-added taxes charged to the product. This amount will then have to be paid by the final consumer upon purchase of the product. Direct taxes, (such as corporate income taxes), allow no border tax adjustment.

Under TVA the correct border taxes are possible, which is not the case under turnover taxes. Furthermore, TVA does not favor vertically integrated producers as can be observed under cascade type turnover taxes. Thereby internal neutrality is guaranteed, irrespective of the number of transactions the product has gone through before reaching its final consumer. Integrated and non-integrated business is taxed alike.

External neutrality is also guaranteed by the value-added tax system. By rebating the total amount of turnover taxes to exports and imposing a border adjustment tax to imports that will be equivalent to the domestically applied turnover tax, domestic and foreign goods are placed

<table>
<thead>
<tr>
<th>Purchases</th>
<th>Total amount charged in bill</th>
<th>Amount of tax included in price</th>
<th>Price exclusive of tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Materials</td>
<td>$100</td>
<td>$20</td>
<td>$80</td>
</tr>
<tr>
<td>Fuel</td>
<td>45</td>
<td>9</td>
<td>36</td>
</tr>
<tr>
<td>Containers</td>
<td>10</td>
<td>2</td>
<td>8</td>
</tr>
<tr>
<td>Value added by the producer not including tax</td>
<td>155</td>
<td>31</td>
<td>124</td>
</tr>
<tr>
<td>Tax payable by producer</td>
<td>25</td>
<td>25</td>
<td>100</td>
</tr>
<tr>
<td>Selling price of product</td>
<td>280</td>
<td>56</td>
<td>224</td>
</tr>
</tbody>
</table>

*This rate is applied to a base that includes the tax itself, the effective normal rate (as distinguished from the nominal rate) is 25% of the price before the tax.

1. Vertical integration eliminates the changing over into different hands, which thereby avoids turnover taxation.
on the same competitive tax level. The cascade type turnover tax with regard to international competition has disturbing effects, since the border tax applied to imports will be higher or lower than the turnover tax domestically applied. This curbs or stimulates imports respectively. On the rebate to exports side the same disturbances to competition occur whenever the refund of turnover taxes is unduly high since it then becomes an export subsidy.

While turnover taxes generally apply to consumption only, value-added taxation includes services in its tax base as well. The tax base, therefore is considerably wider than that of turnover taxes. Consequently, the yield from any given tax rate will be higher and more stable for value-added taxes than for turnover taxes. Provided, of course, that exemptions, if granted at all, are kept at the absolute minimum.

Value-added taxation in the light of the evidence cited above reveals a definite superiority over the cascade type turnover tax. Nevertheless, TVA bears certain inconveniences.

Aside from the multiple tax levy, as afforded by the TVA, problems arise whenever different tax rates prevail within a particular country with regard to the rebates to be given for taxes paid on preceding stages of production. This problem is amplified when goods change from one tax bracket into another.

It should be noted here that France presently applies four separate rates while Germany has one standard value-added tax rate and a reduced rate for a limited number of products including agricultural goods. Similar problems arise whenever exemptions are given to specific sectors of the economy, since it precludes the achievement of optimum neutrality with respect to competition at the retail level. It is also difficult to determine the consequences of exemption and/or differential rates in connection with the shifting of the tax to the ultimate consumer.

The country considering the change-over to value-added taxation faces particularly difficult problems. Defining the base to which value-added tax should be applied requires important decisions. Difficult questions arise in connection with the treatment of unrealized gains or losses in real property, the tax treatment of rents, interest, and dividends, especially among financial institutions, to only mention a few. At present France and Germany both exempt their entire finance industry from value-added taxation. Small enterprises, shopkeepers, and certain professions might have to be exempt from taxes if their total income does not exceed a certain amount. Agriculture, providing the basic needs of a nation, might require a preferential tax treatment. In this enumeration only some of the sectors that will require special consideration under a value-added tax system are mentioned.