MORE THAN 50 YEARS OF TRADE RULE DISCRIMINATION ON TAXATION: HOW TRADE WITH CHINA IS AFFECTED

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For more than 50 years, U.S. manufacturers and exporters have operated under GATT/WTO trade rules which distort trade through discriminatory treatment of different taxation systems. The global trading rules permit the imposition of certain forms of taxes on imports and the removal of certain forms of taxes on exports. The U.S. is the only major trading nation which has not modified its taxation system over time, with the result that U.S. exports face double taxation while U.S. manufacturers, agricultural producers and service providers compete in the U.S. with imports that have been relieved of a significant part of the taxation obligations of the exporting countries. Over this time, U.S. presidents, cabinet members, Congress, business leaders, and economists have sought to correct the discriminatory treatment of taxes which peculiarly distort trade to the disadvantage of the United States. The efforts to date, including in the current Doha Round, have failed to solve the problem. This is a problem not just with historical trading partners such as the EU, but also with new trading powers like the People's Republic of China.

Under GATT/WTO rules, indirect taxes, such as value-added taxes (VAT), excise taxes, and other types of consumption taxes, are treated more favorably than direct taxes, such as income taxes. In application, the differential treatment of direct/indirect tax systems means that countries that have indirect tax systems are permitted (1) to impose indirect taxes, such as the VAT, on incoming imports, and (2) are permitted to provide a rebate of the VAT on outgoing exports. However, the same treatment is not accorded to countries, such as the United States, that rely primarily on direct tax systems. In other words, under the GATT/WTO rules, indirect taxes are adjustable at the border, direct taxes are not.

The consequence of the GATT/WTO disparate treatment of direct and indirect taxes is that U.S. producers and exporters suffer a competitive disadvantage due to double taxation -- U.S. exporters must pay both U.S. taxes, which are not rebated, and foreign VAT; U.S. producers must pay U.S. taxes and compete with imports that do not pay U.S. taxes and which have received rebates of VAT and other indirect taxes.

Economists have found that the disparate border adjustability of direct and indirect taxes produces significant economic distortions. Currently, 137 nations have some form of VAT. Based on international VAT rates and U.S. import and export data, it can be estimated that the total VAT disadvantage to U.S. exporters and producers in 2006 was more than $300 billion.

China is one of the 137 countries that imposes a VAT and allows rebates of VAT on exports. Given the size of U.S. trade with China, the VAT disadvantage to U.S. producers and exporters in 2006 as a result of China's use and application of VAT is estimated to have been as high as $46 billion.

The impact of the VAT disadvantage to U.S. exporters and producers is increasing and is likely to continue to increase. Trade liberalization has played a role in intensifying the VAT disadvantage. As countries have reduced import tariffs, the reduction of tariff revenue has led many countries to replace import tariffs with indirect taxes, such as VAT and other consumption taxes. Indeed, the International Monetary Fund and the OECD (and even the United States in the Doha negotiations), have encouraged developing countries to adopt this policy. A comparison of the European Union's tariff reductions over time with VAT increases over the same period shows a close correspondence. So also, in the 1990s, as China reduced its import tariffs in

preparation for WTO accession, it reformed its tax system and introduced a VAT which now provides more revenue than any other Chinese tax.

The origin of the differential border treatment of indirect and direct taxes in international trade goes back to the 18th and 19th centuries. Following World War II, the VAT was virtually unknown and, to the extent that countries imposed indirect taxes at the border and rebated such taxes on exports, these border taxes were essentially inconsequential in their impact on international trade. The growth and impact of VAT and other indirect taxes was not foreseen by at least the U.S. negotiators in the 1940s when the GATT was developed.

At the time that the GATT was adopted in 1947, it was commonly assumed that indirect taxes were fully passed to the ultimate buyer in the price of the good, but that direct taxes were not similarly passed. This economic assumption became embedded in the GATT's application of the "destination principle" to taxation of indirect taxes and the "origin principle" to taxation of direct taxes with respect to border adjustability. Many economists no longer accept this assumption. However, all attempts so far to revise the GATT/WTO rules to provide equal treatment of direct and indirect taxes have not succeeded.

U.S. concerns about the trade distortions caused by the differential treatment of border taxes came to the fore in the 1960s as European countries gradually introduced VAT in their tax systems and as the European Communities decided to harmonize its VAT. The U.S. viewed these actions as imposing an increased disadvantage on U.S. exporters and producers. In addition, in 1967-68, the United States experienced a negative balance of payments caused, in part, by the border tax adjustments disadvantage in trade with Europe. In 1968, the Johnson

Administration decided to address the border tax distortions by calling for general review of the GATT rules. Although a working party on border tax adjustments was established in Geneva, the effort did not result in any revisions to the GATT rules after two years of work because of the consensus requirement within the GATT (and now the WTO).

U.S. concerns about the border tax adjustment disparity, and efforts to address it, continued, however. These concerns were addressed by the Nixon Administration, the Williams Commission, by persistent statements to Congress by U.S. business leaders, and by Congress, which has repeatedly included in U.S. trade negotiating objectives (Tokyo Round, Uruguay Round and Doha Round) the reform of the GATT's border tax adjustment rules.

As another road to addressing border tax adjustment disparity, there have been repeated legislative attempts to revise U.S. tax law by enacting a VAT, sales taxes, or other taxes that would be border adjustable according to the current GATT/WTO rules. However, none of these efforts has so far succeeded.

With respect to China, notwithstanding the VAT disadvantage to U.S. exporters and producers, the United States Trade Representative has identified a series of particular actions by China that are alleged to constitute present and continuing violations of WTO obligations regarding the application of VAT and consumption taxes. These actions by China include the VAT treatment of certain fertilizers, the unequal application of consumption taxes on various products, border trade policy with Russia, the assessment of VAT on antidumping duties, preferential treatment of VAT rebates, and agricultural VAT policies. Resolution of all of these issues could be addressed at the WTO now.

With respect to eliminating the trade disadvantage of the current GATT/WTO border tax adjustment rules, there are a number of potential actions that the U.S. could take. Unilaterally, Congress could: (1) reform the U.S. tax system to include indirect taxes such as VAT that would be border adjustable, (2) enact the Border Tax Equity Act of 2007, (3) impose import taxes on services and allow rebates of the same on exports. Bilaterally, the U.S. could negotiate agreements with VAT countries that would cover border tax adjustments of direct and indirect taxes. Multilaterally, the U.S. could attempt to negotiate changes to the GATT/WTO agreements so as to treat direct and indirect taxes equally – that is, either allow imposition of direct taxes (such as income taxes) on imports and rebates of direct taxes on exports, or eliminate the preferential border adjustment treatment accorded to indirect taxes under current trade rules.

MORE THAN 50 YEARS OF TRADE RULE DISCRIMINATION ON TAXATION: HOW TRADE WITH CHINA IS AFFECTED

INTRODUCTION

Since the 1970s Congress has called for the elimination of the bias in GATT/WTO trade rules in the border adjustment of taxes which favor indirect tax systems (such as value-added taxes) to the detriment of countries like the U.S. which rely heavily on direct taxes (such as income taxes). Exporters and manufacturers in the United States have had long-standing concerns that the disparity in border treatment of direct and indirect taxes results in U.S. exporters being subject to double taxation while imports into the United States benefit from subsidies that are not reachable under WTO disciplines. China is one of the countries that has a VAT system which both taxes U.S. exports to China and subsidizes Chinese exports to the United States. This paper examines the discriminatory trade effects and economic impact that the differential and disparate treatment of direct and indirect taxes in international trade has on the competitive position of U.S. exporters and producers, reviews the contribution of U.S.-China trade to the indirect tax treatment disadvantage, and suggests potential ways to address this issue unilaterally, bilaterally, and multilaterally under the WTO.

The paper first reviews the economic impact that differential tax treatment has on U.S. exporters and producers. There is then an examination of the historical background to the GATT/WTO distinctions regarding direct and indirect taxes and U.S. efforts to negotiate changes to the GATT/WTO rules. Next, congressional interest in the problem of competitive disadvantages occasioned by the disparate treatment of direct and indirect taxes, and attempts to address the issue legislatively, are reviewed. The paper then turns to a review of China's tax system and the various indirect taxes, including VAT, which are applied and rebated. Based on

U.S.-China trade flows in 2006, the paper estimates the economic effect that China's value-added tax system has on the competitiveness of U.S. goods. The problems and concerns that have arisen with respect to China's application of discriminatory VAT and other indirect taxes on selected products are then examined. Finally, the paper concludes with a review of bilateral and multilateral actions that could be taken to eliminate the discrimination to U.S. producers and exporters from the disparate border adjustment of direct and indirect taxes.

I. U.S. EXPORTERS AND PRODUCERS ARE COMPETITIVELY DISADVANTAGED BY THE DIFFERENTIAL TREATMENT OF DIRECT AND INDIRECT TAXES IN INTERNATIONAL TRADE

> Let me give you an example of how U.S. exporters are at a disadvantage in the global market. The tax burden on a foreign product often consists mainly of a combination of income tax and Value Added Tax (VAT). A foreign exporting company that manufactures products in Country A typically receives a rebate of the 15 percent VAT when its goods are exported. The tax burden of a U.S. product consists mainly of income tax. An exporting NAM member (and around 80 percent do export) receives no tax rebate when its products are exported from the United States but finds that these products are subject to a 15 percent VAT when they are imported into Country A. In some cases, the 15 percent tax on the value of the goods may actually exceed the normal profit margin of the item. As the United States does not use a VAT and therefore does not impose such on imported goods, domestically produced goods that are exported sustain the full effect of the U.S. tax burden plus the VAT of Country A, while imported products sustain only a portion of this heavy tax burden. This has the effect of significantly favoring foreign products within the United States and discouraging U.S. exports.[1]

[1] *Fundamental Tax Reform*: Hearing Before the House Committee on Ways and Means, 106th Cong., 2d Sess. 270 (2000) (Statement of James E. Rose, Jr., Senior Vice President, Taxes and Government Affairs, Tupperware Corporation, Orlando, Florida; and Board Member and Chairman, Tax and Budget Policy Committee, National Association of Manufacturers).

The foregoing statement succinctly describes the situation that U.S. producers and exporters face in competing with products from countries that assess, and rebate upon export, value-added taxes and other indirect-type taxes. U.S. exporters are at disadvantage because they are subjected to double taxation (*i.e.*, U.S. income tax and foreign VAT) and U.S. producers are at a disadvantage because imports into the United States are not subject to U.S. taxes at the border and benefit from subsidies (in the form of rebates of value-added and other indirect taxes) that are not reachable under WTO disciplines.

Under GATT/WTO rules, indirect taxes (such as value-added taxes) are border adjustable, that is, they may be rebated on exports and collected on imports, but the same treatment is not permitted for direct taxes (such as income taxes). Indeed, the rebate of direct taxes is considered a prohibited export subsidy under GATT/WTO rules. (The historical background to this distinction is reviewed in section II). Because the United States tax system relies primarily on direct taxes, the differential treatment of direct and indirect taxes under international trade rules puts U.S. exporters and producers at a profound competitive disadvantage with countries that rely to a greater extent on indirect taxes (*e.g.*, value-added taxes).

Indirect Tax Countries (*e.g.*, VAT countries)		**Direct Tax Countries (*e.g.*, U.S.)**	
Exports:	exempt from, or receive rebates of, indirect taxes	**Exports:**	no exemption from, and no rebates of, direct taxes
Imports:	indirect taxes are imposed	**Imports:**	no direct taxes are imposed

The following table illustrates the price effects of the disparate treatment of direct and indirect taxes upon U.S. exports to VAT countries. The table makes the following assumptions: (1) a product with a pre-tax price of $100; (2) 10% VAT; (3) 10% direct taxes passed on to the buyer; and (4) 5% duties and movement charges.

Price Effects of Disparate Treatment of Direct and Indirect Taxes on U.S. Exports

	Product of VAT Country			Product of United States		
	Exported to VAT country	**Exported to U.S.**	**Consumed domestically**	**Exported to VAT country**	**Exported to Non-VAT country**	**Consumed domestically**
Pre-Tax Price, FOB Port of Export	$100	$100	$100	$100	$100	$100
Taxes in Country of Origin	0	0	10%	10%	10%	10%
Duties and Movement Charges	5%	5%	0	5%	5%	0
Border Taxes in Destination Country	10%	0	0	10%	0	0
Total Price to Consumer	$115.50	**$105**	$110	**$127.05**	$115.50	$110

The foregoing table shows that there is no price effect on exports from one VAT country to another VAT country or from one non-VAT country to another non-VAT country. However, for exports from a non-VAT country, such as the United States, to a VAT country and from a VAT country to a non-VAT country, the price effects are striking – both U.S. exporters and U.S. producers are substantially disadvantaged vis-à-vis competition with products of VAT countries.

The scope and effect of the disadvantage to U.S. exporters and producers from the border treatment of indirect taxes is broad. 137 countries and territories have tax systems that include value-added taxes. All of these countries assess a VAT on imports and virtually all exempt exports from the VAT. Countries applying a VAT account for 94% of U.S. exports and imports.

One can broadly estimate the impact of the differential border treatment of direct and indirect taxes on U.S. exporters and producers by reviewing annual U.S. trade in goods data. If one multiplies the standard VAT rates for all VAT countries in 2006 by the amount of U.S. goods exports to and imports from those countries in 2006, it can be estimated that foreign goods exported to the United States from VAT countries received subsidies (*i.e.*, VAT rebates) approximating $217 billion, and that exports of U.S. goods to VAT countries were burdened with VAT assessments approximating $110 billion. In sum, the border treatment of VAT competitively disadvantaged U.S. exporters and producers of goods by an estimated total of $327 billion in 2006.[2]

VAT Disadvantage in U.S.-World Trade[3]

	U.S. 2006 Exports FAS value ($)	U.S. 2006 Imports Customs value ($)	VAT Collected on U.S. Exports ($)	VAT Subsidy to U.S. Imports ($)
Total for VAT Countries	**884,099,555,944**	**1,778,103,137,964**	**110,291,982,671**	**217,107,460,940**
Total VAT Disadvantage in 2006			**$327,399,443,611**	

[2] This estimate both overcounts and undercounts the VAT effects as it does not account for lesser rates and exemptions or account for a higher VAT rate on U.S. exports due to assessment on a landed duty cost basis. It should be noted also that this estimate is based only on traded goods data. As many VAT countries also apply indirect taxes to services (*e.g.*, a GST, or goods and services tax), U.S. exporters and providers of services are also disadvantaged with respect to services to the extent of their trade with such countries.

[3] Data sources for the table are: Import and export statistics from U.S. Census Bureau, Foreign Trade Statistics (domestic exports and imports for consumption); VAT rates for world from U.S. Agency for International Development, *VAT Revisited* (October 2005); Deloitte Touche Tomatso, "Global Indirect Tax Rates," at http://www.deloitte.com; World Trade Organization, Trade Policy Reviews, at http://www.wto.org; International Monetary Fund, Article IV Reviews, at http://www.imf.org; World Bank, "Doing Business," at http://www.doingbusiness.org; U.S. Trade Representative, 2007 National Trade Estimate Report on Foreign Trade Barriers, at http://www.ustr.gov; U.S. Department of Commerce, "Country Tariff and Tax Information," at http://www.export.gov.

Economists have found that the differential treatment of direct and indirect taxes with respect to border adjustability results in significant economic effects on U.S. exporters and producers. A recent study by Jerry Hausman, Professor of Economics at the Massachusetts Institute of Technology, in May 2006 entitled *An Economic Analysis of WTO Rules on Border Adjustability of Taxes*, found that the "current situation leads to extremely large economic distortions."[4] Professor Hausman posits the following hypothetical:

> Consider the case of a semiconductor chip model made by a producer such as AMD using identical technology in 2 countries: the US, and Germany with possible exports to China. If the chip is produced in the US AMD must pay US corporate income taxes to help fund the government. If AMD attempts to sell the chip in Germany, the chip is subject to 16% VAT so the price is 1.16 (using 1.00 as the base price in the US). However, if the price is 1.00 (in the same units in Germany) after the export rebate the price is 0.86 for export to the US. The price of the US produced chip in China is 1.17 after payment of China's 17% VAT, while the price of the German chip in China is 1.01.
>
> Thus, US exports pay both US taxes and the German tax for exports to Germany, while German exports to the US pay neither. This situation leads to large economic distortions in both trade and investment decisions. For exports to a third country, German exporters are receiving a subsidy while US exporters are receiving no subsidy. For products such as computer chips which have high value to weight ratios and are readily transported, choice of tax system by the origin country can have very large effects on competitiveness of different industries. Further, both investment and production decisions will be affected by these tax and adjustment differences given the importance of international trade in these high-technology industries.[5]

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[4] Jerry Hausman, *An Economic Analysis of WTO Rules on Border Adjustability of Taxes* (May 2006); available at http://www.standupforsteel.org/news_releases_detail.php?page=05-10-2006_full_study.

[5] *See* Jerry Hausman, *An Economic Analysis of WTO Rules on Border Adjustability of Taxes* (May 2006) (emphasis added).

Professor Hausman also found that the effect of the differential treatment of direct and indirect taxes on investment decisions could exacerbate and spread its economic impact by encouraging relocation of manufacturing facilities and lowering U.S. living standards.

> Once the dynamic effects of the distortions on investment are analyzed, the magnitude of the problem increases greatly. Countries that adjust their VAT policies to subsidize exports and tax imports will cause a longer term decrease in investment in the US, decreasing manufacturing capacity and leading to a worsening of the trade balance. A further problem arises if the ability to improve manufacturing processes and innovate in terms of R&D is influenced by proximity to manufacturing. Especially in high technology manufacturing industries where output yield is a crucial variable for profitability, process innovations are an extremely important economic factor. If tax distortions cause "excess" location of US manufacturing capacity to "VAT favorable" countries, over the longer term increases in US productivity gains and innovation are also likely to be distorted and be lower than otherwise if the distortion did not exist. Economists generally agree that over the longer term these increases in US productivity gains and innovation are among the economic factors that determine the US standard of living.
>
> The decreased investment in the US that arises from the distortion on investment returns will lead to a lower US capital stock, which will lead to decreased wages to workers. This lower wage effect as well as reduced wages from decreased productivity will harm US workers. Since wages and return to capital employed are the two major factors that determine the US standard of living, the distortions created by differential treatment of taxation can have important economic effects.
>
> As the US economy increasingly competes in world markets these tax difference become increasingly important.[6]

In his study, Professor Hausman estimated the effect of the current differential treatment of direct and indirect taxes on U.S. exports and imports by reviewing the 2004 trade data for the 20 largest trading partners of the United States. With respect to exports, using export elasticities

[6] *See* Jerry Hausman, *An Economic Analysis of WTO Rules on Border Adjustability of Taxes* (May 2006).

of 1.50 or 1.36, Professor Hausman estimated that, if a VAT was not imposed by U.S. trading partners, U.S. exports would increase by 15.3% or 13.9%, respectively.[7] Professor Hausman concluded: "Both of these estimated effects are substantial and would lead to an increase in the dollar value of US exports of approximately $100 billion in 2004. . . . These results demonstrate the economic significance of current distortions created by disparate border tax adjustments."[8]

Similarly, with respect to imports, using import elasticities of 0.30 or 0.23, Professor Hausman estimated that, if U.S. trading partners did not rebate VAT on exports, U.S. imports from such countries would decrease by 3.7% or 2.8%, respectively, amounting to a reduction in imports ranging from $30-$41 billion based on 2004 import levels.[9] In sum, Professor Hausman concludes that quantification of the disparate treatment of direct and indirect taxes demonstrates that "the economic implications for the United States are very large."[10]

Other economists have reached similar conclusions about the economic effects of the disparate border adjustability of direct and indirect taxes on U.S. exporters and producers. For example:

> European countries (and many others) routinely exempt their exports from value added tax. This saves European exporters about $100 billion a year of tax payments on export sales. . . . Parallel tax savings are not available to U.S. exporters.[11]

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7 *See* Jerry Hausman, *An Economic Analysis of WTO Rules on Border Adjustability of Taxes* (May 2006).

8 *See* Jerry Hausman, *An Economic Analysis of WTO Rules on Border Adjustability of Taxes* (May 2006).

9 *See* Jerry Hausman, *An Economic Analysis of WTO Rules on Border Adjustability of Taxes* (May 2006).

10 *See* Jerry Hausman, *An Economic Analysis of WTO Rules on Border Adjustability of Taxes* (May 2006).

11 *See* Gary Hufbauer, Ernest Christian and Harold Adrion, *Springing Tax Reform From a Bad WTO Case* (Tax Notes, April 17, 2000); available at http://www.cstr.org/commentaries/taxreform/taxnotes-springing2000.html.

> As the only OECD nation without border-adjusted taxation, the United States is the most profitable market for foreign competitors, including their home markets. In effect, their exports to the United States are incentivized to the extent of their VAT rebate (on average 17.7 percent) for either higher profit, unfair competitive advantage, or a combination of the two. At the same time, they enjoy the same advantage in their home markets versus U.S. competition as a consequence of the VAT added to U.S. income taxes contained in imports.[12]

In addition, a recent paper issued by the Manufacturers Alliance/MAPI in March 2007 entitled *U.S. Exporters Beware: European Countries Pressured To Raise Value Added Taxes* found that U.S. companies were at a competitive disadvantage due to two long-term tax trends -- increases in value added taxes (VATs) that are imposed by other countries and ever-less competitive U.S. corporate income taxes.[13] With respect to VAT, the MAPI paper finds that, when border adjusted, value-added taxes are harmful to U.S. companies because, as they enable governments to collect more tax revenue, U.S. firms bear a "larger share of the heavier tax burden" relative to their foreign rivals.[14] In addition, the MAPI report notes that many VAT countries use their additional VAT revenue to finance government-provided health care and retirement benefits, "benefits that U.S. exporters are expected to provide without government assistance."[15] As a result, "U.S. exporters pay twice for worker benefits: once for their own

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[12] *See* David A. Hartman, *The Urgency of Border-Adjusted Federal Taxation* (Tax Notes, September 6, 2004) at 1080; available at http://www.americanproducers.org/hartmantaxnotes.pdf.

[13] *See* Garrett A. Vaughn, *U.S. Exporters Beware: European Countries Pressured To Raise Value Added Taxes* (Manufacturers Alliance/MAPI, February 2007) at 1-2. The MAPI report is available for purchase at http://www.mapi.net/AM/Template.cfm?Section=News_Archive1&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=3604.

[14] *See* Garrett A. Vaughn, *U.S. Exporters Beware: European Countries Pressured To Raise Value Added Taxes* (Manufacturers Alliance/MAPI, February 2007) at 1. *See also* Manufacturers Alliance/MAPI news release, *MAPI International Tax Analysis: Border Adjusted Value Added Taxes Harm U.S. Firms*, March 15, 2007; http://www.mapi.net/AM/Template.cfm?Section=News_Archive1&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=3604.

[15] *See id.*

workers and once more for the workers employed by their foreign rivals."[16] Thus, the MAPI report concludes, "Border adjustment's role in shifting tax burdens means real economic harm for U.S. manufacturers will follow from the fiscal trends pushing European countries toward heavier VATs" and "higher VATs will curb imports substantially – including imports from the United States."[17]

Some economists discount the economic effect of the disparate border treatment of direct and indirect taxes by arguing that any negative trade effects that may result from border-adjusting indirect taxes are balanced by exchange-rate adjustments. However, other economists respond that while this may be what economic theory predicts, in fact exchange rates do not offset the real disadvantages experienced by U.S. exporters and producers. Two examples cogently express this response. First, Professor Hausman:

> Of course, it has been claimed that in the long run changes in exchange rates or other economic variables will happen in the market to eliminate many of these problems. But economic experience has demonstrated that exchange rates may not fully adjust or take extremely long periods to adjust so that the price adjustment then occurs through domestic prices and wages. * * * Thus, waiting for economic adjustment through exchange rate adjustment is unlikely to solve the distortions that arise from differential tax and subsidy treatment of exports and imports. Instead, adjustment of domestic prices and wages are more likely to be affected by the distortions created by differential rebate and subsidy policies of imports and exports.[18]

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16 *See id.*

17 *See* Garrett A. Vaughn, *U.S. Exporters Beware: European Countries Pressured To Raise Value Added Taxes* (Manufacturers Alliance/MAPI, February 2007) at 2. *See also* Manufacturers Alliance/MAPI news release, *MAPI International Tax Analysis: Border Adjusted Value Added Taxes Harm U.S. Firms*, March 15, 2007.

18 *See* Jerry Hausman, *An Economic Analysis of WTO Rules on Border Adjustability of Taxes* (May 2006). Professor Hausman also points out that China, one of the largest trading partners of the United States, does not have a freely floating currency. *See id.*

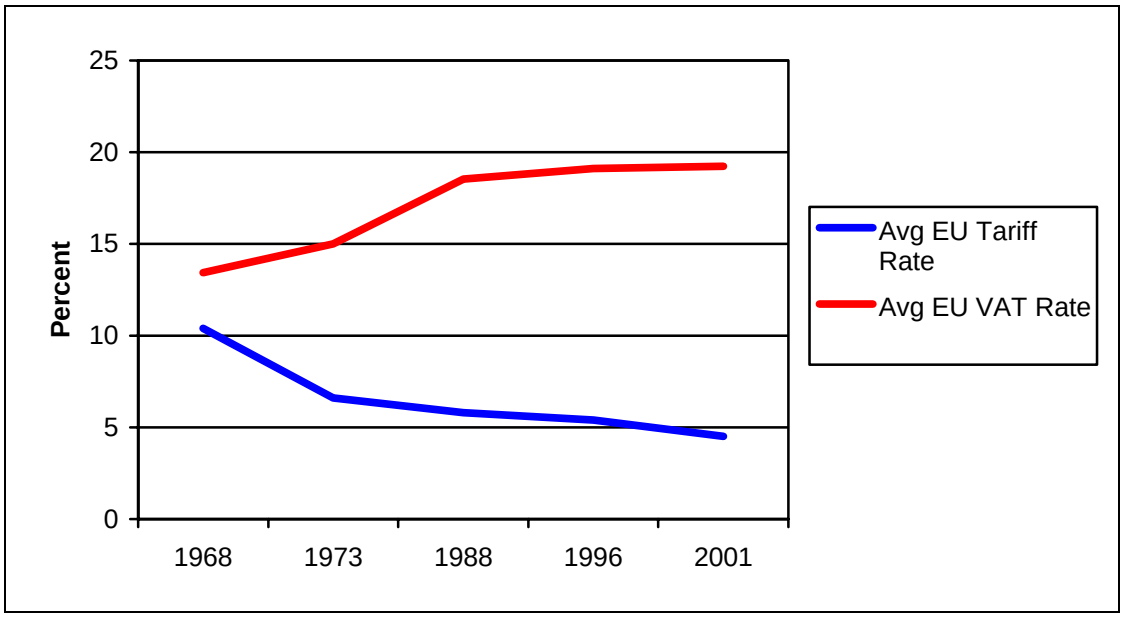
Second, Gary Hufbauer:

> In economic theory, border adjustments for uniform businesses {sic} taxes are equivalent to exchange rate adjustments of approximately the same magnitude. So given that theoretical equivalence, the classic answer to national differences in business tax systems is that exchange rate adjustments will eventually offset any tax differences, . . . and wash away any permanent effect on business location, decisions or competitive disadvantage.
>
> So according to the classic logic, business firms in neither the exporting country nor the importing country should care where their business taxes are adjusted at the border. But there we have the theory. On the other hand, we have the practice, and the practice is they do care, and they care a lot.
>
> No country has imposed a VAT, or at least no country of any significance, without adjusting at the border. If they believe their classic theory, they would say, hey, the exchange rate will take care of it, no need to adjust. They do not believe it, and they have adjusted instead.[19]

In addition, there is an important, but overlooked factor, which is exacerbating the competitive disadvantage and discriminatory impact of VAT on U.S. exporters and producers. That factor is trade liberalization and the trend to replace lost tariff revenue with value added taxes. Over the last 40 years, as countries have agreed to reduce their import tariffs they have turned increasingly to value-added and other indirect domestic taxes to make up for reduced import tariff revenue. This trend is an observable fact. For example, as demonstrated in the table and chart below, a comparison of tariff reductions agreed to, and VAT rates imposed by, the EU over time shows that the reduction in tariffs corresponds almost precisely with an increase in VAT rates.

[19] *See The Rebate of Value-Added Taxes at the Border and the Competitive Disadvantage for US Small Businesses*, Hearing before the House Committee on Small Business, 108th Cong., 2d Sess. 3 (July 7, 2004) (statement of Gary C. Hufbauer, Institute for International Economics).

EU Tariff Rates and VAT Rates: 1968 – 2001[20]					
	1968	**1973**	**1988**	**1996**	**2001**
Tariff Rates	10.4%	6.6%	5.8%	5.4%	4.5%
VAT Rates	13.44%	15.01%	18.54%	19.11%	19.24%
EU-25 Countries with VAT	3	11	15	24	25



[20] Data sources for Table and Chart:

Tariff Rates: For 1968 & 1973: simple average MFN tariff rates on industrial products applied by EU countries. *See* P. Hoeller, N. Girouard & A. Clecchia, *The European Union's Trade Policies and Their Economic Effects*, OECD Economics Department Working Papers No. 194, OECD ECO/WKP(98)7 (1998) at 22. For 1988, 1996 & 2001: simple average MFN tariff rates applied by EU countries on imports of non-agricultural and non-fuel products in 1996. *See* UNCTAD Handbook of Statistics; available at http://stats.unctad.org/Handbook/TableViewer/tableView.aspx.

VAT Rates: simple averages of standard VAT rates in effect in EU countries in the relevant year. *See* European Commission, *VAT Rates Applied in the Member States of the European Community*, DOC/1829/2006 (Sept. 1, 2006); available at http://stats.unctad.org/Handbook/TableViewer/tableView.aspx.

EU-25 Countries with VAT: based on the year of VAT adoption for each of the EU-25 countries. *See* R.M. Bird & P. Gendron, *VAT Revisited: A New Look at the Value Added Tax in Developing and Transitional Countries*, USAID (2005) at pp. 167 – 169.

The widening gap in the EU between tariff rates and VAT rates is only likely to increase; indeed, Germany recently raised its VAT rate from 16% to 19%, effective January 1, 2007.

China has followed this trend as well. As China prepared for accession to the WTO over the 1990s, it liberalized its trade regime by, *inter alia*, reducing tariffs.

> The pace of tariff reform in China has also been rapid. While average tariffs were high in the early 1990s, they fell sharply after 1994. Significant tariff reform was implemented in October 1997, reducing average tariffs below 20 per cent. . . . Progressive reductions in tariffs since1992 have reduced average tariffs by more than half and even more in the manufacturing sector.[21]

During the 1990s, China's simple mean import tariff for all products declined from 42.9% (1992) to 39.9% (1993) to 36.3% (1994) to 23.6% (1996) to 17.6% (1997) and to 17.5% (1998).[22] Over the same period, China undertook major reform of its tax system in 1994, and in particular, introduced a value-added tax, which has become China's main indirect tax, accounting for about 37% of total tax revenue in 2004.[23] Since 1994, China's VAT has been "levied at a standard rate of 17%, with a reduced rate of 13% on some items, and exemptions for others."[24]

As part of its WTO accession commitments, China has continued to reduce its import tariffs.

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[21] Elena Ianchovichina & Will Martin, *Trade policy reform and China's WTO accession*, in China and the World Trading System (eds., D.Z. Cass, B.G. Williams, & G. Barker) (Cambridge, 2003) at 97-98.

[22] *See* World Bank: *1999 World Development Indicators* at p. 340 (Table 6.6).

[23] *See Trade Policy Review – People's Republic of China; Report by the Secretariat*, WT/TPR/S/161/Rev.1 (26 June 2006) at p. 115-116, paras. 189, 191. China's VAT was introduced pursuant to the *Provisional Regulations on Value Added Tax*, adopted by the State Council on 26 November 1993 and effective 1 January 1994. *See id.* at 116, para. 191.

[24] *See Trade Policy Review – People's Republic of China; Report by the Secretariat*, WT/TPR/S/161/Rev.1 (26 June 2006) at p. 116, para. 191.

China's simple average applied rate (%)	2001	2002	2003	2004	2005
	15.6	12.2	11.1	10.2	9.7

Source: *Trade Policy Review – People's Republic of China; Report by the Secretariat*, WT/TPR/S/161/Rev.1 (26 June 2006) at p. 65 (Table III.1).

The Trade Policy Review of China conducted in 2006 noted:

> China has progressively lowered its MFN tariff and reduced non-tariff barriers to trade. Nonetheless, the tariff remains one of China's main trade policy instruments and a significant source of tax revenue (accounting for some 4.3% of total taxes collected). In 2005, the overall average MFN tariff was 9.7%; the averages for agricultural and non-agricultural products were 15.3% and 8.8%, respectively.[25]
>
> * * *
>
> The average applied MFN rate in 2005 is 9.7%, (9.8% including the AVEs based on the authorities' data) down from 17.6% in 1997, 15.6% in 2001 before China became a Member of the WTO, and 12.2% in 2002 just after it acceded to the WTO.{*Footnote omitted*} The tariff is higher for agricultural products, 15.3% (15.2% including AVEs), according to the WTO definition of agriculture, although it has declined from 23.1% in 2001 and 18.2% in 2002. The average tariff for non-agricultural products is 8.8% (8.9% including AVEs), declining from 14.4% in 2001 and 11.2% in 2002 (Table III.1); 15.6% of tariffs exceed 15% (international tariff peaks), down from 40.1% in 2001.[26]

Interestingly, the referenced footnote that is omitted in the foregoing excerpt states:

> Tariffs tend to be a relatively "expensive" type of tax distortion. Hence, a tariff cut, financed by raising indirect taxes to compensate the Government for the lost revenue would increase welfare. More specifically, for each dollar of tax revenue raised in China, the welfare gain could be as much a US$0.29 if the Government

[25] *See Trade Policy Review – People's Republic of China; Report by the Secretariat*, WT/TPR/S/161/Rev.1 (26 June 2006) at p. 60, para. 2.

[26] *See Trade Policy Review – People's Republic of China; Report by the Secretariat*, WT/TPR/S/161/Rev.1 (26 June 2006) at p. 68, para. 26.

> switched from tariffs to output taxes as the revenue collecting policy instrument.[27]

This footnote by the WTO Secretariat in China's Trade Policy Review Report reflects the fact that the trend of tariff reductions with corresponding increases in VAT or other indirect domestic taxes is not just an incidental or inevitable consequence of trade liberalization. In fact, the policy has been actively promoted and advanced by major international economic development organizations such as the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD). The following selected excerpts from publications by these organizations illustrate how the VAT-for-tariffs policy is being promoted.

From IMF publications:

> Standard policy advice for countries facing a loss of trade tax revenue as a consequence of trade liberalization emphasizes increasing domestic consumption taxes, both excises and (the particular concern here) the VAT. More specifically, a conventional prescription is to respond to a cut in the tariff on some good by increasing the consumption tax on the same item by the same amount (or slightly less). This evidently preserves the gain in production efficiency from the tariff cut itself; for a small economy, it leaves the consumer price unchanged (or slightly lower), so that consumer welfare increases; and, since tax is now levied on domestic production as well as imports, government revenue increases. This simple strategy thus enables a welfare gain to be realized from trade liberalization without any reduction in aggregate tax revenue. Note too that this strategy is equivalent, in the simplest case, to one of combining a tariff cut with whatever increase in the consumption tax is needed to keep the consumer price constant ….[28]

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[27] *See Trade Policy Review – People's Republic of China; Report by the Secretariat*, WT/TPR/S/161/Rev.1 (26 June 2006) at p. 68, para. 26, fn. 16 (*citing* Erbil, Can (2004), *Trade Taxes are Expensive*, mimeo).

[28] *See* Michael Keen, *VAT, Tariffs, and Withholding: Border Taxes and Informality in Developing Countries*, IMF Working Paper WP/07/174 (July 2007) at 18 (emphasis added); available at http://www.imf.org/external/pubs/ft/wp/2007/wp07174.pdf.

Trade tax revenue has become less important over the past 20 years as countries have reduced tariffs, but it continues to be a major source of government finance in many low and middle-income countries, commonly accounting for one-fifth of total tax revenue, and often more. To the extent that trade liberalization cuts tariff revenues, these countries may have to develop other sources of government finance. . . . {S}ome low-income countries—including Malawi, Senegal, and Uganda—have succeeded in recovering their lost trade tax revenues. In all of these cases, a significant part of the revenue recovery came from strengthening domestic consumption taxes— excises and, typically, a VAT (value-added tax). . . . These success stories demonstrate that the difficulties are not so much technical as political: policymakers need to have a strong commitment to reforming domestic tax systems. Their experience offers useful lessons. Liberalization itself can limit revenue loss and even increase net revenue to the extent that it spurs growth and imports—especially if nontariff barriers, whose elimination raises revenues, are cut. But with deeper tariff reform, revenue recovery also requires a committed and continuous effort, over several years, to broaden tax bases, purge exemptions, simplify rate structures, and improve revenue administration. Strengthening the domestic consumption tax system through excises and, especially, through a simple, broad-based VAT, can have a crucial role to play in this regard, ….[29]

The formal theory of policy reform offers little guidance on what is in practice one of the more pressing reform issues facing many developing countries: how to secure the efficiency gains from eliminating remaining tariff barriers--often still considerable--while preserving the public (tax plus tariff) revenues. This paper has developed and explored one very simple strategy for doing so: simply offset tariff reductions, point-for-point, with increases in destination-based consumption taxes, thereby leaving consumer prices unchanged. For a small open economy, it has been shown, coordinated reforms of this kind are certain to increase both welfare and public (tax plus tariff) revenues, so long as the underlying tariff reform improves production efficiency.

[29] *See* IMF, *Integrating Poor Countries into the World Trading System*, Economic Issues No. 37 (2006) at 9-11 (emphasis added); available at http://www.imf.org/external/pubs/ft/issues/issues37/ei37.pdf.

> This result provides a clear rationale for the importance commonly attached to the development of domestic sales taxes, notably the value-added tax, as an accompaniment to tariff reform.[30]

> Reform of tax policy and of tax and customs administration, by protecting the revenue base, provide essential support to trade liberalization. Successful trade liberalization can be greatly facilitated if steps are taken to strengthen domestic taxes, especially at the earliest stages of the process, because it takes time for tax and customs administrations to improve revenue collection.
>
> * * *
>
> The best tax systems are those that cause a minimum of distortion in the allocation of resources, are equitable, and are relatively easy to administer. In practice, comprehensive tax and tariff policy reforms typically include most or all of the following:
>
> - A broad-based consumption tax, notably a VAT, should be introduced or strengthened, preferably with a single rate, minimal exemptions, and a threshold to exclude smaller enterprises from taxation. Although VATs are often initially applied to manufactures and imports, they are typically subsequently extended to the distribution sector and to agricultural inputs. Experience suggests that excise taxes should be restricted to a limited list of products, principally petroleum products, alcohol, and tobacco. VATs and excises should be applied equally to imports and domestic products.[31]

From OECD publications:

> The complementarity of a sound macroeconomic framework and trade policy reform is illustrated by the use of tax policy in compensating for tariff revenue loss resulting from trade liberalisation.
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> * * *

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[30] *See* Michael Keen & Jenny E. Ligthart, *Coordinating Tariff Reduction and Domestic Tax Reform*, IMF Working Paper WP/99/93 (July 1999) at 18; available at http://www.imf.org/external/pubs/ft/wp/1999/wp9993.pdf.

[31] *See* Liam Ebrill, Janet Stotsky, & Reint Gropp, *Revenue Implications of Trade Liberalization*, IMF Occasional Paper No. 180 (1999) at 7-8 (emphasis added).

> The degree of reliance on import duties as a source of government revenue differs considerably among countries and so will the adjustment requirements. A recent OECD study demonstrates that where tariff revenue losses are replaced with a consumption tax, there is significant scope for obtaining positive welfare gains from a joint package of tariff and tax reform without compromising government revenue.[32]

> The recent policy advice in the area of fiscal implications of trade liberalisation stresses the use of other taxes as a compensating measure. A shift away from trade taxes towards other forms of taxation such as income, sales or value added taxes has already been taking place for some time in many countries. In fact, the need to offset revenue losses from trade liberalisation by strengthening domestic taxation has in many cases been a key consideration in the adoption of the VAT. . . .
>
> The recommendation to shift away from trade taxes towards domestic consumption and income taxes reflects the consensual view that trade taxes are a relatively inefficient way of raising revenue. . . .
>
> This has formed the basis for the policy advice by the IMF and the World Bank that have, for some time now, been advocating and supporting a move towards more broadly-based tax systems in developing countries. . . .[33]

Moreover, even the United States has encouraged other nations to consider adopting the policy of using indirect taxes like the VAT to replace lost tariff revenue resulting from trade liberalization. In the Doha trade negotiations, the United States submitted a paper to the Negotiating Group on Non-Agricultural Market Access (NAMA) entitled *Revenue Implications for Trade Liberalization.* The paper notes that during discussion of NAMA modalities a number

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[32] *See* OECD, *Trade and Structural Adjustment* (2005) at 11, 21 (emphasis added); available at http://www.oecd.org/dataoecd/58/40/34753254.pdf.

[33] *See* Przemyslaw Kowalski, *Impact of Changes in Tariffs on Developing Countries' Government Revenue*, OECD Trade Policy Working Paper No.18, TD/TC/WP(2004)29/FINAL (18 April 2005) at 24-25 (emphasis added); available at http://www.olis.oecd.org/olis/2004doc.nsf/7b20c1f93939d029c125685d005300b1/05d329f09bb681ecc1256fe700484717/$FILE/JT00182548.PDF.

of developing countries were concerned about the "revenue implications of trade liberalization" because they rely on tariffs as an important source of government revenue and the "elimination of tariffs could have serious consequences for their fiscal stability."[34] To address these concerns, the U.S. paper reviews favorably the "tariff revenue trends in the context of ongoing programs of fiscal and tax reform."[35]

> Trade liberalization, when accompanied by sound macroeconomic and fiscal policies, including reform of domestic tax regimes, provides a significant opportunity for developing countries to stimulate growth and reduce poverty.[36]
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>
> With the proliferation of free trade agreements in all regions, many governments are already facing the revenue issue and are responding positively by eliminating tariffs and improving taxes. Most developing countries in Latin America, the Middle East, and Europe already rely primarily on other revenue sources. Asian countries, which in many cases are more reliant on import duties, have already demonstrated a capacity to expand revenue through non-trade taxes such as value-added taxes, other taxes on goods and services, and income taxes.
>
> * * *
>
> The revenue effects of trade liberalization can be mitigated by building on the domestic tax reforms that are already underway, with the advice and assistance of the international financial institutions.
>
> * * *
>
> For those countries that need assistance, the international financial institutions, particularly the IMF and World Bank, can provide

[34] Market Access for Non-Agricultural Products, *Revenue Implications of Trade Liberalization*, Communication from the United States, TN/MA/W/18/Add.2 (11 April 2003) at para. 2.

[35] Market Access for Non-Agricultural Products, *Revenue Implications of Trade Liberalization*, Communication from the United States, TN/MA/W/18/Add.2 (11 April 2003) at para. 3.

[36] Market Access for Non-Agricultural Products, *Revenue Implications of Trade Liberalization*, Communication from the United States, TN/MA/W/18/Add.2 (11 April 2003) at para. 4.

> advice and assistance for countries willing to undertake tax and trade reform efforts in the context of sound economic programs.
>
> * * *
>
> Virtually all developing countries already have income tax systems in place, and most developing countries have value-added taxes (VATs), including almost half of the least developed countries. For developing countries as a group, there generally appears to be an inverse relationship between a country's dependence on a value-added tax (VAT) for revenue and its dependence on import duties. This suggests that there may be substantial capacity to shift from import duties to other taxes, even among the least developed countries.[37]

> The IMF has outlined a number "best practices" for implementing comprehensive tax and tariff reforms.[38] The best tax systems are those that cause a minimum of distortion in the allocation of resources, are equitable, and are relatively easy to administer. In practice, comprehensive tax and tariff policy reforms typically include most of the following:
>
> - A broad-based consumption tax, such as a value-added tax (VAT), should be introduced or strengthened. Such taxes should be applied equally to imports and domestic production, preferably with a single rate, minimal exemptions, and a threshold to exclude smaller enterprises from taxation. These taxes may have the greatest potential to replace tariffs as a source of revenue and would envision a continuing role for customs services.[39]

Whether knowingly or not, the United States' support of the VAT-for-tariffs policy undermines the express congressional trade negotiating objective directed at correcting the disparate treatment of border taxes under WTO rules. Moreover, in practical terms, encouraging

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[37] Market Access for Non-Agricultural Products, *Revenue Implications of Trade Liberalization*, Communication from the United States, TN/MA/W/18/Add.2 (11 April 2003) at para. 6.

[38] Market Access for Non-Agricultural Products, *Revenue Implications of Trade Liberalization*, Communication from the United States, TN/MA/W/18/Add.2 (11 April 2003) at para. 16 (*citing* Ebrill, Stotsky, and Gropp, *Revenue Implications of Trade Liberalization*, IMF Occasional Paper 180 (1999)).

[39] Market Access for Non-Agricultural Products, *Revenue Implications of Trade Liberalization*, Communication from the United States, TN/MA/W/18/Add.2 (11 April 2003) at para. 16.

this policy fosters the VAT disadvantage. As U.S. exporters and producers theoretically benefit from tariff cuts by other countries, if those same countries then impose a new VAT or increase an existing VAT to compensate for the reduction in tariff revenue, the U.S. exporter and producer faces the same charges on importation. While domestic product also pays the VAT, it may be accompanied by reductions in direct taxes and in any event is not assessed (or is rebated) on exports.

In sum, while trade liberalization is a worthy goal of U.S. trade policy, the trend of tariff reductions with corresponding VAT introduction or increases works to intensify the long-standing discrimination and competitive disadvantage that U.S. exporters and producers have endured as a result of the GATT/WTO rules imposing differential border adjustability of direct and indirect taxes.

II. HISTORICAL BACKGROUND TO THE DIFFERENTIAL TREATMENT OF INDIRECT AND DIRECT TAXES IN INTERNATIONAL TRADE WITH RESPECT TO BORDER ADJUSTABILITY

A. Border Adjustability of Taxes

The effect of border tax adjustments on international trade has been a controversial issue for at least four decades. The controversy stems from the fact that the international trade rules established by the General Agreement on Tariffs and Trade (GATT) and continued by the World Trade Organization (WTO) treat direct taxes and indirect taxes differently. As one scholar has noted, the GATT/WTO rules are "deliberately asymmetric: they permit adjustment for indirect taxes (such as sales and value-added taxes) but not for direct taxes (such as corporate or

individual income taxes)."[40] The United States relies primarily upon a direct tax system, and direct taxes are not adjustable at the border. The rest of the world relies to a significant degree upon indirect tax systems, and indirect taxes are adjustable at the border. Thus, the United States has complained for many years that the GATT/WTO rules on the border adjustability (or not) of indirect and direct taxes has worked to the disadvantage of U.S. businesses.

At the time that the GATT was adopted in 1947, it was a common economic belief that indirect taxes were fully passed along to the ultimate buyer in the price of the good, but that direct taxes were not passed on to the price of goods. In an attempt to achieve tax neutrality in the trade of goods, the drafters of the GATT decided to apply the "destination principle" of taxation to the treatment of indirect taxes and the "origin principle" of taxation to the treatment of direct taxes.

The "destination principle" of taxation holds that products should be taxed according to where they are used or consumed, regardless of the place of production. Thus, under the "destination principle," domestic taxes paid on products that are exported would be rebated while imported products would be subject to the same domestic taxation as domestic products in the importing country. In contrast, the "origin principle" holds that products should be taxed according to where they originate or are produced, regardless of where they are consumed. Thus, under the "origin principle," products would be subject to domestic taxation but upon exportation would not receive any rebates of domestic taxes nor would imported products be subject to domestic taxes. Again, as this differential treatment flowed from the economic

[40] Gary C. Hufbauer, *Fundamental Tax Reform and Border Tax Adjustments* (Institute for International Economics, 1996), at vii.

assumptions of the time that indirect taxes were fully pushed forward into the price of a product but that direct taxes were not, it seemed equitable to apply the destination principle to indirect taxes in order to achieve tax neutrality.

B. 18th and 19th Century Examples of the Application of Border Tax Adjustments

The application of the destination principle to the border adjustability of indirect taxes has a long history. For example, in 1791, the First Congress passed an excise tax on distilled spirits that provided for the remission of the excise tax when the product was exported.

> Sec. 15 *And be it further enacted*, That upon all spirits which after the said last day of June next, shall be distilled within the United States, from any article of the growth or produce of the United States, in any city, town or village, there shall be paid for their use the duties following: . . .
>
> * * *
>
> And for the encouragement of the export trade of the United States:
>
> Sec. 51 *Be it further enacted*, That if any of the said spirits (whereupon any of the duties imposed by this act shall have been paid or secured to be paid) shall, after the last day of June next, be exported from the United States to any foreign port or place, there shall be an allowance to the exporter or exporters thereof, by way of drawback, equal to the duties thereupon, according to the rates in each case by this act imposed, deducting therefrom half a cent per gallon, ...[41]

Later in the 19th century, when the United States enacted excise taxes on alcohol (1868) and tobacco (1872), it provided for remission of such taxes upon the export of those products.[42]

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[41] Act of March 3, 1791 ("An Act Repealing, after the last day of June next, the duties heretofore laid upon Distilled Spirits imported from abroad, and laying others in their stead; and also upon Spirits distilled within the United States, and for appropriating the same"), 1 Cong. Ch. 15, March 3, 1791, 1 Stat. 199, 203, 210.

[42] *See* Gary C. Hufbauer, *Fundamental Tax Reform and Border Tax Adjustments* (Institute for International Economics, 1996), at 37.

Also, in the early 19th century, the economist David Ricardo articulated both the idea that indirect taxes are pushed forward into the price of a good and the rationale of the destination principle.

> The rise of wages, a tax on income, or a proportional tax on all commodities, all operate in the same way; they do not alter the relative value of goods, and therefore they do not subject us to any disadvantage in our commerce with foreign countries. We suffer indeed the inconvenience of paying the tax, but from that burthen we have no means of freeing ourselves.
>
> A tax, however, which falls exclusively on the producers of a particular commodity tends to raise the price of that commodity, and if it did not so raise it the producer would be under a disadvantage as compared with all other producers; he would no longer gain the general and ordinary profits by his trade. By rising in price, the value of this commodity is altered as compared with other commodities. If no protecting duty is imposed on the importation of a similar commodity from other countries, injustice is done to the producer at home, and not only to the producer but to the country to which he belongs. It is for the interest of the public that he should not be driven from a trade which, under a system of free competition, he would have chosen, and to which he would adhere if every other commodity were taxed equally with that which he produces. A tax affecting him exclusively is, in fact, a bounty to that amount on the importation of the same commodity from abroad; and to restore competition to its just level, it would be necessary not only to subject the imported commodity to an equal tax, but to allow a drawback of equal amount, on the exportation of the home-made commodity.
>
> The growers of corn are subject to some of these peculiar taxes, such as tithes, a portion of the poors' rate, and, perhaps, one or two other taxes, all of which tend to raise the price of corn, and other raw produce, equal to these peculiar burthens. In the degree then in which these taxes raise the price of corn, a duty should be imposed on its importation. If from this cause it be raised ten shillings per quarter, a duty of ten shillings should be imposed on the importation of foreign corn, and a drawback of the same amount should be allowed on the exportation of corn. By means of this duty and this drawback, the trade would be placed on the same footing as if it had never been taxed, and we should be quite sure

> that capital would neither be injuriously for the interests of the country, attracted towards, nor repelled from it.
>
> The greatest benefit results to a country when its Government forbears to give encouragement, or oppose obstacles, to any disposition of capital which the proprietor may think most advantageous to him. By imposing tithes, &c. on the farmer exclusively, no obstacle would be opposed to him, if there were no foreign competition, because he would be able to raise the price of his produce, and if he could not do so he would quit a trade which no longer afforded him the usual and ordinary profits of all other trades. But if importation was allowed, an undue encouragement would be given to the importation of foreign corn, unless the foreign commodity were subject to a duty, equal to tithes or any other exclusive tax imposed on the home-grower.
>
> But the home-grower would still have to complain, if he was refused a drawback on exportation, because he might then say, "Before your duty, and before the price of my produce was raised in consequence of it, I could compete with the foreign grower in foreign markets; by making the remunerating price of my corn higher, you have deprived me of that advantage, therefore give me a drawback equal to the duty, and you, in every respect, restore me to the position, as it regards both my own countrymen, as producers of other commodities, and foreign growers of raw produce, in which I was before placed." On every principle of justice, and consistently with the best interests of the country his demand should be acceded to.[43]

Moreover, 19th century treaties between European countries have been cited as examples of the long-standing application of the destination principle in international trade.[44]

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[43] David Ricardo, *Works and Correspondence of David Ricardo* (Liberty Fund Inc., 2004), Vol. IV at 217-219, *On Protection to Agriculture, 1822*; available at http://olldownload.libertyfund.org/EBooks/Ricardo_0687.04.pdf.

[44] *See* Gary C. Hufbauer, *Fundamental Tax Reform and Border Tax Adjustments* (Institute for International Economics, 1996), at 47. Hufbauer states: "A treaty drafted in 1862 between France and the Zollverein provided for the remission of consumption taxes on exports; a convention in 1882 between Great Britain and France contained the corollary provision that imported goods would be taxed no more heavily than domestically produced goods." *Id.*

C. 1946-1948 – Creation of the General Agreement on Tariffs and Trade (GATT)

The General Agreement on Tariffs and Trade (GATT) does not contain a unified or comprehensive provision that addresses the treatment of border taxes. Rather, the GATT rules on the border adjustability of direct and indirect taxes are found in several articles. With respect to taxes on imports, the relevant provisions of GATT 1994 are articles II and III.

Article II: Schedules of Concessions

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

Article III: National Treatment on Internal Taxation and Regulation

> 2. The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. . . .

With respect to the remission or exemption of taxes on exports, the relevant provisions of GATT 1994 are articles VI and XVI.

Article VI: Anti-dumping and Countervailing Duties

> 4. No product of the territory of any contracting party imported into the territory of any other contracting party shall be subject to anti-dumping or countervailing duty by reason of the exemption of such product from duties or taxes borne by the like product when destined for consumption in the country of origin or exportation, or by reason of the refund of such duties or taxes.

Article XVI: Subsidies
Interpretative Note Ad Article XVI

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

The provisions of the General Agreement on Tariffs and Trade (GATT) (Article II, III, VI, and XVI) that relate to the border treatment of direct and indirect taxes have their origin in documents drafted by the United States following World War II. In December 1945, the United States government published a document titled *Proposals for Expansion of World Trade and Employment* which proposed establishment of an International Trade Organization of the United Nations and suggested "rules to govern trade barriers, restrictive business practices, intergovernmental commodity arrangements, and the international aspects of domestic employment policies.[45] In February 1946, the Economic and Social Council of the United Nations, at the first meeting, called for an international conference on trade and employment to consider the proposal to create an International Trade Organization. It also established a Preparatory Committee to draft a Charter for the Organization. In advance of the conference, held in London in the fall of 1946, the U.S. government elaborated on its earlier proposals and prepared, as a basis for discussion, a *Suggested Charter for an International Trade Organization of the United Nations*.[46]

With respect to national treatment, Article 9 of the *Suggested Charter* provided:

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[45] U.S. Department of State, *Suggested Charter for an International Trade Organization of the United Nations* (September 1946), at Foreword.

[46] *See* U.S. Department of State, *Suggested Charter for an International Trade Organization of the United Nations* (September 1946).

> 1. The products of any Member country imported into any other member country shall be exempt from internal taxes and other internal charges higher than those imposed on like products of national origin, and shall be accorded treatment no less favorable than that accorded like products of national origin in respect of all internal laws, regulations or requirements affecting their sale, transportation or distribution or affecting their mixing, processing, exhibition or other use, * * *.[47]

With respect to antidumping and countervailing duties, Article 11 of the *Suggested Charter* provided:

> 3. No product of any Member country imported into any other member country shall be subject to antidumping or countervailing duty by reason of the exemption of such product from duties or taxes imposed in the country of origin or exportation upon the like product when consumed domestically.[48]

With respect to export subsidies, Article 25 of the *Suggested Charter* provided:

> 2. Except as provided in paragraph 3 of this Article, no Member shall grant, directly or indirectly, any subsidy on the exportation of any product, or establish or maintain any other system which results in the sale of such product for export at a price lower that the comparable price charged for the like product to buyers in the domestic market, due allowance being made for differences in conditions and terms of sale, for differences in taxation, and for other differences affecting price comparability. The preceding sentence shall not be construed to prevent any Member from exempting exported products from duties or taxes

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[47] U.S. Department of State, *Suggested Charter for an International Trade Organization of the United Nations* (September 1946), at Article 9.1.

The national treatment principle with respect to internal taxes and charges was a provision included in various U.S. bilateral trade agreements entered into in the 1930s pursuant to the Reciprocal Trade Agreements Act of 1934 (Tariff Act of 1930, tit. III, as amended by Act of June 12, 1934, 48 Stat.943 (1934). One such example is the U.S.-Canada Reciprocal Trade Agreement, Nov. 15, 1935, art. V and VI, 49 Stat. at 3950, 3960, 3963 (1936). *See* Roger W. Rosendahl, *Border Tax Adjustments: Problems and Proposals*, LAW & POL'Y INT'L BUS., Vol. 2, at 85, 93-94, 144-145 (1970).

[48] U.S. Department of State, *Suggested Charter for an International Trade Organization of the United Nations*, at Article 11.3 (September 1946).

> imposed in respect of like products when consumed domestically or from remitting such duties or taxes which have accrued. * * *[49]

Thus, the concepts of national treatment for imports with respect to internal taxes, and that the exemption or remission of domestic duties or taxes on products exported should not be considered within the realm of export subsidies or be a basis for imposing countervailing duties, were present in the suggested charter initially put forward by the United States.

In the series of draft texts (*i.e.*, Geneva and Havana texts) that followed the London conference, these concepts were carried forward. The provisions respecting national treatment of import-related taxes and charges (articles II and III) were included in the final General Agreement on Tariffs and Trade that was adopted in 1947 and entered into force on January 1, 1948. So also, the provision that antidumping and countervailing duties shall not be imposed by reason of the exemption or rebate of domestic taxes on exports (article VI) was contained in the final GATT 1947. However, because at the final stage the negotiators were not able to agree on the prohibition of export subsidies, all of the proposed language dealing with export subsidies was omitted from the GATT 1947, including the provision that excluded from the scope of export subsidies the exemption or remission of duties or taxes on exported products that had been included in each prior draft text. As adopted, article XVI of GATT 1947 required only notification and consultation if a subsidy operated to increase exports or decrease imports, as follows:

> If any contracting party grants or maintains any subsidy, including any form of income or price support, which operates directly or indirectly to increase exports of any product from, or to reduce

[49] U.S. Department of State, *Suggested Charter for an International Trade Organization of the United Nations*, at Article 25.2 (September 1946) (emphasis added).

> imports of any product into, its territory, it shall notify the CONTRACTING PARTIES in writing of the extent and nature of the subsidization, of the estimated effect of the subsidization on the quantity of the affected product or products imported into or exported from its territory and of the circumstances making the subsidization necessary. In any case in which it is determined that serious prejudice to the interests of any other contracting party is caused or threatened by any such subsidization, the contracting party granting the subsidy shall, upon request, discuss with the other contracting party or parties concerned, or with the CONTRACTING PARTIES, the possibility of limiting the subsidization.

D. 1955 – Review of the GATT Adds Export Subsidy Provisions to GATT Article XVI

In the 1954-1955 Review Session of GATT, various proposals were made to amend GATT article XVI regarding subsidies. In particular, it was proposed to incorporate the export subsidy provisions of the draft texts that had been omitted from the GATT 1947. After negotiations, it was agreed to amend article XVI by including a prohibition of export subsidies provided to manufactured goods (section B to GATT article XVI). The draft provision that excluded from the scope of export subsidies the exemption or remission of duties or taxes on exported products was not incorporated in GATT article XVI but, rather, was included as an interpretive note to article XVI which provided that the "exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy."[50] These amendments to GATT article XVI were given effect by the

[50] General Note *Ad* Article XVI (emphasis added).

1955 Protocol Amending the Preamble and Parts II and III of the General Agreement, which entered into force on October 7, 1957.[51]

E. 1960 – GATT Working Party on Subsidies – Illustrative List of Export Subsidies

In 1960, a GATT Working Party on Subsidies considered what steps should be taken to implement the provisions of paragraph 4 of GATT article XVI. In the course of their review, France made a proposal to draw up a list of prohibited export subsidies based on a previous OEEC (predecessor to OECD) list. This list provided that the remission or exemption of direct taxes (and excessive rebates of indirect taxes) on exports were prohibited but that remission or exemption of indirect taxes on exports was permitted.

> At its meeting in September 1960 the Council examined the proposal of the French Government (L/1260) that full effect be given to the prohibition of export subsidies as envisaged in paragraph 4 of Article XVI (C/M/1).
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> * * *
>
> In formulating their proposal the French Government indicated that it would favour an instrument listing a certain number of practices which would be prohibited under paragraph 4 of Article XVI, provided such an enumeration were not considered exhaustive. They suggested that the CONTRACTING PARTIES could draw up a list on the basis of the list annexed to Decision C(59)202 of the OEEC Council. The following are the practices enumerated in that Decision:
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> * * *
>
> (c) The remission, calculated in relation to exports, of direct taxes or social welfare charges on industrial or commercial enterprises.
>
> (d) The exemption, in respect of exported goods, of charges or taxes, other than charges in connexion with importation or indirect taxes levied at one or several stages on the same

[51] 2 U.S.T. 1767, T.I.A.S. No. 3030, 278 U.N.T.S. 168. The Protocol was adopted at Geneva on March 10, 1955.

> goods if sold for internal consumption; or the payment, in respect of exported goods, of amounts exceeding those effectively levied at one or several stages on these goods in the form of indirect taxes or of charges in connexion with importation or in both forms.[52]

The Working Party issued its report in November 1960. The Report listed the proposed export subsidy measures put forward by France and further stated:

> The Working Party agreed that this list should not be considered exhaustive or to limit in any way the generality of the provisions of paragraph 4 of Article XVI. It noted that the governments prepared to accept the Declaration {*i.e.*, the Declaration of 19 November 1960 Giving Effect to the Provisions of Article XVI:4[53]} ... for the purpose of that Declaration, these practices generally are to be considered as subsidies in the sense of Article XVI:4 ....[54]

Thus, in 1960, those GATT members accepting the Declaration Giving Effect to the Provisions of Article XVI:4, which included the United States, agreed that the remission of direct taxes or social welfare charges in relation to exports would be considered a prohibited export subsidy, but that the exemption or rebate of indirect taxes not in excess of the amount levied would not be considered an export subsidy, or indeed as a subsidy at all, and was therefore recognized as a permissible practice.

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[52] Subsidies, Action under Article XVI:4, W.17/3 (2 November 1960), W.17/3/Corr.1 (4 November 1960) (emphasis added).

[53] Declaration of 19 November 1960 Giving Effect to the Provisions of Article XVI:4, L/1381 at Annex A (November 1960); 9 BISD 32-33 (1961).

[54] Report of the Working Party on Subsidies, Provisions of Article XVI:4, L/1381 at para. 5 (November 1960), adopted on 19 November 1960; 9 BISD 185, 186 (1961).

F. Why the U.S. Agreed to the Existing GATT Rules on Border Tax Adjustments

Given the concerns expressed by U.S. business about the disadvantageous trade effects resulting from the differential treatment of direct and indirect taxes with respect to border tax adjustments and the long-standing efforts of the U.S. Government to change the GATT rules on border tax adjustments (discussed *infra*), many have asked why the U.S. agreed to the adoption of the GATT Agreement and the 1955 and 1960 amendments thereto that established the border tax adjustment rules. The general consensus of observers and government officials is that, at the time the GATT was adopted in 1947, as well as in 1955 (when Article XVI was amended to include the interpretive note that exemption from, or remission of, indirect taxes for exported products is not considered to be a subsidy) and in 1960 (when the first illustrative list of prohibited export subsidies was agreed to), the United States accepted the then common economic belief that indirect taxes were always pushed forward into the price of goods and that direct taxes were absorbed in the cost of production. Thus, the U.S. apparently did not recognize in 1947, 1955 or 1960 that the border adjustability of indirect taxes posed a problem, nor did the U.S. anticipate or foresee that a significant trade disadvantage would develop with the increased use by other countries (such as European Community) of indirect taxes (including value added taxes) over time.

In hindsight, it was, as the Senate Finance Committee observed, a "major blunder" for the United States to allow, first in 1955, the exemption and rebate of indirect taxes on exports to be excluded from the definition of a subsidy, and then, in 1960, both to allow the exemption and rebate of indirect taxes on exports to be excluded from the definition of a subsidy and to allow

the exemption and rebate of direct taxes on exports to be included in an illustrative list of export subsidies.

The following is sampling of observations on why the U.S. agreed to the existing GATT rules on border tax adjustments.

Senate Finance Committee Staff:

> In 1960, the contracting parties adopted a Working Party Report which listed a number of practices construed to be subsidies. Among these were the remission of direct taxes or social welfare chares on industrial or commercial enterprises and "the exemption in respect of exported goods, of charges or taxes, other than charges in connection with importation or indirect taxes *levied at one or several stages on the same goods* if sold for internal consumption." The implications of practices listed . . . were not fully appreciated by the United States. They, in effect permitted the European countries to impose border taxes on imports and rebate indirect taxes on exports in accordance with their value added or cascade turnover taxes.
>
> In the late forties and early fifties it is not surprising that U.S. trade officials were willing to incorporate existing commercial practices on border tax adjustments into the GATT agreement. There were much larger problems in international trade than border tax adjustments, which at that time were low—in the range of 2-4 percent and limited to around one-sixth of the goods traded—and then only in the case of a few nations. The United States {had} a $10 billion trade surplus in 1947 which must have had an effect on our negotiators' attitudes.
>
> But the failure to appreciate the consequences of excluding the so-called "indirect tax" rebates in 1960 from the general prohibition against export subsidies while including a specific prohibition against rebating "direct taxes", was a major blunder. The United States by that time had run into serious balance of payments difficulties. Western Europe had become a prosperous "third force." Giving away commercial advantages to prosperous Europe for the sake of their own internal tax harmonization objectives was an unwise and costly move, in which vague

political objectives out-weighted clear commercial considerations.[55]

John R. Petty, Assistant Secretary of Treasury:

> By indirection, this {i.e., the 1960 Working Party Report and Declaration} extended the interpretive note to Article XVI by excluding from the definition of an export subsidy the rebating or exemption of multi-stage indirect taxes. Clearly, the implications of this Declaration were not adequately considered by the United States. . . .
>
> {T}here is no consistent rationale behind the GATT rules on border tax adjustments, nor clear-cut guidance on the meaning of the GATT provisions. Article II and III were incorporated almost in their entirety from existing practices, probably modeled after a U.S.-Canadian commercial treaty. The separate treatment of the import duties and the history of clarifying the status of export remissions confirms that no consistent consideration was given to this subject; certainly no specific economic theory was used as the underpinning for the treatment of border tax adjustments. Instead, it would appear that the matter of "border tax rules" was not even a contentious issue. Rather, these rules simply codified certain practices.
>
> It is not surprising that the drafters of the GATT were willing to accept *the status quo.* Problems quite apart from the question of border tax adjustments demanded the attention of the drafters. In a postwar, exchange-control world, where fixed exchange rates were at best approximations of reality, concern voiced about the discrimination that would arise if the world shifted to a buyer's market would probably have been met by some retort such as "we'll worry about that problem if and when it ever arises." Little wonder! In the late 1940's and early 1950's, border tax rates were low—in the range of 2% to 4%—and limited to around one-sixth of the goods trade—and only in the case of a few nations. Furthermore, a seller's market existed in which demand was highly unresponsive to small price variations. Finally, the $10 billion

[55] Staff of Senate Committee on Finance, *Staff Analysis of Certain Issues Raised by the General Agreement on Tariffs and Trade*, 91st Cong., 2d Sess. 8-9 (December 19, 1970). The same text is included in Senate Finance Committee Print, *Summary and Analysis of H.R. 107810 – The Trade Reform Act of 1973*, 93d Cong., 2d Sess. 106-107 (February 26, 1974).

> commercial trade surplus of the United States in 1947 must have had an effect on the attitude of the United States' negotiators. This is best illustrated by the then-prevalent and understandable United States' policy of deliberately encouraging a transfer of financial assets to Western Europe in order to facilitate European reconstruction.[56]

U.S. Representative to GATT:

> When the present GATT language was drawn up more than two decades ago, the question of border taxes did not appear to be a major one. Levels of indirect taxes were much lower. Under these circumstances, overlying simple and sweeping assumptions about tax shifting seemed acceptable, and already existing practices were incorporated without searching examination. The rules were drafted in very general terms. The United States at that time had no pressing reasons for seeking more elaborate provisions which provided more equitable safeguards for its trading position. On the contrary, at that time the United States was conscious of the need to assist other countries in relieving the pressures of the so-called dollar gap and the requirements for postwar reconstruction. Little detailed attention was paid to a problem which might hypothetically arise which would be harmful to our then strong payments position.
>
> * * *
>
> When the current practices were in their early stages of development principally after World War I, indirect taxation tended to be confined to sumptuary taxes on a limited number of goods or to low-rate general taxes. Border tax problems were then simpler and relatively little attention was paid to the border tax issue.[57]

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[56] John R. Petty, Assistant Secretary of Treasury for International Affairs, Paper prepared for the Twenty-first Annual Conference of the Canadian Tax Foundation (November 20, 1968), *reprinted in* Appendix (at 122-123) to Brief of Petitioner Zenith Radio Corporation in *Zenith Radio Corp. v. United States*, U.S. Supreme Court Appeal No. 77-539, filed March 23, 1978.

[57] *Working Party on Border Tax Adjustments, Secretariat Note on Meeting of 30 April to 2 May 1968*, L/3009 (17 May 1968) at Annex (Statement by Representative of United States).

Professor John Jackson:

> It is doubtful that at the time the GATT was drafted the ultimate consequences of Articles II and III, as applied to border tax adjustments were understood. In comparison to the then existing tariffs or other restrictive measures, the border tax adjustments probably seemed relatively inconsequential. But over the decades, as tariffs came down and quotas on manufactures were eliminated, other protection devices became more prominent. The border tax adjustment took on new significance and finally has emerged as a headline item and an issue of political attention.[58]

Noel Hemmendinger:

> In the period after World War II the United States accepted, in some cases in the GATT itself and in other cases on a *de facto* basis, the existence of many illiberal practices because the U.S. economy was so far stronger than any other that these obstacles to trade were equilibrating and not disequilibrating factors. In the last several years, when the United States has had balance of payments difficulties, it has quite properly been pounding away at many of these restrictions that continue to exist, on the ground that they are now disequilibrating.[59]

G. 1963-1967 – Kennedy Round and Growing Concern Regarding Non-Tariff Barriers (including border tax adjustments)

John R. Petty, Assistant Secretary of Treasury, observed that "{a}s early as 1953 there began to be some recognition of the fact that border tax adjustments could create advantages for nations using them ... as other barriers to trade fell, and the adjustments were substantially increased."[60] This recognition came in the OEEC Working Party on Artificial Aids to Exporters

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58 John H. Jackson, *World Trade and the Law of GATT* (1969) at 297-98.

59 Noel Hemmendinger, *Non-Tariff Trade Barriers*, 63 AM. SOC'Y INT'L. L. PROC. 204, 206 (1969).

60 John R. Petty, Assistant Secretary of Treasury for International Affairs, Paper prepared for the Twenty-first Annual Conference of the Canadian Tax Foundation (November 20, 1968), *reprinted in* Appendix (at 124) to

which "discussed the possible trade-diversionary effect of the introduction of the French value-added tax."[61]

In 1961, the negative effects that might result from rebates of indirect taxes on European exports were noted by Professor Roy Blough of Columbia University in testimony before Congress. He stated:

> So I think that as we go into the trade program -- which, as I say, I am very strongly in favor of -- one of the things which will need to be done, either through negotiations in connection with the trade program, or in some other way, is to remove hidden subsidies, or hidden burdens, or to make an effort to secure substantial equalization of them, so that it will not be Government action which is responsible for an industry in one country being able to produce some product at a substantial advantage over that of another country.
>
> As I understand the situation in Germany, for example, a substantial part of the tax on German business is in the form of a turnover tax, a sort, of a sales tax. And this turnover tax, as I understand it, is not applicable to exports, although it is applicable to internal sales of products.
>
> Now, we have no such tax. But we have a corporation income tax. It would be comparable, for example, if we were to grant several percentage points of exemption or reduction in the Federal income tax on profits from exports. I am not suggesting we do this. I do not consider it desirable. But this is about what Germany is doing. And this is what I am talking about when I say there are certain hidden subsidies. There may also he hidden penalties. For example, some people say our international competitiveness is impaired because our tax system is more burdensome on business than are the tax systems of Europe. I do

Brief of Petitioner Zenith Radio Corporation in *Zenith Radio Corp. v. United States*, U.S. Supreme Court Appeal No. 77-539, filed March 23, 1978.

[61] John R. Petty, Assistant Secretary of Treasury for International Affairs, Paper prepared for the Twenty-first Annual Conference of the Canadian Tax Foundation (November 20, 1968), *reprinted in* Appendix (at 124) to Brief of Petitioner Zenith Radio Corporation in *Zenith Radio Corp. v. United States*, U.S. Supreme Court Appeal No. 77-539, filed March 23, 1978.

> not know whether this is the case, or not, but I think it is a matter that deserves study.[62]

The concern identified by Professor Blough was heightened in 1963 when the EEC decided to harmonize their tax systems and the U.S. raised the issue at the OECD.

> In 1963, United States' concern about the trade effects of border taxes was further aroused by the decision of the member states of the EEC to harmonize their tax systems, by adopting the value-added tax (TVA). The United States' government requested the OECD to undertake a careful and comprehensive study of border tax adjustments. In making the proposal, the United States stated: "A study of this subject is particularly timely at the present moment. A number of countries which impose turnover tax adjustments at the border are contemplating changes in the level of such compensatory adjustments, others are considering a change in the method of applying the tax (e.g., a change from the cascade to a value-added type) and some countries which heretofore have not employed a general sales tax by the central government are considering introducing it ..."[63]

At the OECD, the U.S. sought a standstill agreement concerning border tax adjustments but the EEC opposed the proposal, "arguing that agreement on a standstill would interfere with their objective of attaining a harmonized tax system by 1970."[64] As a result, the OECD was only able to agree on a notification procedure to keep member countries informed about any changes in border tax adjustments.

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62 *Foreign Economic Policy:* Hearings before the Subcommittee on Foreign Economic Policy of the Joint Economic Committee, 87th Cong., 1st Sess. 175 (1961) (Statement of Prof. Roy Blough, Professor of International Business, Columbia University Graduate School of Business).

63 John R. Petty, Assistant Secretary of Treasury for International Affairs, Paper prepared for the Twenty-first Annual Conference of the Canadian Tax Foundation (November 20, 1968), *reprinted in* Appendix (at 125) to Brief of Petitioner Zenith Radio Corporation in *Zenith Radio Corp. v. United States*, U.S. Supreme Court Appeal No. 77-539, filed March 23, 1978.

64 John R. Petty, Assistant Secretary of Treasury for International Affairs, Paper prepared for the Twenty-first Annual Conference of the Canadian Tax Foundation (November 20, 1968), *reprinted in* Appendix (at 125) to Brief of Petitioner Zenith Radio Corporation in *Zenith Radio Corp. v. United States*, U.S. Supreme Court Appeal No. 77-539, filed March 23, 1978.

At the GATT, as it entered into the Kennedy Round of multilateral trade negotiations in 1963, the United States also attempted to raise the issue of border tax adjustments. One of the Kennedy Round negotiating groups was a Subcommittee on Non-Tariff Barriers. In 1963, the United States proposed that the Subcommittee should consider a number of non-tariff barriers, including "border tax adjustments."[65] Ultimately, the Kennedy Round did not address non-tariff barriers, as the U.S. Special Trade Representative explained.

> Because of the complexity of the issues involved and other reasons, it was not possible to negotiate on the question of border taxes applied by certain countries to compensate for internal taxes. Nevertheless, against the possibility that changes in these taxes may nullify or impair tariff concessions or other benefits of the agreement, the United States has reserved the right to initiate action under the GATT to seek compensation for such nullification or impairment.[66]

In 1964, the Joint Economic Committee issued a report on the U.S. balance of payments. The Committee noted that the U.S. balance of payments had been in deficit in 13 of the past 14 years. Among its recommendations to address this problem, the Committee noted the following with respect to border tax adjustments.

> **(3) Certain international practices must be reexamined in view of the urgency of restoring balance in international payments.**
>
> The committee believes that there is a strong case for the proposition that the United States is adversely affected by the GATT rules which permit the rebate on exports of indirect taxes but not the remission in relation to exports of direct taxes where

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[65] *See Non-Tariff Barriers*, TN.64/NTB/5 (12 November 1963) at 2. *See also Non-Tariff Measures to be Brought Within the Scope of the Negotiations*, TN.64/NTB/8 (15 November 1963) at 1; *Stage Reached by the Sub-Committee on Non-Tariff Barriers*, TN.64/22 (30 April 1964) at 2.

[66] Office of the Special Representative for Trade Negotiations, *GATT 1964-67 Trade Conference: Report on United States Negotiations* (1967), at 167.

> the result is a lower foreign than domestic price for the same product. The United States derives a greater proportion of its tax revenues from direct taxes than do other countries, and present rules may consequently place it at a substantial competitive disadvantage in world markets. The committee recommends that this matter be studied within the administration and in consultation with other nations, and that appropriate steps be taken to eliminate such disadvantages to the United States as may be inherent in current practices.[67]

The expressions of concern by U.S. businessmen and the government about the competitive disadvantages resulting from the GATT rules on border tax adjustments increased and began to gather momentum after the conclusion of the Kennedy Round. In June 1967, at a meeting of the Trade Negotiations Committee discussing the conclusion of the Kennedy Round, the United States raised the issue of border tax adjustments. With the prospect of the EEC moving toward tax harmonization and value-added tax systems, the United States stated that changes in border tax adjustments, notwithstanding their consistency with the GATT, could nullify or impair concessions and benefits that the United States had negotiated in the Kennedy Round. Although Canada and Japan agreed with the U.S. statement, the EEC rejected it, as is reflected in the notes of the meeting:

> 4. The representative of the United States also said that changes in border tax adjustments, whether or not accompanied by internal tax changes and irrespective of their consistency with the provisions of the General Agreement on Tariffs and Trade, may have trade effects that nullify or impair concessions or other benefits provided in the Kennedy Round Protocol. In this connexion the United States declared that, given the absence of sufficient detailed information, it was unable to determine, and therefore unable to anticipate, in which specific ways particular changes in border tax adjustments may nullify or impair individual

[67] Joint Economic Committee Report No. 965, *The United States Balance of Payments*, 88th Cong., 2d Sess. 16 (March 19, 1964).

> concessions or other individual benefits provided for in the Protocol. The representatives of Canada and Japan associated themselves with this declaration.
>
> 5. The representative of the European Economic Community said that the Community was harmonizing the legislation of the various member States with respect to turnover taxes. The European Economic Community was carrying out this harmonization in full conformity with the letter and spirit of the provisions of the General Agreement. It could not accept a statement implying that compensatory charges applied in conformity with the letter and spirit of the General Agreement could in any way have, within the meaning of Article XXIII, trade effects that nullified or impaired benefits accruing to its partners directly or indirectly from the concessions granted by it in the Kennedy Round. It was in the context of this same interpretation of the rules of the General Agreement that the member States and the Community had undertaken and undertook their obligations pursuant to that Agreement; and had, from the outset, taken part in all the work undertaken under the Agreement.[68]

In 1967, following the conclusion of the Kennedy Round, Congress took stock and looked forward to those trade issues that still needed to be addressed in future negotiations. In a submission to the Joint Economic Committee, William Diebold of the Council on Foreign Relations noted that the economic assumptions underlying the GATT rules on border tax adjustments were increasingly being questioned by economists.

> Nontariff barriers are nothing new. . . . Now major reductions in tariffs are making other nontariff barriers more prominent. Maintaining an attack on them should be a major feature of the next phase of American foreign trade policy. . . .
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> * * *
>
> . . . Any number of taxes and other kinds of charges may in one way or another impede trade, including perhaps some which for generations economists said were neutral in their impact.
>
> * * *

[68] *Proceedings of the Sixteenth Meeting, Held at the Palais des Nations, Geneva on 28 June 1967*, TN.64/W/17 (18 July 1967) at 2, paras. 4 and 5.

> Taxes . . . that are plainly subterfuges for tariffs will of course not pass muster under GATT or any other sensible international agreements about trade barriers. But as tariffs fall, many kinds of once-innocent taxes begin to look suspicious, especially for the discrimination they may hide. In recent years, long-established principles about the effect of "indirect" taxes on international trade have been called into question. Economists are questioning the facts and theories on which the rules about taxes in GATT and in other agreements are based. Their doubts coincide to a considerable degree with the businessman's commonsensical and untutored reaction that if his goods have to pay a tax on entry into a country while his competitor's goods are exempted from the same tax when they are exported, he is at a disadvantage. After years of work, the six countries of the European Community have decided to harmonize at least the systems of their turnover taxes – and an aligning of the rates will probably follow. In England and the United States questions are being asked as to whether it would not be helpful to the international competitive positions of those countries if part of the corporation income taxes were turned into this kind of transaction tax which would be forgiven on exports and levied on imports. <u>The border tax issue may well be the most important of the nontariff barriers to be fought over in the next few years</u>.[69]

In its report on the future of U.S. foreign trade policy, the Subcommittee on Foreign Economic Policy of the Joint Economic Committee stated that the U.S. needed to squarely face the discrimination to U.S. exports from border tax adjustments.

> The European Common Market practice of rebating their own indirect taxes on their exports and levying these same taxes on imports – a practice sanctioned, incidentally, by the rules of the GATT – constitutes a conspicuous form of discrimination against U.S. exports. Moreover, similar border adjustments by the United States would be an ineffective weapon, neither mitigating nor offsetting the discriminatory process, because the tax structure of the United States places relatively small emphasis on indirect

[69] *Issues and Objectives of U.S. Foreign Trade Policy:* A Compendium of Statements submitted to the Subcommittee on Foreign Economic Policy of the Joint Economic Committee, 90th Cong., 1st Sess. 7-9 (1967) (Statement of William Diebold, Jr., Senior Research Fellow, Council on Foreign Relations) (emphasis added).

> taxes. This issue is one that the United States will have to resolve.[70]

In November 1967, five months after the completion of the Kennedy Round, , in a review of the GATT's future work program, the United States again raised the prospect of adverse effects on U.S. exports from an increase in border tax adjustments due to European tax harmonization. In particular, the Special Trade Representative, Ambassador William M. Roth, indicated the need for GATT members to address the issue multilaterally.

> The work of the GATT will not, however, be confined only to the issues we can now foresee. New problems will undoubtedly arise from time to time and we shall have to work together on them. One possible difficulty may arise out of the plan of some of the important trading countries in Europe to make significant changes in their tax systems. These will increase their border tax adjustments. We are seriously concerned as we have indicated before, that these adjustments in certain cases adversely affect our exports. Should these fears prove, in fact, to be justified, we would expect to take up this matter in accordance with normal GATT procedure. If it becomes evident, in the coming months, that there is a general multilateral problem here, it might then become advisable for the CONTRACTING PARTIES to give this kind of problem their attention.[71]

H. 1967-68 – U.S. Balance of Payments Problem Grows; President Johnson Issues Statement on Balance-of-Payments Problem on January 1, 1968

One of the underlying reasons that the competitive disadvantages of border tax adjustments became an important issue to the U.S. government in the late 1960s was its negative

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[70] *The Future of U.S. Foreign Trade Policy:* Report of the Subcommittee on Foreign Economic Policy of the Joint Economic Committee, 90th Cong., 1st Sess. 5 (1967).

[71] *Review of the Work of the Contracting Parties and Future Programme, Statement of the Hon. Mr. William M. Roth, Special Trade Representative, Executive Office of the President of the United States, on23 November 1967*, W.24/40 (24 November 1967) at 2, 4.

impact on the country's balance of payments. At this time, the United States still adhered to the gold standard and the monetary system established by Bretton Woods.

> Between 1958 and 1971, the primary objective of U.S. foreign economic policy was to find a way to control the American balance-of-payments deficit and stem the loss of gold from the U.S. Treasury. Many of the policies that were enacted or considered in order to solve the payments problem and ease the gold drain conflicted with the larger goals of American foreign policy, strategy, and domestic economic policy. This clash created enormous tensions within both the U.S. government and the Western alliance, and affected a whole range of policies, from American troop deployments overseas to U.S. investment in Europe. Despite these political tensions, American policy makers feared an economic catastrophe if the payments deficit was not reduced and the gold outflow ended.[72]

In the second half of 1967, the Johnson Administration's concern about the worsening balance of payments came to the fore. In August 1967, Treasury Secretary Fowler informed President Johnson of measures under consideration to improve the BOP situation.

> At the same time we call upon industry for real short-term sacrifices on the direct investment front, we should offer them an attractive and appealing long-term package of export assistance and incentives. Here is where we stand in this area:
>
> * * *
>
> --We are analyzing the impact of proposed EEC tax harmonization (and border tax adjustments) on our trade position.
>
> --We have discussed a broad variety of tax and non-tax incentives with industry and believe the following, properly presented, can help our national export effort with minimal risk of retaliation:
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> * * *
>
> --rebate of local excise and perhaps property taxes

[72] Francis J. Gavin, *Gold, Dollars, and Power: The Politics of International Monetary Relations, 1958-1971* (University of North Carolina Press, 2003) at Introduction; available at http://uncpress.unc.edu/chapters/gavin_gold.html.

* * *

> In connection with tax incentives, a commitment--in the post-Kennedy Round world—to re-examine GATT rules, to study proposed changes in European tax systems, and to negotiate, if necessary, tax "harmonization" for U.S. exporters. We would refer specifically to the proposed change in German border taxes (which German authorities themselves say amounts to a 2-3 percent export price cut and which, in effect, is a D mark devaluation of that amount) as a source of immediate and particular concern.[73]

In November 1967, a Department of Commerce memorandum described the status of proposals for the 1968 balance of payments program. The memo noted that a series of tax incentives for exports had been rejected due to opposition from the Departments of Treasury and State but that a review of GATT rules was favored.

> *3. Tax Incentives for Exports*
>
> The following have been rejected, principally because of Treasury and State opposition.
>
> (1) A credit against total income tax liability calculated as a flat percentage of export sales.
> (2) A lower rate of corporate income tax for profits derived from exporting.
> (3) A credit against income tax liability based on accelerated depreciation of plant and equipment used in the production of export goods.
> (4) An investment tax credit applicable to plant and equipment used for the production of export goods.
> (5) Exemption from income tax of remitted income of U.S. sales subsidiaries abroad.
> (6) Rebate of property tax and indirect taxes for exported goods.
> (7) Overexpensing for increases in export promotion expenditures.
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> * * *

[73] *Memorandum From Secretary of the Treasury Fowler to President Johnson*, August 8, 1967; U.S. Department of State, Foreign Relations, 1964-1968, Volume VIII, International Monetary and Trade Policy (Document 137); available at http://www.state.gov/www/about_state/history/vol_viii/131_139.html.

> *8. Reexamination of GATT rules*
>
> Concerning the treatment of direct and indirect taxes, subsidies, and countervailing duties. This proposal emerges as an alternative to a strong tax incentive for exports. All agencies agree that reexamination is desirable, but tactics remain to be worked out.[74]

Also in November 1967, Treasury Secretary Fowler sent a balance of payments memorandum to the President to which was attached a background memo. The background memo described why a GATT review of border tax rules was desirable:

> --The GATT. It is time for a positive and outward looking re-examination of those provisions of the GATT which are trade restrictive in their nature. These provisions may be trade restrictive in the sense of (1) what a country can do when it is in balance of payments deficits, and they may be trade restrictive; (2) in the area of non-tariff barrier practices; as well as (3) the permissible subsidies which act preferentially for one tax system (EEC, Japan, United Kingdom) and discriminate against a country using another tax system (U. S.).
> A review of this type is totally in keeping with the 20th anniversary of GATT and falls in perfect stride with the post-Kennedy Round situation. This would provide another occasion to demonstrate to the world at large and to our protectionists at home that we will use trade expansive and not trade restrictive measures and the rules of the game must be brought up to date to assure this.[75]

As Cabinet discussions regarding the balance of payment program for 1968 entered December 1967, the focus of the debate was whether the United States should impose its own border tax adjustments on imports and rebate the same on exports based on the amount of

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[74] *Department of Commerce Paper*, November 7, 1967; U.S. Department of State, Foreign Relations, 1964-1968, Volume VIII, International Monetary and Trade Policy (Document 148); available at http://www.state.gov/www/about_state/history/vol_viii/140_149.html.

[75] *Background Memorandum*, attachment to *Memorandum From Secretary of the Treasury Fowler to President Johnson*, November 9, 1967; U.S. Department of State, Foreign Relations, 1964-1968, Volume VIII, International Monetary and Trade Policy (Document 149); available at http://www.state.gov/www/about_state/history/vol_viii/140_149.html.

indirect taxes that U.S. manufacturers pay. The Cabinet Committee on Balance of Payments met on December 21, 1967. The minutes to that meeting reflect a lengthy and robust back-and-forth regarding the various proposals before them to address the disadvantages of border tax adjustments by other countries, particularly the EEC.

> Secretary Fowler commenced the discussion and said this meeting was basically a reporting session although he would welcome comments. In general, the balance-of-payments figures for 1967 are grim. He emphasized the need of holding closely all information in this meeting and to impart it only on a "need-to-know" basis.
>
> * * *
>
> Border Taxes
>
> Ambassador Roth introduced his portion of the "package" which concerned trade. He argued that he is primarily concerned with the retaliation which the imposition of a U.S. border tax would probably involve, pointing out that our surplus makes us uniquely vulnerable. It is the net benefit which we must seek. He agreed that something must be done in order to show a complete package but he emphasized that other areas, especially capital flows, must be covered: if the restrictions in the area of capital flows are strong it is possible to go further in the area of trade.
>
> Both the Dutch and Germans will increase their border taxes on January 1, 1968. The Dutch will go up 1-2 percent and the Germans, moving from their present cascade indirect tax system to the added-value system, will move from about 4 percent to about 10 percent. In considering what we might do in this area we must be mindful of the limitations of GATT. Can we put together our own border tax based upon our own tax structure that gives us something similar to the advantage the Europeans enjoy? Treasury has compiled the secondary indirect taxes in this country; a figure of 2-2.5 percent represents various state and local taxes, customs duties and some federal excise taxes. This figure is increased to 4.3 percent if property taxes are included. If these secondary indirect taxes were rebated on a product-by-product basis they could be considered legal under GATT. However, it is true that five European countries rebate these "hidden" taxes and compensate at the border on a basis somewhat closer to a national average basis than to a product-by-product basis.

Ambassador Roth pointed out that the basic question was not one of legal niceties but one of retaliation. We all agree that Canada, the U.S., Japan and maybe some EFTA countries would have to adjust with us. There are two basic proposals. The Treasury approach which would announce the legislation and seek discussions subsequently and the Roth approach which reverses the procedure.

The key issue is whether the Europeans will retaliate or not. The second approach is designed to reduce this possibility without sacrificing more than two or three weeks of time. Assistant Secretary Solomon pointed out that the proposal reduces the chances of retaliation, compared to the U.S. Treasury proposal. He indicated that it was necessary to consult with the nations which would probably follow our action; moreover, the request for a GATT waiver would make it difficult for the Common Market countries to retaliate.

* * *

Ambassador Roth questioned whether the difference was really one of only 2.5% and 4%. If we are to make trade gains in the use of the border tax other countries must exercise restraint. Normally, in trade negotiations others would say, "What would you pay to achieve these trade gains?" Would you pay an injury clause in your countervailing duty law? Would you amend Section 22 of your Agricultural Assistance Act?

Under Secretary Rostow said that it was important for the President's statement to be firm and effective. The statement could say that legislation is being considered. He reminded the Committee of the recent OECD ministerial resolution that the balance-of-payments positions of member countries are "a matter of common concern". The risk of retaliation is great and therefore pursuant to this resolution and through negotiations perhaps the risk of retaliation can be minimized. Concerned as he was with retaliation he seemed to be favoring Alternative Two.

Chairman Ackley pointed out that we needed retroactivity in announcing our border tax and it was also necessary to specify an exact rate to avoid anticipatory imports and a delay in exports waiting for the rebate. We must be mindful of the impact of the President's statement upon the exchange markets. If we get a big boost from the border tax announcement will the props be knocked out of it when the retaliation starts?

Secretary Fowler referred to the visit today of an old friend who was familiar with the border tax area. Secretary Fowler read from Weir Brown's memorandum, dated December 21, on the border tax.

> "The draft now under consideration in the Treasury is built on a good central principle. This central idea is that we could adopt a tax adjustment for imports and exports without introducing a new sales tax on domestic sales.
>
> "My (Weir Brown) modifications to the present plan would be as follows:
>
> "1. We should state that the U.S. has been aware that many of its major trading partners have for years made tax adjustments to their imports and exports. They have justified this essentially on the grounds that imported goods had not been subject to their domestic tax system and that exported products were to be consumed abroad.
>
> "2. These countries are now in the process of making further increases in the levels of these border adjustments, having a still further impact on trade of other countries. The U.S. Government has questioned the wisdom of these increases, and in fact of the border adjustment system as a whole. We recognize, however, that Europeans have their own special reasons for their actions, including the objective of harmonization among the Six.
>
> "3. The U.S. Government has now determined that--given the prevalence of border adjustments by certain other countries and given the need to correct its balance of payments deficit--it will adopt its own form of border adjustment. While it is impossible to identify exactly the tax component of prices for any country, our Government has determined that a suitable rate for us to adopt would be 8 per cent (or 6), and this figure would be used in calculating a rebate on exported goods and in applying a levy to imports.
>
> "4. The foregoing border adjustment would be applied by the United States to imports coming from and exports going to all those countries which themselves now practice a system of border adjustments. (This would have the effect of excluding the applicability of the border adjustment from trade with Canada and Japan. I believe it would be possible also, by legal interpretation, to declare that the British purchase tax is not an across the board system and that the U.S. adjustment would not

> apply in the U.K. case.) Although many LDC's would automatically be covered by the foregoing provision, we could make a specific exemption for LDC's."
>
> Governor Daane asked if the program would be adequate and convincing without the border tax? It seemed to him that we must go more in the direction of the Treasury alternative because we are concerned about the actions Germany and Holland are taking and, therefore, we are entitled to respond. Responding to a question from Under Secretary Nitze, Secretary Fowler said the program might achieve $1.5 billion improvement without the border tax and the border tax might contribute an additional $1.5 billion to perhaps $2-1/2 billion. Ambassador Roth said that he thought the State Department estimated net trade gain figure, after retaliation, might be in the $800 million range.
>
> The Vice President commented that anything you can do under alternative number 2 you can do under alternative number 1. The basic issue is how do you best get into a negotiating position. No one can tell me the Germans are easy to negotiate with, they may be more stubborn than de Gaulle. Alternative number 2 says that there will be time enough; but in his judgment the time has gone by. They will not change their January 1 implementation date; nor will Congress wait. If you are going to be asking for a tax bill from Congress you have to offer them something like this. Why don't you admit that you are the world's biggest cowards? The Europeans are feeling their oats and we should show some of our muscles. It is time to treat a crisis like a crisis. We need a package and one without cosmetics. It must be firm; it must be creditable; and it must have muscle. We must also take administrative action. The Europeans do not think we have the guts to do it and let's be frank; the President cannot have Vietnam and the dollar crisis at the same time next summer! We need a program and we need to show that we mean it. The balance-of-payments position of the United States is worse than the public knows and we cannot have this creditability issue coming up again by us appearing to sweep something under the rug. Remember this, there are no votes in Germany. That is the Humphrey message for the day.
>
> Ambassador Roth pointed out that alternative 2 did not involve long negotiations; just two weeks.[76]

[76] *Minutes of Meeting of the Cabinet Committee on Balance of Payments*, December 21, 1967; U.S. Department of State, Foreign Relations, 1964-1968, Volume VIII, International Monetary and Trade Policy (Document 161); available at http://www.state.gov/www/about_state/history/vol_viii/160_169.html.

On December 22, 1967, Special Assistant Califano prepared a memorandum for the President which laid out "the present balance of payments problem, the program that Fowler is proposing, the extent of disagreement in the government and some of the questions that you {the President} should consider in determining whether to go forward with it."[77] Regarding the issues of export incentives and border taxes, the memo stated:

> 6. Joe Fowler is firming up a program to announce before New Year's Day. In addition to a number of minor elements, it includes the following major items, the first 3 of which are particularly controversial:
>
> --A 'border tax adjustment'--a tax of 2 percent (or more) on imports and an equal subsidy on exports.
>
> * * *
>
> 7. The border tax adjustment would add 2 percent (or more) to the cost of our imports and would rebate 2 percent of foreign sales to our exporters. It would be designed to make up for the cost of "hidden" excise taxes such as those on gasoline, freight, and telephones.
>
> --A few other nations are doing this under GATT rules now, and many are doing things equally dubious under the rules.
>
> --Fowler is particularly enthusiastic about this proposal because
>
> --it will cost very little in revenues;
>
> --in his judgment, it will sail through Congress and at the same time head off the quota drive;
>
> --it shows toughness with the Europeans.
>
> --The disadvantages and dangers are
>
> --it is an obvious devaluation of the dollar in trade, despite our big export surplus;
>
> --it looks like a move toward protectionism;

[77] *Telegram From the President's Special Assistant (Califano) to President Johnson in Thailand*, December 22, 1967; U.S. Department of State, Foreign Relations, 1964-1968, Volume VIII, International Monetary and Trade Policy (Document 162); available at http://www.state.gov/www/about_state/history/vol_viii/160_169.html.

> --it will surely be countered by Canada, Japan, the U.K., and perhaps others, either by similar action or by outright devaluation;
>
> --if it provoked retaliation by continental Europe, we would lose all the potential trade gains, possibly trigger off a trade war, and stir up financial markets badly.
>
> --Everyone agrees that we are being hurt under existing GATT practices. But some of your advisers (STR, State, and CEA) would prefer not to announce the action until we have a hard and quick (2 or 3 weeks) negotiation with the Europeans, either persuading them to reverse their own border tax practices or else to accept ours. This is intended to minimize the risk of retaliation (if we have to move), and to preserve our long-standing leadership in trade liberalization.[78]

On December 23, 1967, Special Assistant Califano sent a telegram to the President and indicated that all of the Cabinet Committee was in basic agreement on going forward with an "import tax/export subsidy program (border tax)." The telegram noted:

> Ackley, Trowbridge, Boyd, Martin, Fried, Solomon, Gene Rostow, Fowler, Deming, Okun, Clark Clifford, Schultze, Rusk (for part of the meeting), Goldstein and I met today on the balance of payment program. The Vice President and Secretary McNamara had left town for Christmas, but they are in agreement. Except as indicated below all the above individuals are in agreement on the following program:
>
> 1. Import tax/export subsidy program (border tax).
>
> --A 2 to 4 percent export subsidy, under which exporters would be given somewhere between 2 and 4 percent of the sales price of their exports as a cash rebate and the same percentage would be applied as a tax on imports.
>
> --The less-developed countries would be exempt from the import tax and there would be some sectoral differentials among product categories.
>
> There is some disagreement on the precise percentage but that can be worked out. There is also some disagreement on the tactics:

[78] *Telegram From the President's Special Assistant (Califano) to President Johnson in Thailand*, December 22, 1967; U.S. Department of State, Foreign Relations, 1964-1968, Volume VIII, International Monetary and Trade Policy (Document 162); available at http://www.state.gov/www/about_state/history/vol_viii/160_169.html.

> Whether you should announce that you will be sending a bill with specific percentages forward when you announce a general balance of payment program next week (the Fowler view), or whether you should indicate that you intend to work out a program, which would include a border tax with the other countries (the Rusk view).
>
> The issue revolves around the tone in any public announcement and Rusk, Rostow and Fowler believe they can straighten out the State- Treasury differences. Schultze, Martin and Trowbridge lean toward the Fowler view. Roth and Ackley lean toward the Rusk view. Rusk is concerned about an increase in imports due to anticipation of the tax and retaliatory actions if the tax is too specifically announced before it goes to Congress and before some negotiation and consultation with our allies. Fowler believes there will be some anticipatory imports in any case and a specific, firm announcement will assist negotiations with our allies.
>
> As far as the percentage of import tax and export cash rebate is concerned, the trick is to pick the percentage which will get us the best net effect--to avoid or minimize retaliation.[79]

In response to the foregoing telegrams from Special Assistant Califano, however, President Johnson indicated that he did not favor going forward with border tax measures at that time.

> Point 6--The Fowler program--
>
> A. I don't like the "border tax adjustment" at all except as a bargaining point in GATT which is, of course, of no use for the present immediate requirement. It will stimulate speculators as a step toward devaluation. It will damage our international image in many areas. It hits at an area which is not the root of the problem.
>
> * * *
>
> Point 7--The border tax adjustment--in addition to my own points as stated I agree entirely with the disadvantages listed:
>
> 1. Devaluation of dollar in trade despite export surplus,

[79] *Telegram From the President's Special Assistant (Califano) to President Johnson*, December 23, 1967; U.S. Department of State, Foreign Relations, 1964-1968, Volume VIII, International Monetary and Trade Policy (Document 163); available at http://www.state.gov/www/about_state/history/vol_viii/160_169.html.

2. Protectionism,

3. Will be countered by others,

4. In the end retaliation by Europe might make U.S. worse off.[80]

One commentator has described the intense Cabinet activity of the last weeks of 1967 as the balance of payments problem reached a crisis.

> Three days before the 1967 Christmas holiday, presidential aide Joseph Califano sent a telegram to Lyndon B. Johnson summarizing the findings of an emergency study produced by the cabinet committee on the balance of payments. This committee had been told to produce a serious and far-reaching program to bring the ballooning payments deficit of the United States down to equilibrium. Since 1958, when the payments deficits had first caught the attention of the Eisenhower administration, countless committees and high-level officials had crafted proposals to arrest the outflow of American dollars and gold. But this task became urgent when Great Britain, in the face of massive speculation on the currency markets, was forced to devalue sterling on 17 November 1967. The president's closest advisers believed that unless the American deficit was drastically reduced, speculators would attack the dollar next. A run on the dollar could force the United States to suspend its promise to convert dollars into gold, ending the commitment that had served as the cornerstone of the postwar international monetary regime. If the pledge to redeem dollars for gold was not honored, many economists feared that forces of economic disorder would be unleashed, producing a worldwide depression equal to the economic collapse of the 1930s.[81]

In the closing days of December 1967, at the end of the discussions on the balance of payments problem and what to do about border taxes, the course of action finally decided upon

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[80] *Telegram From President Johnson to the President's Special Assistant (Califano)*, December 23, 1967; U.S. Department of State, Foreign Relations, 1964-1968, Volume VIII, International Monetary and Trade Policy (Document 166); available at http://www.state.gov/www/about_state/history/vol_viii/160_169.html.

[81] Francis J. Gavin, *Gold, Dollars, and Power: The Politics of International Monetary Relations, 1958-1971* (University of North Carolina Press, 2003) at Introduction; available at http://uncpress.unc.edu/chapters/gavin_gold.html.

by President Johnson was not to have the United States impose its own border tax measures but to seek negotiations on border tax rules at the GATT.

On January 1, 1968, President Johnson responded to the balance of payments crisis by issuing a statement on the balance of payments problem and outlining a program to address it.[82] He noted that the U.S. international balance of payments position was "a subject of vital concern to the economic health and well-being of this Nation and the free world."[83] He first set out the urgency of the issue and the need for action:

> For 17 of the last 18 years we have had such {balance of payments} deficits. For a time those deficits were needed to help the world recover from the ravages of World War II. They could be tolerated by the United States and welcomed by the rest of the world. They distributed more equitably the world's monetary gold reserves and supplemented them with dollars.
>
> Once recovery was assured, however, large deficits were no longer needed and indeed began to threaten the strength of the dollar. Since 1961, your Government has worked to reduce that deficit.
>
> * * *
>
> Preliminary reports indicated ... a 1967 balance of payments deficit in the area of $3.5 to $4 billion – the highest since 1960.
>
> * * *
>
> The time has now come for decisive action designed to bring our balance of payments to--or close to--equilibrium in the year ahead.
>
> The need for action is a national and international responsibility of the highest priority.[84]

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82 *Public Papers of the Presidents of the United States: Lyndon B. Johnson, 1968-69*, Book I, at 8-13; also available at http://www.presidency.ucsb.edu/ws/index.php?pid=28804&st=&st1=.

83 *Public Papers of the Presidents of the United States: Lyndon B. Johnson, 1968-69*, Book I, at 8.

84 *Public Papers of the Presidents of the United States: Lyndon B. Johnson, 1968-69*, Book I, at 8-9.

President Johnson then proposed a program of both short and long-term measures to correct the payments problem. The temporary measures included restraints on direct investment abroad, curbs on foreign lending by banks, taxes on foreign travel, and efforts to alleviate government expenditures overseas.[85] The long-term measures included export incentives and reducing the negative impact of nontariff barriers, particularly border tax adjustments.[86] In this regard, President Johnson sought "prompt cooperative action" with U.S. trading partners.

> In the Kennedy Round, we climaxed three decades of intensive effort to achieve the greatest reduction in tariff barriers in all the history of trade negotiations. Trade liberalization remains the basic policy of the United States.
>
> We must now look beyond the great success of the Kennedy Round to the problems of nontariff 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.
>
> In keeping with the principles of cooperation and consultation on common problems, I have initiated discussions at a high level with our friends abroad on these critical matters--particularly those nations with balance of payments surpluses.
>
> These discussions 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.[87]

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85 *Public Papers of the Presidents of the United States: Lyndon B. Johnson, 1968-69*, Book I, at 10-11.

86 *Public Papers of the Presidents of the United States: Lyndon B. Johnson, 1968-69*, Book I, at 11-12.

87 *Public Papers of the Presidents of the United States: Lyndon B. Johnson, 1968-69*, Book I, at 12. The President's reference to the initiation of discussions at a high level with "friends abroad" is to U.S. efforts to have the issue of border tax adjustments reviewed by GATT members.

I. 1968-1970 – GATT Working Party on Border Tax Adjustments

In March 1968, at a meeting of the GATT Council, the United States brought its concerns about the problems of border tax adjustments to the GATT and formally requested that a GATT working party be established to examine the issue. In making this request, the U.S. noted that it had become "increasingly concerned with the adjustments made at the frontier by some contracting parties in respect of certain kinds of indirect taxes" and that a review was warranted in that border tax adjustments had "come to have relatively greater importance" for a number of reasons: (1) "tax systems had changed considerably since the GATT provisions on border tax adjustments had been drafted and a more sophisticated view of the effects of these would be taken today"; (2) "border tax adjustments had been expanded and developed in response to changes in tax systems at a time when tariffs and other barriers to trade were being progressively reduced"; and (3) "there were in prospect changes in tax systems in several countries which would raise further the adjustments made at frontiers."[88]

Pursuant to the U.S. proposal, it was agreed to establish a GATT Working Party with the following terms of reference:

> 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;

[88] *Minutes of GATT Council Meeting Held at the Palais des Nations, Geneva on 28 and 28 March 1968*, C/M/46 (5 April 1968) at 8.

> 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.[89]

At the first meeting of the Working Party, a number of countries expressed a range of initial views. Japan, for example, was supportive of the U.S. position, stating that it shared the concerns of the U.S. about the border tax adjustment rules and that the Working Party should seek a cooperative result.

> 6. The representative of Japan said that his delegation shared the concern of the delegation of the United States regarding the problem of border taxes. They recognized the need for international co-operation in the reduction of non-tariff barriers. The matter for discussion in the Working Party was not, however, to determine whether or not the border tax adjustments made by each country were justified but to examine the essential character of such taxes in the context of the GATT rules. The discussion should be oriented towards finding a rational solution, rather than toward a confrontation of national interests.
>
> 7. The Japanese Government attached special interest to the strict distinction which was made n the application of the GATT rules between direct and indirect taxes. The assumption that all indirect taxes were fully passed forward and that all direct taxes were fully passed back seemed to them unrealistic and resulted in some disequilibrium in the trade effects on individual countries, depending on whether their systems were based on direct or indirect taxes. . . . The Working Party must therefore endeavor to find a procedure for the imposition of border tax adjustments which was acceptable to all contracting parties . . . .[90]

In contrast, the European Communities was not supportive of any changes to the existing GATT rules. While the EC agreed with the U.S. that the questions before the Working Party

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[89] *Minutes of GATT Council Meeting Held at the Palais des Nations, Geneva on 28 and 28 March 1968*, C/M/46 (5 April 1968) at 11-12.

[90] *Working Party on Border Tax Adjustments, Secretariat Note on Meeting of 30 April to 2 May 1968*, L/3009 (17 May 1968) at paras. 6-7.

involved the fundamental rules and practices of GATT, and while it said that it was willing to participate in the work of the Working Party, the EC pointed out that the questions before the Working Party

> also involved an examination of universally accepted rules dating back to the inception of indirect taxes. From the outset the contracting parties have considered that these taxes should be {sic} principle affect only national consumption. In general, his delegation considered that, in this world where perfection was not the rule, the rules adopted in GATT, OECD and numerous integration treaties had operated in a relatively satisfactory way.[91]

The EC delegation further noted that "they were far from sharing the view that countries relying predominantly on direct taxes were at a disadvantage compared with those for which these taxes are less important," and that it did not agree that border tax adjustments could nullify or impair negotiated tariff concessions."[92] Other countries, such as Sweden, took a more neutral and objective stance toward the work of the Working Party, noting that as the issue "had been discussed for a long time in international bodies and in bilateral discussions," but unanimity had not yet been achieved, the Working Party should first seek common ground.[93]

The United States presented the argument for change. In its initial statement to the Working Party, the United States comprehensively outlined the reasons why it believed that it

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91 *Working Party on Border Tax Adjustments, Secretariat Note on Meeting of 30 April to 2 May 1968*, L/3009 (17 May 1968) at para. 11.

92 *Working Party on Border Tax Adjustments, Secretariat Note on Meeting of 30 April to 2 May 1968*, L/3009 (17 May 1968) at para. 12.

The EC expressed a similar attitude in other meetings. For example, at the fourth meeting of the Working Party, the EC representative "noted the desire of the United States that the GATT rules should be amended. That desire was based on a hypothesis – that border tax adjustments were arbitrary – which in fact still remained to be proved, and that was precisely the task of the Working Party. The problem had been studied in the OECD which had not reached any conclusions that such adjustments were arbitrary." *Working Party on Border Tax Adjustments, Secretariat Note on Meeting of 8 to 11 October 1968*, L/3125 (23 November 1968) at 1.

93 *Working Party on Border Tax Adjustments, Secretariat Note on Meeting of 30 April to 2 May 1968*, L/3009 (17 May 1968) at para. 8.

was time to reexamine and revise the GATT rules on border tax adjustments. As the U.S. statement cogently summarized the border tax adjustment problem, the U.S. statement at the first meeting of the Working Party is presented below in full.

Statement by Representative of United States
Before GATT Working Party on Border Tax Adjustments
April 30, 1968

> The United States welcomes the convening of this Working Party. We realize that the examination we are about to embark upon will be complex, and that fundamental policy issues regarding governmental intervention in trade will be raised. Nonetheless, we believe that it is essential at this time that the entire question of border tax adjustments be re-examined, and we hope that the appearance of such strong delegations is an indication of the desire of all of us to deal with this problem constructively and expeditiously.
>
> When the present GATT language was drawn up more than two decades ago, the question of border taxes did not appear to be a major one. Levels of indirect taxes were much lower. Under these circumstances, overlying simple and sweeping assumptions about tax shifting seemed acceptable, and already existing practices were incorporated without searching examination. The rules were drafted in very general terms. The United States at that time had no pressing reasons for seeking more elaborate provisions which provided more equitable safeguards for its trading position. On the contrary, at that time the United States was conscious of the need to assist other countries in relieving the pressures of the so-called dollar gap and the requirements for postwar reconstruction. Little detailed attention was paid to a problem which might hypothetically arise which would be harmful to our then strong payments position.
>
> Times have changed, and the United States must now pay very careful attention to rules and practices which are unfairly prejudicial to our trading interests. As President Johnson stated in his 1 January statement on this issue, "We must now look beyond the great success of the Kennedy Round to the problem of non-tariff barriers that pose a continued threat to the growth of world trade and to our competitive position."

More generally, the effect on trade of border tax adjustments and other nontariff barriers is relatively much more important multilaterally now than when the GATT was drawn up. Since that time, tariffs have become considerably less of a hinderance to trade, and quantitative restrictions have been substantially reduced in number and scope. Border tax adjustments have been placed in sharper focus by these developments particularly since there has been a steady increase in the rates and coverage of indirect taxes in many important trading countries. Most of this increase has been reflected in higher border tax adjustments. In some cases these rates are very high and cover almost all traded products. Consequently, in some countries the border tax adjustments on many items are well in excess of the tariff rate, and changes in border tax rates may often dwarf recently negotiated trade concessions.

When the current practices were in their early stages of development principally after World War I, indirect taxation tended to be confined to sumptuary taxes on a limited number of goods or to low-rate general taxes. Border tax problems were then simpler and relatively little attention was paid to the border tax issue. Now, the general growth of indirect taxes has made prominent the issue of border tax adjustments, and a major re-examination is essential. But the problems have recently been further accentuated by the series of upward changes in border tax adjustments which have taken place in the past few months, and by the variety of new changes contemplated by various member countries of this Working Party. These changes, coming as they have at a time when the international balance-of-payments adjustment process is already under strain, have exacerbated a serious multilateral trade and payments adjustment problem.

For some time now, both in international organizations and in bilateral consultations, United States representatives have indicated a growing concern over the present arrangements on border tax adjustments and their effects on trade. As early as July 1963, the United States proposed in the Organization for Economic Co-operation and Development a comprehensive study of the problems of border tax adjustments and their effect on trade. Our concerns are well-documented in the various discussions and consultations held in that Organization. Also, in the GATT during the past several years, United States representatives have at various times suggested that this problem needed to be explored more fully. Since these adjustments are governed principally by the GATT, under Articles II, III and XVI in particular, we believe that

a GATT review of its own rules is now in order. We believe that the Working Party should review the relevant rules in these articles with a view toward amending them or reaching new agreement on their interpretation and application in light of the current world trade and payments situation and of the need to improve the GATT in our continuous search for fairer trading rules and practices.

We have not come to this Working Party with fixed and inflexible views as to the results it must achieve. We wish the discussion to be a wide-ranging one. There will undoubtedly be other members of the Working Party who will wish to raise aspects of the problem which have not yet occupied us, or to present substantive argumentation to develop points that we have made. We shall welcome such contributions.

There are several general problem areas with which we should like to deal in this Working Party.

First, we should like to have a serious comprehensive discussion of whether there should in fact be border adjustments to compensate for national differences in taxation. There are no adjustments for a wide range of government measures which directly affect prices, nor for many forms of taxation which affect prices. Why then should governments make specific border adjustments for certain types of taxes? When governments adopt new domestic economic policies which have side effects on trade or payments, domestic action is not necessarily accompanied by offsetting action to neutralize the balance-of-payments effect. Many government actions, for example, affect general price levels. But only in the case of indirect tax measures is there an institutionalized provision for such offsets. What is the characteristic of indirect taxation that makes it uniquely qualified for automatic border adjustments?

If there are to be border adjustments, then they should be designed to allow no more adjustment at the border than is warranted by the impact on prices caused by taxes. From this point of view, we doubt that the current GATT rules and border tax practices are a good approximation of reality. The underlying assumption of the current rules is that certain kinds of indirect taxes are always fully passed forward in prices to the ultimate buyers of those goods, but that direct taxes and other indirect taxes are never passed forward to the buyers of those goods. Several issues arise out of this theoretical distinction.

Under present rules, it is unclear whether certain border tax adjustments are legal or not. In the first place, the definitions of direct and indirect taxes are by no means unanimously agreed. The GATT itself does not refer to the distinction, and the report of the Experts Group on this question is ambiguous in many respects. This is not surprising. Even today, economists have difficulty in defining direct and indirect taxes, depending upon the conceptual framework within which they are working and the purpose for which they wish to find definitions. The distinction between taxes which are shifted and those which are not is generally considered insufficient for analytical purposes and distinctions are often made between taxes which are meant to be shifted (whether they are or not) and those not so meant; between taxes on expenditures and taxes on receipts, and taxes on business enterprise as opposed to taxes on individuals. There are many examples: some authorities consider property taxes as direct, and others consider them indirect; some authorities consider employer contributions to social security as direct and some as indirect. In the second place there is wide diversity of opinion of just which taxes are "levied on" or "borne by" goods. The practice of certain countries varies significantly from the practice of other countries on this point. In the third place, under current rules, countries have had difficulty in assigning precise border adjustments to products in relation to taxes on those products. Averaging has often been used to determine the precise amount of adjustment at the border for some taxes removed from the last stages of production. The averages, because of the nature of the problem, have sometimes been based on sweeping and dubious calculations. The current system allows, and perhaps even encourages, imprecise arithmetic to determine the amount of adjustments. In these cases, imprecision often can mean continuous pressure for upward adjustments as a result of protectionist desires.

Putting aside these problems of classification and impression, there is a fundamental issue. Even when one is talking about relatively easily classifiable taxes, such as income and sales taxes, the economic validity of the distinction implied by the GATT between direct and certain indirect taxes is open to serious question. We think it is a fair statement to say that economists generally believe that indirect taxes are neither always nor fully shifted forward, and that direct taxes are seldom borne fully by the producer. There are differences of view on the extent of forward shifting of direct and indirect taxes but the extreme assumptions underlying the present GAIT provisions are patently wrong.

Therefore, a border adjustment equivalent to the full internal indirect tax has the same effect on international trade as an export subsidy or an additional customs duty on imports. Similarly the failure to make border adjustments for that portion of direct taxes shifted forward into prices penalizes the domestic producer vis-à-vis his foreign competition, both at home and in export markets. This handicaps countries relying primarily on direct taxation.

Well-known economists and fiscal experts brought together in a symposium organized by the Secretary-General of the Organisation for Economic Co-operation and Development in September 1964 reached conclusions along these lines. In brief, the conclusions of the exports were: 1. "In practice indirect taxes are not fully shifted into product prices ..." and 2. "Certain direct taxes, and particularly the corporation profits tax, may be partially shifted into product prices although the degree of shifting may vary from country to country."

Similarly, the Business and Industry Advisory Committee to the OECD (BIAC) in a report on the problem of tax shifting stated: "In a strongly competitive situation the prices obtainable—and hence the degree of tax shifting—are substantially determined by the market itself." The BIAC study on tax shifting found that while producers normally try to shift all taxes, their ability to do so is determined by a range of factors, including the state of the business cycle the producer's control over his market, and institutional factors which vary from country to country.

Thus, it appears to my delegation that the GATT rules create the inequitable situation where indirect taxes which are not fully shifted forward to the consumer can be rebated on export but corporate income taxes which are shifted forward to the consumer cannot be rebated on export. The inequity also exists with respect to the use of compensatory import charges.

In summary, the present GATT provisions on border tax adjustments do not neutralize the effects of taxes on trade. Instead, they are export promoting and import restricting for the indirect tax countries. The basic assumptions underlying the GATT provisions are not realistic. The full border tax adjustment provided for with respect to indirect taxes constitutes both an export subsidy and an import surcharge. Adjustments for indirect taxes should be eliminated or they should be reduced under carefully circumscribed conditions, or some comparable advantage should be granted to countries who do not have heavy indirect taxes to balance the advantages now granted to the indirect tax countries.

This brings me to the second basic, general problem area which we wish to have examined. That is the question of changes—that is to say, increases—in rates of border tax adjustments. Many countries have made or are making increases in their border tax adjustment rates. Some of the same countries, as well as a number of other countries, are planning to increase their border tax rates in the near future. These changes will raise obstacles to exports into their markets and give price advantages to their products in export markets. We are particularly concerned in cases where tariff concessions which we had obtained by reciprocal bargaining have been offset, or are currently threatened by new or increased compensatory import charges and by export rebates affecting other markets where we have received concessions.

These changes take two different forms, although they are sometimes mixed together: sometimes, changes are made on the argument that an adjustment from undercompensation to full compensation at the border is allowed. Sometimes changes are made in relation to a changeover from one system of indirect taxation to another system of indirect taxation.

Quite apart from the question of price shifting, changes raise fundamental problems. Once a country has established its rate of domestic taxation, its rates of border tax adjustment, its tariff rates, and its exchange rates, then any increase in the rates of border tax adjustment will create new advantages for the country's trade. Clearly, a change from so-called undercompensation to some higher, so-called full compensation level has markedly favourable effects on the trade of the country making such a change.

The changes which have recently taken place and which are soon to take place have intensified the balance-or-payments problem of my country. We believe that these changes have a fundamental adverse effect on the balance-of-payments adjustment process. The changes have been made even by countries which are in substantial payments surplus, and who ought to be seeking ways to avoid exacerbating balance-of-payments difficulties of other countries. The United States Government, in the framework of international co-operation, is presently seeking to achieve equilibrium in its balance of payments in a manner conducive, in the long term, to an increased flow of world trade. Increases in the level of border tax adjustment operate directly against these efforts. There is understandable interest in harmonization of their tax systems by the members of the European Communities. The shift from a turnover to a value-added system may be applauded as a tax

simplification measure, but the increases in border tax adjustments which accompany such action can be harmful to the process of achieving a better pattern of multilateral payments balances.

In saying this we recognize the right of each country or group of countries to adopt any tax system it chooses. But, I repeat: the concurrent increases in border tax adjustments by surplus countries can be disequilibrating and contrary to the balance-of-payments adjustments which are needed internationally. Taking into account the basic problems which require new examination, and mindful of the urgencies brought about by the present and planned changes in the border tax adjustments of some countries, the United States Government respectfully requests that all countries contemplating changes in border tax adjustments refrain from increasing the level of their adjustments pending completion of the work of this Working Party. This is a difficult request to meet. We recognize the awkwardness it may create for certain countries. But we believe that these planned changes will very seriously exacerbate an already very difficult international trade and balance-of-payments situation, and that a standstill for the time being is a modest step compared with the general difficulties further rate changes may create for the United States, and for all countries.

A third general problem area which we believe requires careful and detailed examination is the ambiguity in present rules and the need for a more precise code of practices relating to present rules and any changes which might eventually be contemplated by this Working Party. We are concerned with the ambiguities already referred to regarding distinctions between direct and indirect taxes. An attempt must be made to clear up what is legitimate and what is not. The question of what is meant by the terms "levied on" must be reexamined. Averaging and allocating practices should be examined. The valuation bases for assessment of border adjustments should be examined. Where a product is not produced in the home market, serious doubt exists that border adjustments should be made. Cases where production at home may be provided with special exemptions or escapes from taxes while at the same time requiring border tax adjustments on similar foreign goods should be examined. The broad scope for abuse of turnover tax systems, because of the ambiguity in them, should be examined. Ultimately, the question of what is "levied on" a product must be re-examined. New tax systems which might be adopted should be caught up in this basic review.

In order to assist other delegations in assessing the significance of present practices and the scope and dimension past, present, and projected developments in border tax practices in a number of countries, we shall make available to other delegations some descriptive information we have collected on border tax practices in a number of countries. We would welcome comments upon and additions to this compilation. Its purpose is to provide background as to why we believe the problems are growing in number, and why the work of this Working Party is a matter of urgency.

We would hope that in due course certain OECD documents can be released generally to members of this Working Party. Eventually, the documentation of this Working Party itself may grow large. The subject, as I said at the outset, is extremely complex. We believe, however; that it is extremely important, and that new approaches must be found, in spite of the great burden of work which it will place upon us.

The Working Party will in due course reach conclusions. We hope these conclusions will take the form of recommendations to change certain aspects of the GATT rules, and new interpretations of existing rules which might, perhaps, take the form of a Code, or a multilateral agreement of some kind. As I stated earlier, our ideas are not fixed. We would welcome suggested approaches by other countries. We are guided by certain broad considerations. We question whether there is a sound conceptual basis for any general border tax adjustments. If, however, it is a widely held view that some forms of border tax adjustments should continue, we believe that these border adjustments should not act in such a way as to give an unfair advantage to countries with one type of tax system and to penalize countries with other types of tax systems. If border tax adjustments are to serve the purpose of neutralizing the effect on trade of price and resource distortions, caused by taxation systems, the rules should not have the effect of encouraging countries to adopt one sort of tax system over another sort of tax system, merely because the GATT rules on border taxes give trade advantages to one system over the other. We believe that a country generally should be able to choose its tax system primarily because of domestic considerations without regard to trade advantages conferred by GATT rules on certain tax systems. Finally, we believe that the border tax adjustments, and changes in them, should not be set or operated in such a way that they

> exacerbate the international balance-of-payments adjustment process.[94]

From April 1968 to October 1970, the GATT Working Party conducted a detailed study of the tax systems of twenty-two countries and the relevant GATT rules on border tax adjustments.[95] In November 1970, the Working Party issued its report.[96] In the end, however, the Working Party failed to reach consensus to revise the GATT rules. At best, the Working Party report presented the differing viewpoints regarding the border adjustability of direct and indirect taxes, and noted where there was either convergence or divergence of views. The result of the Working Party was that the status quo with respect to the GATT rules was maintained. The only concrete results of the Working Party were that GATT member countries agreed to "keep one another informed of major changes in their tax adjustment legislation and practices involving international trade, and to hold consultations on these changes if requested."[97]

Excerpts from the Working Party report, illustrating the issues addressed and the differing views expressed, are set out below.

With regard to the provisions of the GATT relevant to border tax adjustments, the Working Party Report said:

> 4. For the purpose of its examination, ... 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

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94 *Working Party on Border Tax Adjustments, Secretariat Note on Meeting of 30 April to 2 May 1968,* L/3009 (17 May 1968) at Annex (Statement by Representative of United States).

95 *GATT Activities in 1970/71* (Geneva 1972) at 38.

96 *Report by the Working Party on Border Tax Adjustments,* L/3464 (20 November 1970), adopted on 2 December 1970; 18 BISD 97 (1972).

97 *GATT Activities in 1970/71* (Geneva 1972) at 37.

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)".

* * *

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. * * * 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. * * * 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 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. * * *[98]

With regard to the possible effects of border tax adjustments on international trade, the Working Party Report said:

> 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 macroeconomic 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

[98] *Report by the Working Party on Border Tax Adjustments*, L/3464 (20 November 1970) at paras. 4-15.

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 undercompensation. 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. * * *
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> 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.[99]

In conclusion, the Working Party Report said:

> 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. * * *
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> 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.[100]

[99] *Report by the Working Party on Border Tax Adjustments*, L/3464 (20 November 1970) at paras. 21-26.

[100] *Report by the Working Party on Border Tax Adjustments*, L/3464 (20 November 1970) at paras. 40-43.

J. 1969-1971 – Nixon Administration's Concerns Regarding Border Tax Adjustments

The border tax issue continued to be a controversial and pressing topic as the Nixon Administration took control of the government in 1969. The concerns in the early years of the Nixon Administration are reflected in the following chronology of selected Nixon Administration memos and other background papers from the 1969-1970 time period.

In the first month of the Nixon Administration, a task force on foreign trade policy, chaired by Alan Greenspan, prepared a report for the new administration. Included in its recommendations was one respecting the ongoing GATT discussion on border taxes.

> We are concerned here with a number of concrete issues that will arise--or ought to be acted on--in the first six or eight months of the new administration.
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> * * *
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> (7) The United States should continue to discuss with European countries their border taxes and to take part in the re-examination of GATT rules about these matters. Decisions about a value-added tax in the United States should be made in terms of domestic economic requirements, not those of trade policy. The majority of the task force is not favorably disposed to the use of border taxes or comparable import surcharges for balance of payments purposes when compensation for domestic taxes is not involved, but some members felt that the subject merits more detailed exploration.[101]

In March 1969, in a memorandum to President Nixon, Secretary of State William Rogers addressed the border tax adjustments issue.

> Border tax adjustments (BTAs) have become an important issue. A number of U.S. companies assert that the adjustments made by most European countries have the same effect as increased tariffs.

[101] *Report of the Task Force on Foreign Trade Policy*, January 31, 1969; U.S. Department of State, Foreign Relations, 1969-1976, Volume IV, Foreign Assistance, International Development, Trade Policies, 1969-1972 (Document 181); available at http://www.state.gov/r/pa/ho/frus/nixon/iv/15576.htm.

This is a very complicated issue, and the impact of border tax adjustments remains unclear in spite of all the international work done on it. We have argued that the existence of full border adjustments for high European sales or value added taxes harms the trade of countries such as the U.S. that rely less heavily on such taxes. There is no agreement on this point. However, a stronger case can be made that increases in border adjustments do damage trade when not accompanied by equal increases in domestic taxation. The Europeans have been bringing their border taxes up to the level of their domestic rates. No matter how justified Europeans may claim these increases are on the basis of equity, they mean that our exports are competing on a less favorable basis than previously. However, there are knotty theoretical problems in quantifying any damage. The most significant increase, which was made by Germany a year ago, was more than reversed in a November change made for balance of payments purposes.

I do not agree, however, that the answer to this problem is for us to make a unilateral increase in our border adjustments. We now make full border adjustments for the direct effect of our own excise and state and local sales taxes. We could go slightly further on grounds that our adjustments do not fully provide for the secondary effects of these taxes, e.g. calculating and adjusting for the expense to our exporting firms of the gasoline tax they pay to keep their trucks running. If we should make such a case, which might allow our border adjustments to be some 2% higher than currently, some other countries could easily make similar higher adjustments based on the same grounds, with little or no net gain for us. The previous Administration considered such a move but decided against it on the ground that we would gain little from it in trade terms.

We are now well into a U.S. initiated GATT examination of BTA practices and their effects on trade. We are trying to persuade other countries that the present system is inequitable and that border adjustments must be more strictly controlled. So far we have not found much support even among countries with taxation systems similar to ours for changes in the rules, though some foreign officials have indicated we do have a point.

> Should the GATT effort not improve the situation we will have to consider whether taking unilateral action is a satisfactory substitute. Such a move at this time, however, is premature.[102]

In April 1969, in preparation for a National Security Council meeting on major issues for decision in trade policy, a briefing memorandum prepared for Paul Volcker, Under Secretary of Treasury for Monetary Affairs, noted a difference in approach to the problem of border taxes between the State Department and Treasury:

> *Border Tax Adjustments*--There is interagency agreement at the staff level that a change in the GATT rules concerning border tax adjustment should be pursued by the U.S. Government. There is disagreement on the nature of the change which will be necessary. The State Department is backing a soft approach which would cause the least problems for the EEC. They advocate a change in the GATT rules which would allow temporary border tax adjustments during times of balance of payments difficulties, i.e., the use of BTA's to assist the adjustment process. They do not want to push for substantive change in the GATT rules which would eliminate the discrimination against countries which rely more heavily on direct taxes than indirect taxes. The Treasury Department has been the major force within the U.S. Government advocating substantial changes in the GATT rules on border tax adjustments.[103]

The paper prepared by the National Security Council Staff for the April 9th meeting on trade policy laid out the border tax adjustments issue as follows.

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[102] *Memorandum from Secretary of State Rogers to President Nixon*, March 24, 1969; U.S. Department of State, Foreign Relations, 1969-1976, Volume IV, Foreign Assistance, International Development, Trade Policies, 1969-1972 (Document 188); available at http://www.state.gov/r/pa/ho/frus/nixon/iv/15576.htm.

[103] *Memorandum from the Director of the Office of International Economics, Department of the Treasury (Pelikan) to the Under Secretary of the Treasury for Monetary Affairs (Volcker)*, April 8, 1969; U.S. Department of State, Foreign Relations, 1969-1976, Volume IV, Foreign Assistance, International Development, Trade Policies, 1969-1972 (Document 191); available at http://www.state.gov/r/pa/ho/frus/nixon/iv/15576.htm.

Border Tax Adjustments

There are two aspects to the border tax issue and they are usually confused. First, there is a structural problem in the GATT rules: indirect taxes (such as excise taxes and taxes on value-added) can be rebated on exports and imposed on imports while direct taxes (such as corporate and personal income taxes) cannot. The trade balances of countries with relatively heavier use of indirect taxes are thus in principle favored. As with other NTBs, however, there is no agreed analysis of these effects in practice. The clearest effect occurs when countries increase their border adjustments without changing their internal tax rates, usually in connection with a shift in their method of taxation.

Second, there is the possibility of using uniform border taxes as a temporary device to help countries adjust their balance of payments positions. Such measures could be legalized without changing the structural rules. The import surcharges used by Canada in 1962 and the UK in 1964-1966 are examples. The Johnson Administration seriously considered such an approach last year.

We could address ourselves to either or both of these problems. The balance of payments aspect is best considered in that context, however, and this trade discussion should be limited to the structural aspects.

The options are:

(1) Increase our own border taxes unilaterally, either legally and in small amounts to adjust for U.S. indirect taxes not now rebated, or illegally and in larger amounts to cover some of our direct taxes;

(2) Apply countervailing duties against foreign rebates on their exports and subsidize our exports to countries which apply border taxes;

(3) Propose changes in the GATT rules to allow for border adjustment for direct taxes;

(4) Propose undercompensation of indirect taxes by countries which rely heavily on them;

(5) Seek agreement that countries will not increase their adjustments even when they change their domestic tax rates, without international consultation.

No Presidential decision is required at this time. (My tentative view is that we should seek agreement only on changes in

> adjustments as per last-mentioned option, since any of the unilateral approaches would probably generate foreign retaliation and launch a trade war, and intensify international and internal study of the effects of BTAs as part of the over-all effort on NTBs outlined above, with a view toward including them in a major trade negotiation in a year or so. We can gain very little from negotiating on BTAs alone since we have nothing to offer in return for foreign concessions.)[104]

Although no specific actions were taken regarding border tax adjustments as a result of the April 9th NSC meeting, it was noted that:

> The President indicated that the Administration should take greater cognizance of the problems of U.S. businessmen and their concerns abroad, even when ultimately they may have to be over-ridden by foreign policy considerations. The business community should be convinced that its interests are adequately represented by the Government.[105]

In May 1970, in discussions with French financial officials at Camp David, Treasury Secretary David Kennedy expressed the concerns of Congress regarding the trade effects of border tax adjustments.

> Secretary Kennedy said there was a feeling of concern in Congress, which he shared, about the effect on trade of the differences between the U.S. and European tax systems. We have been studying what we might do in this regard, but it is hard to make a change in our system, which relies heavily on income taxes. Some people have suggested that we ought to introduce a

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[104] *Analytical Summary and Issues for Decision Prepared by the National Security Council Staff*, NSC Meeting, April 9, 1969; U.S. Department of State, Foreign Relations, 1969-1976, Volume IV, Foreign Assistance, International Development, Trade Policies, 1969-1972 (Document 192); available at http:/www.state.gov/r/pa/ho/frus/nixon/iv/15576.htm. (Note: it is unclear who is presenting "my tentative view" in the last paragraph.)

[105] *Action Memorandum from the President's Special Assistant for National Security Affairs (Kissinger) to President Nixon*, April 15, 1969 (Tab A: Actions Resulting From the NSC Meeting on Trade, April 9, 1969); U.S. Department of State, Foreign Relations, 1969-1976, Volume IV, Foreign Assistance, International Development, Trade Policies, 1969-1972 (Document 195); available at http:/www.state.gov/r/pa/ho/frus/nixon/iv/15576.htm.

> value-added tax and some people think that we should adopt border taxes. However, we have not taken any decisions on these matters. So far the only proposal to be adopted is the DISC proposal.[106]

In June 1970, Treasury Secretary Kennedy prepared a detailed memorandum for the Council of Economic Advisers specifically addressing border tax adjustments. In the memorandum, Secretary Kennedy recognized the growing problem as well as the difficult position of the United States in trying to persuade its trading partners to make structural changes to GATT rules.

> Tax Adjustments at the Border
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> Chairman McCracken's memorandum of June 8 suggests that we proceed with the three points outlined by Ambassador Gilbert while setting aside the issue of the basic inequity of GATT rules.[107] I do not believe that approach would relieve either our economic or political difficulties. Of the three points proposed by Ambassador Gilbert, two are clearly of minimal importance and solutions would result in no substantial trade benefits for U.S. producers. The third faces us with the same basic issue of GATT inequity which Chairman McCracken suggests we set aside. Any substantive proposal on changes would require an amendment of GATT provisions concerning the amount of allowable adjustments.

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106 *Memorandum of Conversation*, May 3-5, 1970; U.S. Department of State, Foreign Relations, 1969-1976, Volume III, Foreign Economic Policy, 1969-1972; International Monetary Policy, 1969-1972 (Document 146); available at http:/www.state.gov/r/pa/ho/frus/nixon/iii/5347.htm.

107 Footnote 2 to the Memo states: "McCracken's June 8 memorandum summarized the results of a June 5 meeting, where agreement was reached on how to proceed at the July GATT meeting. Gilbert outlined three points: "opposition to adjustments for taxes occultes; a requirement for confrontation and justification in the event of changes in a country's tax system involving border adjustments, and international control or surveillance of 'averaging.'" GATT rules allowed Contracting Parties to levy border taxes, sometimes known as border tax adjustments, imposing domestic, indirect taxes (i.e., excise, value added, and turnover taxes) on imports and rebating and/or excusing such taxes on their exports. A number of European nations and Japan, which relied heavily on indirect taxes (such as value added and turnover taxes), imposed significant border taxes, whereas the United States, which relied primarily on direct taxes (particularly income and property taxes), had only very limited scope for making border tax adjustments. In many circles this was viewed as discrimination against U.S. exports and subsidization of imports into the United States, contributing significantly to the U.S. balance-of-payments deficit. . . . ."

The U.S. has talked about taxe occulte[108] and averaging primarily for tactical purposes--keeping the talks alive while we consider the basic issue. The problems of averaging and border adjustments for taxe occulte have largely passed us by as they do not inherently exist in the value added tax system. As Italy and Belgium will be adopting the TVA within 18 months, only Spain and Austria, among the developed nations, will be left with cascade tax systems[109]--the area of most abuse regarding averaging and taxe occulte. A modification of taxe occulte procedures would limit possible U.S. action while leaving Europeans free to obtain benefits equivalent to adjustment for taxe occulte by simple modifications of their TVA systems. It is clear that there is little economic or political advantage in pursuing a change regarding these points.

As for the third point, I agree that countries should not be allowed unilaterally to disrupt the international trading mechanism by changes in their border adjustments.

Border tax adjustments will continue to be a problem as EC tax harmonization proceeds. Eventually all of Western Europe will be using the TVA and making substantial changes in their border adjustments. These changes, condoned by the bias in the GATT rules, will have serious disruptive effects on both trade and international balance of payments adjustments. Failure to resist this undercutting of our economic strength will badly damage our ability to prevent other similar actions.

In order to argue that changes should be controlled, we must demonstrate that they have trade effects. But in most instances this is true only if direct taxes are, in part or in whole, passed forward to the consumer and/or indirect taxes are partially absorbed by the producer. Either position directly contradicts GATT rules and confronts us with the issue of amending them to correct the bias in favor of indirect tax systems. Unless the rules are amended, countries would argue that their actions are in conformity with

[108] Footnote 3 to the Memo states: "The taxe occulte is the "hidden" amount of tax that accrues in the value of a product, depending on the number of transactions that occur during a product's production and distribution. Unlike value added taxes where the rate of application is generally clear, when taxe occulte occurs the effective rate is difficult to gauge, giving rise to the question of what is the appropriate, "average" rate for border tax purposes. See Border Tax Adjustments and Tax Structures in OECD Member Countries (Paris: Organization for Economic Cooperation and Development, 1968), pp. 20-21 and 58-63."

[109] Footnote 4 to the Memo states: "The cascade tax, or the turnover tax, was used in several European countries. Community members were expected to replace their cascade taxes with value added taxes."

GATT and they have no responsibility to offset any trade effects of changes in adjustments.

Thus advocacy by the U.S. of proposals covering the points raised by Ambassador Gilbert would seem to make sense only as part of a package which includes a major change in how nations handle border adjustments for taxes.

Chairman McCracken's thesis that past changes in tax adjustments at the border are washed out by exchange rate changes disturbs me.[110] It seems to me wrong in implying an equilibrium that simply does not exist and cannot practicably be obtained.

We have all recognized the absolute necessity of attaining a stronger goods and services position. The present bias in the border tax adjustment rules complicates the achievement of this goal.

The plain fact is that exchange rate changes of the last 10 or 15 years have not and will not eliminate the problem of existing border tax adjustments: our trade balance and balance of payments structure have deteriorated in recent years. The fact that some exchange rate changes might have been different without the border adjustments, if true, provides no answer to the U.S. structural problem. Furthermore, numerous changes in border adjustments have occurred which were not offset even partially by exchange adjustments. Thus, Belgium and Italy have not modified their exchange rates since 1949, the Dutch since 1961, and most of Scandinavia since the immediate post World War II period. Changes in taxes and border adjustments have occurred regularly, with rates and product coverage generally increasing. It is only with respect to the 1960 and 1968 German revaluation and the 1961 Dutch revaluation that we can conceivably say that exchange rate change even went in the right direction in order to offset in part the trade effects of the border adjustment. But even in those cases, it cannot be definitively stated that the trade effects of cumulative border tax adjustments were effectively offset. It seems to me fruitless to argue that remaining disequilibria can simply be offset by further exchange rate changes that in practice are both unlikely in the degree necessary and deeply disturbing to the international monetary climate.

[110] Footnote 5 to the Memo states: "McCracken argued that if a country made a 10 percent border tax adjustment for, say, a value added tax, by rebating that amount on exports and levying that amount on imports, any trade impact of that adjustment would be offset by a corresponding 10 percent appreciation in that country's currency, which would render its exports 10 percent more expensive in foreign currencies and its imports 10 percent more expensive in domestic currency."

Carried to its logical conclusion, Chairman McCracken's argument implies that the U.S. need not worry about the level of existing U.S. and foreign tariffs, U.S. and foreign subsidies or most U.S. and foreign import barriers as changes in exchange rates have eliminated their economic impact on U.S. and foreign trade interests. If this were so, the trade message submitted by the President need not have called for tariff reducing authority nor provided for retaliatory authority against foreign subsidies in third country markets. Although exchange rate changes may conceivably eliminate balance of payments disequilibrium, in the sense of reserve losses and gains, we must always question whether the process of adjustment is desirable, the new equilibrium is appropriate for the world and for the U.S., and the resulting payment structure and resource allocation are truly efficient. A new equilibrium with the EC in a heavy trade surplus and the U.S. relying on capital inflows would be structurally unsatisfactory for the U.S. and for the entire world.

On a political level, I also do not believe that an argument that exchange adjustments have eliminated the impact of old border adjustments will be persuasive. Certainly these exchange adjustments do not eliminate our countervailing duty problems as the border adjustments continue to exist. In this regard I would point to recent statements by Congressman Mills that he intends to amend the countervailing duty law to require action against all rebates of taxes.

As I mentioned before, any effective mechanism for controlling changes in border adjustments must have as its basis the same arguments already put forward on the amount of adjustment for direct and indirect taxes. To achieve an effective control limiting a country's ability to make such adjustments or changes in them would require a basic amendment to the GATT rules. By limiting our substantive proposals to controlling changes in adjustments we do not reduce the need for achieving a structural change in GATT. We would, however, have thrown out one of our basic arguments, receiving nothing in exchange, and prejudicing our credibility on other U.S. initiatives.[111]

[111] *Memorandum from Secretary of the Treasury Kennedy*, June 30, 1970; U.S. Department of State, Foreign Relations, 1969-1976, Volume III, Foreign Economic Policy, 1969-1972; International Monetary Policy, 1969-1972 (Document 41); available at http:/www.state.gov/r/pa/ho/frus/nixon/iii/5341.htm.

John Connally, successor to David Kennedy as Treasury Secretary, also expressed the view that the border tax adjustments issue should be addressed directly. The following is a colloquy between Treasury Secretary Connally and Utah Senator Bennett:

> Senator BENNETT. . . . The GATT seems to permit countries with value added taxes to rebate such taxes on exports and impose them at the border on imports under the theory that valued added taxes are always shifted forward to the consumer while corporate income taxes are absorbed by the producer.
>
> You are a businessman. Do you feel that the GATT provisions are sound with respect to these, to this attitude and, particularly, with respect to border tax adjustment?
>
> Secretary CONNALLY. No, sir; I do not think they are basically sound. I think there again we were in a posture where we did not, I assume, feel that the taxes—the rate of the indirect taxes were fairly low as I recall at the time of the negotiations, approximately 2 to 4 percent—were a great factor. And we were still a very strong Nation.
>
> We saw none of these problems; apparently, and we let them drive a wedge of distinction between the imposition of an indirect tax and a direct tax such as an income tax.
>
> Well, now, ultimately there is no difference. Ultimately any company, however they are taxed, has to pass on—
>
> Senator BENNETT. That is right.
>
> Secretary CONNALLY (continuing). That tax as a cost of the item manufactured to the consumer.
>
> But they distinguished it on the basis that an indirect tax like the value-added tax was in a different position, that it was passed on to the consumer and it could, therefore; be rebated without, violation of any of the international agreements—the GATT agreement—but you could not do it on income taxes.
>
> Now, it just so happens we rely predominently on the income tax. We do not have the value-added tax. The European countries rely heavily on indirect taxes.
>
> So the time has come for us to either demand the same treatment for direct taxes, or to play their game and insist that their value-added tax be treated the same as our direct taxes or that in

> any future tax measures, that we at least consider the possibility of adopting the value-added tax.
>
> Senator BENNETT. Don't you think, looking at the thing philosophically, don't you think we would all be better off if we renegotiated the basis of our international trade rather than continue to patch our own tax system to match the limitations in GATT?
>
> Secretary CONNALLY. I think the circumstances have changed to the point, Senator Bennett, where there is now such a completely different set of circumstances that surrounds the various trading partners in the world that any patching operation is not going to hold for any substantial period of time.
>
> I think there has to be an overall look taken at it.[112]

K. 1970-1972 – Williams Commission Report

In a November 18, 1969 message to Congress, President Nixon said that he intended to appoint a Commission on World Trade to examine the entire range of U.S. trade polices and objectives, to analyze the problems the U.S. was likely to face in the 1970s, and to prepare recommendations on what to do about them.[113] To that end, on May 21, 1970, President Nixon announced the formation of the President's Commission on International Trade and Investment Policy, which was referred to as the "Williams Commission" because it was chaired by IBM Chairman Albert Williams.[114] The Williams Commission tendered a 3-volume report to the

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[112] *Foreign Trade:* Hearings before the Subcommittee on International Trade of the Senate Finance Committee on World Trade and Investment Issues, 92nd Cong., 1st Sess., Part 1, at 44-45 (1971).

[113] Richard M. Nixon, Special Message to the Congress on United States Trade Policy. November 18th, 1969; available at John Woolley and Gerhard Peters, *The American Presidency Project* (online), http://www.presidency.ucsb.edu/ws/index.php?pid=2325&st=&st1=.

[114] *United States International Economic Policy In An Interdependent World*: Report to the President submitted by the Commission on International Trade and Investment Policy (July 1971, Washington, D.C.) at ix (Preface).

President, entitled United States International Economic Policy in an Interdependent World, in late July, 1971.[115]

One of the many trade policy topics examined by the Williams Commission was international trade distortions, and included under that subject was the trade effects of national tax structures.

The Commission noted that the issues of border tax adjustments had gained considerable prominence in international trade discussions as they related to present GATT rules dealing with internal taxation. The Commission described the situation: that GATT rules permit border tax adjustments on internationally-traded goods to the extent that indirect taxes (*e.g.*, excise and other consumption taxes) may be rebated on exports and imposed on imports (to the extent equivalent to those imposed on domestic like goods), but that direct taxes (*e.g.*, income or profit taxes) were not eligible for border adjustments. The Commission noted that these rules initially had been proposed by the United States at the time GATT was negotiated and that they reflected long-standing practices of major trading countries. The Commission described why the U.S. became concerned about the GATT's border tax adjustment rules.

> During the 1960s however, the United States, faced with balance-of-payments difficulties and the prospect of major changes in European tax systems that might aggravate these problems, began to question the fairness of the GATT rules. The United States argued that the rules assumed implicitly that indirect taxes were always fully shifted forward into product prices while direct taxes were never shifted forward, and that to the extent these assumptions did not hold - and most economists today believe they

[115] *United States International Economic Policy In An Interdependent World*: Report to the President submitted by the Commission on International Trade and Investment Policy (July 1971, Washington, D.C.).

> do not - a trade advantage was conferred on countries with extensive indirect tax systems.[116]

The Commission further noted that the issue had been examined before, first at the OECD and then at the GATT, that "most countries disagreed with the U.S. position, arguing that the implicit tax-shifting assumptions of GATT were approximately correct and that in any case a more equitable system could not be devised," and that neither the OECD or the GATT had recommended change in the rules.[117]

While the Commission generally recognized that there was uncertainty regarding the extent to which various taxes are reflected in product prices, *i.e.*, that "indirect taxes are probably not fully shifted into prices and direct taxes are probably shifted forward to a large extent," the Commission did not recommend any specific action to change the GATT rules. The Commission examined the main alternatives to the present GATT rules but found problems with each, as summarized below.[118]

Alternative	Problem
Limit permissible adjustments for indirect taxes	Would encourage imports and discourage exports in countries with internal taxes above the limit.
Allow countries to make adjustments at the border for direct taxes	Determining the adjustment amount as it is impossible to determine the direct tax (e.g., the corporate income tax) borne by individual products.
Impose a general import tax and export subsidy to offset disadvantage to the U.S.	Difficult to get agreement on existence and extent of any disadvantages. U.S. hidden indirect taxes are small. This type of adjustment is of questionable legality under present GATT rules.
U.S. could adopt a value-added tax	Any decision on adoption of a TVA by the U.S. should be based primarily on domestic tax considerations.

[116] *United States International Economic Policy In An Interdependent World*: Report to the President submitted by the Commission on International Trade and Investment Policy (July 1971, Washington, D.C.) at 103.

[117] *United States International Economic Policy In An Interdependent World*: Report to the President submitted by the Commission on International Trade and Investment Policy (July 1971, Washington, D.C.) at 103.

[118] *United States International Economic Policy In An Interdependent World*: Report to the President submitted by the Commission on International Trade and Investment Policy (July 1971, Washington, D.C.) at 105-107.

In the end, the Commission did not believe that there was a workable alternative to the present border tax adjustment rules. Instead, the Commission said that the U.S. needed to improve its balance of payments situation.

> In summary, we believe that *major changes in national tax systems can have significant balance-of-trade and payments effects. However, we do not believe that a realistic alternative to present international trade rules relating to internal taxation can be devised to cope with these problems. Primary reliance must be placed on an improved balance-of-payments adjustment process. In addition, the United States should make maximum use of the reporting and consultation procedures recently established in OECD and GATT in order to explore specific ways of minimizing adverse trade effects of contemplated tax changes.* [119]

L. 1968-73 – Reflections of U.S. Business Concerns Regarding the Trade Disadvantages Resulting from GATT Rules on Border Tax Adjustments

> In the United States, concern about the adverse trade effects of border tax adjustments has been mounting steadily, not only in the Executive Branch of the government but in industry and the Congress as well.[120]

Throughout the late 1960s and into the early 1970s, U.S. business repeatedly expressed to Congress their concern that the GATT rules on border tax adjustments and the increasing use of adjustable indirect taxes in the EC as well as other countries were resulting in a growing trade disadvantage for U.S. businesses, as well as diminishing the value of negotiated tariff reductions. U.S. business groups urged the U.S. to negotiate changes in the GATT rules applicable to border

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[119] *United States International Economic Policy In An Interdependent World*: Report to the President submitted by the Commission on International Trade and Investment Policy (July 1971, Washington, D.C.) at 107 (emphasis in original).

[120] John R. Petty, Assistant Secretary of Treasury for International Affairs, Paper prepared for the Twenty-first Annual Conference of the Canadian Tax Foundation (November 20, 1968), *reprinted in* Appendix (at 124) to Brief of Petitioner Zenith Radio Corporation in *Zenith Radio Corp. v. United States*, U.S. Supreme Court Appeal No. 77-539, filed March 23, 1978.

tax adjustments and also suggested a variety of actions that the U.S. should consider taking to address the trade disadvantages, including imposing import charges, export rebates and adoption of a U.S. value-added tax. The following provides a representative sampling of such concerns and proposals over the 1968-73 period.

Statement of the Committee on Commercial Policy, U.S. Council of the International Chamber of Commerce, Inc.:

> All countries impose some nontariff barriers, but businessmen and Government officials alike tend to be conscious only of those imposed by other governments. For example, U.S. businessmen are considerably, and we think justifiably, concerned over the border tax adjustment system used by the EEC countries as well as others. . . . The amount of net disadvantage to outside competitors resulting from longstanding border tax adjustments is a matter for debate on economic grounds, and the EEC countries generally deny that there is any such disadvantage. But there can be no question that the recent and expected adoption by other EEC countries of high-rate value-added taxes comparable to those of France will create a substantial disadvantage to U.S. producers.[121]

Statement of the Manufacturing Chemists' Association, Inc.:

> Taxation systems and particularly border tax adjustments are important cost considerations affecting trade. . . . The intended harmonization of border taxes along the lines of a value added tax system used by France at a figure of 10 to 15 percent has raised many questions regarding the additional effect on imports into and exports from the EEC and its compliance with the GATT rules. Accordingly, it is pertinent and of major importance to consider the effect which taxes can have in enabling the American exporter to compete in world markets and particularly in the EEC. . . . It is essential that the United States urge renegotiating that part of the GATT rules which forms the basis for treating direct and indirect taxes differently so that an effective export incentive can be accorded to U.S. manufacturers and to insure that tax systems do not discriminate against U.S. exports.[122]

Statement of the Synthetic Organic Chemical Manufacturers Association ("SOCMA"):

> *Border taxes.* -- Increased border taxes in most Common Market countries will substantially offset the tariff reductions made in the Kennedy Round. The imposition of these taxes on imports and the rebate of turnover taxes on exports provides these countries with an unfair competitive advantage over the United States and other income tax base countries which are not permitted by the GATT to collect such taxes or provide such rebates. The U.S. countervailing duty statute should be enforced until our trading partners agree to an acceptable revision of the

[121] Senate Finance Committee, *Compendium of Papers on Legislative Oversight Review of U.S. Trade Polices*, 90th Cong., 2nd Sess., Vol. 2, at 463-464 (1968) (Statement of the Committee on Commercial Policy, U.S. Council of the International Chamber of Commerce, Inc.).

[122] Senate Finance Committee, *Compendium of Papers on Legislative Oversight Review of U.S. Trade Polices*, 90th Cong., 2nd Sess., Vol. 2, at 475-476 (1968) (Statement of the Manufacturing Chemists' Association, Inc.).

> GATT to provide fair and equitable treatment which does not discriminate against countries with an income tax system.[123]

Moreover, SOCMA pointed out that while tariffs were reduced by the Kennedy Round, EEC border taxes were actually being raised, with the result that "the average cost of entry into the EEC for U.S. goods will be higher after the Kennedy round reductions than before."[124]

> We believe that the inequities resulting from the distinction made by article VI of the GATT between direct-indirect methods of taxation can and must be cured if we are to obtain any benefit at all from our past tariff reductions. We simply cannot permit our trading partners to offset even in part via border taxes whatever benefits we might otherwise have obtained from the tariff reductions they have made or to expand the value of our tariff reductions by increasing border tax rebates.[125]

Statement of Dr. Harry P. Guenther, Dean, Georgetown University, School of Business Administration:

> In the European Economic Community (EEC), tariffs have not been the only barriers to trade recently subject to revision and tariffs are a relatively smaller part of the barrier to trade than is true of the United States. Because of the border tax mechanism, allowing charges to be levied on imports equivalent to domestic indirect taxes (and the tax is applied to c.i.f. value and the tariff to landed value including the tax), U.S. exports face a significant barrier in addition to the tariff. Thus, tariff cuts or removal are of less relative significance to EEC countries than to the United States.[126]

Like SOCMA, Dr. Guenther also pointed out that the Kennedy Round tariff cuts removed a greater portion of U.S. barriers than those for EEC countries because the tariff cuts in the EEC were "offset due to border tax harmonization."[127]

Statement of Dr. Lewis E. Lloyd, Economist, the Dow Chemical Co.:

> The use of turnover, value-added or cascade consumption taxes and special surcharges in some EEC countries are another potent non-tariff barrier.
>
> In moving to harmonize the taxes on business within the EEC, several countries are adding or adjusting their value-added tax. This becomes significant, because whereas the total tax against

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123 Senate Finance Committee, *Compendium of Papers on Legislative Oversight Review of U.S. Trade Polices*, 90th Cong., 2nd Sess., Vol. 2, at 479 (1968) (Statement of the Synthetic Organic Chemical Manufacturers Association).

124 Senate Finance Committee, *Compendium of Papers on Legislative Oversight Review of U.S. Trade Polices*, 90th Cong., 2nd Sess., Vol. 2, at 494 (1968) (Statement of the Synthetic Organic Chemical Manufacturers Association).

125 Senate Finance Committee, *Compendium of Papers on Legislative Oversight Review of U.S. Trade Polices*, 90th Cong., 2nd Sess., Vol. 2, at 495 (1968) (Statement of the Synthetic Organic Chemical Manufacturers Association).

126 Senate Finance Committee, *Compendium of Papers on Legislative Oversight Review of U.S. Trade Polices*, 90th Cong., 2nd Sess., Vol. 2, at 655 (1968) (Statement of Dr. Harry P. Guenther, Dean, Georgetown University, School of Business Administration).

127 Senate Finance Committee, *Compendium of Papers on Legislative Oversight Review of U.S. Trade Polices*, 90th Cong., 2nd Sess., Vol. 2, at 660-661 (1968) (Statement of Dr. Harry P. Guenther, Dean, Georgetown University, School of Business Administration).

business in Europe does not differ greatly from ours, in most countries half or more of the corporate tax is in the form of a value-added or turnover tax, whereas most of our corporate tax is profits tax. When we ship to Germany, we will already have paid income tax on the total income, and will in addition have to pay a border tax equal to the turnover tax that would have been paid if the product had been made in Germany; so the total tax on exports from the United States to Germany will be considerably higher than on German production.

By contrast, when a firm in Germany or a number of other European countries ships to the United States, the value-added or turnover tax is refunded. Thus, the tax on a U.S. export sold in Germany may be twice as much as the tax that a German producer pays on exports to the United States. This is one example which shows how taxing differences can affect international trade.[128]

Manufacturing Chemists' Association:

Action should be taken by the United States to effect removal by our trading partners of border taxes and other nonprofit barriers. In 1963, this industry described European border taxes to the Department of Commerce as nontariff barriers affecting trade. In February 1966, after a year of survey and study, the industry provided the Office of the Special Trade Representative a detailed study on the effect of European indirect tax system on U.S. chemical exports. Before the conclusion of the Kennedy round in February 1967, the chemical industry provided another updated report to emphasize the expected impact of rising border taxes in the EEC. It was unfortunate and a mistake, we believe, that border taxes were not dealt with in the Kennedy round. The chemical industry believes that the United States could impose a border tax equivalent to the sum of indirect taxes imposed on U.S. manufacturers (both Federal and State), and rebate such taxes on exports. Secondly, an attempt should be made to have the GATT rules amended to allow for rebates on direct taxes as well as indirect taxes.

Perhaps a temporary surcharge should be placed on imports. This impediment would be understood by the other countries of the world as a temporary expedient to solve a serious balance-of-payments problem.[129]

Synthetic Organic Chemical Manufacturers Association:

The unreciprocal chemical deals were made still more unreciprocal by the border tax-export rebate mechanisms employed by most of our principal European trading partners. While we were agreeing to reduce substantially our entire barrier to their exports (tariffs), they were agreeing .to lesser reductions in their tariffs, which are only a portion of their barrier to our exports. They made no reduction at all on their border taxes, the other significant part of their overall trade barrier.

As if this were not enough, our negotiators knew at the time they agreed to these deals that most of the Common Market countries would be raising their border taxes by more than they were agreeing to lower their tariffs, The end result was that their total barrier to our trade—tariff plus border taxes—will be higher after the entire Kennedy round reduction than before the Kennedy round began.

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[128] Senate Finance Committee, *Compendium of Papers on Legislative Oversight Review of U.S. Trade Polices,* 90th Cong., 2nd Sess., Vol. 2, at 695 (1968) (Statement of Dr. Lewis E. Lloyd, Economist, Dow Chemical Co.).

[129] *Foreign Trade and Tariff Proposals:* Hearings Before the House Ways and Means Committee, 90th Cong., 2d Sess., Part 11, at 5778 (1968) (summary of testimony contained in Part 10 at pages 4484-4504).

To eliminate these disadvantages we propose the United States act promptly to adopt its own border tax. The Government witnesses recognize that it would be legal for the United States, even under existing interpretations of the GATT, to adopt a border tax. If it is reasonable for imports into Europe to bear the burden of indirect taxes, it is equally reasonable, and indeed imperative, for imports into the United States to bear this burden. Similarly, if it is reasonable for Europeans to rebate or exonerate their producers from these indirect taxes to stimulate exports, it is equally reasonable and again imperative, for the United States to do this, too. This first step will not eliminate our entire disadvantage, but it will be a needed first step in the right direction.

We should also continue to press for immediate action in the GATT to remove the remainder of the disadvantage to our trade caused by the discriminatory interpretations currently placed on the GATT rules, letting it be known that if cooperative action is not forthcoming promptly, we will have to take the unilateral action necessary to fully remove the remainder of the disadvantage to our trade.[130]

Synthetic Organic Chemical Manufacturers Association and Dry Color Manufacturers Association:

Long drawn-out negotiations on border taxes is no answer. In the domestic market and in third countries, we simply cannot bear the 10-to 15-percent handicap which results from foreign export rebates and expect to remain competitive. Similarly, our exports cannot bear a 10-to 15-percent border tax handicap and expect to remain competitive. We recommend:

(1) Immediate imposition of a U.S. border tax and export rebate to the full extent permitted under the GATT rules (total amount of indirect taxes imposed on U.S. products).

(2) Enforcement of U.S. countervailing duties statute against all imports which receive the benefit of a turnover tax rebate or any other subsidy.

(3) Immediate reconsideration of the inequitable interpretation of GATT rules in order to provide fair and equitable treatment for countries with an income tax system.[131]

Manmade Fiber Producers Association, Inc.:

Foreign border taxes paid on behalf of U.S. exporters should be allowed as a direct credit against their income tax liability.

There is a distinction between the proposals that the United States subsidize its exports by remission of its own taxes and this proposal which would allow a tax credit to a U.S. exporter in respect to foreign border taxes that had to be paid to get his goods into that country.[132]

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130 *Foreign Trade and Tariff Proposals:* Hearings Before the House Ways and Means Committee, 90th Cong., 2d Sess., Part 11, at 5778-79 (1968) (summary of testimony contained in Part 10 at pages 4504-4511).

131 *Foreign Trade and Tariff Proposals:* Hearings Before the House Ways and Means Committee, 90th Cong., 2d Sess., Part 11, at 5779 (1968) (summary of testimony contained in Part 10 at pages 4512-4590).

132 *Foreign Trade and Tariff Proposals:* Hearings Before the House Ways and Means Committee, 90th Cong., 2d Sess., Part 11, at 5779 (1968) (summary of testimony contained in Part 6 at pages 2464-2490).

This proposal to allow a tax credit to U.S. exporters was further explained by Eugene L. Stewart, Counsel to the MFPA: "In this sense we are not subsidizing our exports by remission of our taxes, but we are recognizing that a foreign country's border taxes are a barrier to our getting into that country and by this method of a tax credit we have a system, as it were, of automatic countervailing measures to offset their unfair border taxes." *Foreign*

E.I. duPont de Nemours & Co.:

> Although details may be lacking, it is clear that U.S. industry is competitively disadvantaged by the recent changes in the border tax systems in Europe. We believe the United States should impose a border tax on imports equivalent to the amount of indirect taxes borne by U.S. manufacturers. Further, all goods exported from the United States should be relieved of the indirect tax burden by an export tax rebate.[133]

Tanners' Council of America, Inc.:

> The system of border taxes and remission of internal turnover taxes in Western Europe has long been a thorn in the side of fair trade or competition.[134]

National Machine Tool Builders' Association (NMTBA):

> In many major markets, U.S. machine tool exports are exposed to nontariff border taxes. These include a "value added" tax of 20 percent in France, a 10-percent equalization tax in Germany, and in Italy a 4-percent duty and a 7.5-percent compensatory import tax.[135]

American Textile Manufacturers Institute, American Yarn Spinners Association, the Cordage Institute, the National Association of Wool Manufacturers, the National Knitwear Manufacturers Association; and the Northern Textile Association:

> In West Europe, the chief nontariff trade barrier facing American textile exports is the border tax. The range of rates from country to country and among textile products is wide—2.4 to 20 percent—however, in each case the tax is levied on the cost, insurance, and freight duty-paid value-thereby greatly increasing the effective tax harrier.[136]

National Shoeboard Conference:

> Border taxes—and other nontariff charges—burden U.S. exports to an extent impossible to overcome. In cases where the formal tariffs were reduced as much as 50 percent in the Kennedy

Trade and Tariff Proposals: Hearings Before the House Ways and Means Committee, 90th Cong., 2d Sess., Part 6, at 2489 (1968).

133 *Foreign Trade and Tariff Proposals:* Hearings Before the House Ways and Means Committee, 90th Cong., 2d Sess., Part 11, at 5779 (1968) (summary of testimony contained in Part 10 at pages 4596-4615).

134 *Foreign Trade and Tariff Proposals:* Hearings Before the House Ways and Means Committee, 90th Cong., 2d Sess., Part 11, at 5780 (1968) (summary of testimony contained in Part 9 at pages 4082-4089).

135 *Foreign Trade and Tariff Proposals:* Hearings Before the House Ways and Means Committee, 90th Cong., 2d Sess., Part 11, at 5780 (1968) (summary of testimony contained in Part 7 at pages 2845-2969).

136 *Foreign Trade and Tariff Proposals:* Hearings Before the House Ways and Means Committee, 90th Cong., 2d Sess., Part 11, at 5780 (1968) (summary of testimony contained in Part 6 at pages 2360-2405).

round, the continuation of the nontariff charges precludes any benefit to be derived from the tariff reduction. A border tax could be imposed on U.S. imports to offset foreign border tax systems.[137]

Committee for Economic Development:

The United States can take positive, constructive action by moving toward the elimination of nontariff barriers and subsidies that are obstacles to trade and distort the patterns of trade. U.S. producers are more adversely affected by nontariff barriers than are producers in our competing industrial countries. Probably the type of nontariff measure that has disturbed the American business community most of all is the border tax, which unquestionably results in some discrimination against producers in the United States. It may well he that the best first step toward negotiations to limit the trade-distorting effects of border taxes would be for the United States to exercise its right to have a general value-added tax of its own. The Committee for Economic Development recommends that such a tax be substituted for part of the present corporate income tax at the time when the tax structure is being reconsidered.[138]

Caterpillar Tractor Co.:

Extensive use of border taxes abroad (uplift; equalization, and value added taxes) is having a retarding-effect on U.S: exports. There should be discussions under the GATT aimed at eliminating these trade barriers.[139]

First National City Bank:

In the past, the United States has been inclined to accept other countries nontariff barriers. If this was understandable and even justifiable in the early postwar years; it is no longer so today. The United States should act aggressively, by every legal means, against other countries nontariff barriers which hurt our exports.

We should attack specific barriers, one at a time, by means tailored to the particular objective.

Strong U.S. action is also needed on European border taxes. For example, the United States might take the position that the GATT rule on border taxes should not be used to justify increases in border tax adjustments by countries with persistent balance-of-payments surpluses. If no reasonable agreement can be reached, the United States should be prepared to use countervailing duties in cases where border adjustments are increased in such a way as to thwart the balance-of-payments adjustment process.[140]

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137 *Foreign Trade and Tariff Proposals:* Hearings Before the House Ways and Means Committee, 90th Cong., 2d Sess., Part 11, at 5780 (1968) (summary of testimony contained in Part 9 at pages 4124-4130).

138 *Foreign Trade and Tariff Proposals:* Hearings Before the House Ways and Means Committee, 90th Cong., 2d Sess., Part 11, at 5780 (1968) (summary of testimony contained in Part 3 at pages 1225-1233).

139 *Foreign Trade and Tariff Proposals:* Hearings Before the House Ways and Means Committee, 90th Cong., 2d Sess., Part 11, at 5781 (1968) (summary of testimony contained in Part 3 at pages 1035-1039).

140 *Foreign Trade and Tariff Proposals:* Hearings Before the House Ways and Means Committee, 90th Cong., 2d Sess., Part 11, at 5781 (1968) (summary of testimony contained in Part 4 at pages 1810-1823).

Synthetic Organic Chemical Manufacturers Association ("SOCMA") and Dry Color Manufacturers Association ("DCMA"):

> The associations asserted: The border tax-export rebate device, permissible under GATT and used by many of our trading partners, is one of the major nontariff barriers affecting our trade. Reform of GATT should be a major objective of the forthcoming negotiations and a solution to this border tax problem should receive high priority.[141]

SOCMA and DCMA proposed the following:

> We are not proposing that any of our trading partners change their tax laws. The tax burden their people will bear and the expenditure of tax revenues is their concern.
>
> What we are proposing is that the trade distorting nature of this border tax export rebate system be recognized and dealt with affirmatively. There are several courses of action which should be explored.
>
> First, GATT could be amended to permit countries which primarily rely upon direct taxes to adjust for such taxes in the same manner as countries as countries which primarily rely on indirect taxes are now permitted to do.
>
> Second, GATT could be amended to permit all countries to adjust for both direct and indirect taxes at the border. These two alternatives would involve the use of complicated formula to determine the appropriate border adjustment for each country.
>
> The simplest and third solution would be for the GATT to be made neutral on indirect taxes as it now is on direct taxes. Thus, neither direct nor indirect taxes would be assessed at the border nor rebated on exports. . . .
>
> The border tax problem is urgent. We ask the committee to address it. The VAT is becoming more and more widespread. Unless something is done its harmful effect on trade will grow and further concessions by our trading partners will be cancelled or offset by increase in VAT or increased views of VAT.[142]

Magnavox Co.:

> The company contended: . . . The rebate of indirect taxes should be named in the TRA of 1973 as a bounty or grant subject to countervailing duty.[143]

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[141] *Trade Reform:* Hearings before the House Ways and Means Committee on H.R. 6767, The Trade Reform Act of 1973, 93rd Cong., 1st Sess., Part 15, at 5239 (1973) (summary of testimony contained in Part 6 at pages 1704-1734).

[142] *Trade Reform:* Hearings before the House Ways and Means Committee on H.R. 6767, The Trade Reform Act of 1973, 93rd Cong., 1st Sess., Part 15, at 5239 (1973) (summary of testimony contained in Part 6 at pages 1704-1734).

[143] *Trade Reform:* Hearings before the House Ways and Means Committee on H.R. 6767, The Trade Reform Act of 1973, 93rd Cong., 1st Sess., Part 6, at 1733 (1973) (testimony of Robert C. Barnard, counsel to Dry Color Manufacturers Association).

M. Trade Act of 1974 – For the Tokyo Round, Congress Identifies Reform of Border Tax Adjustment Rules as a U.S. Negotiating Objective

As noted above, the Williams Commission did not recommend specific action to address the GATT rules on border tax adjustments. However, one of the Commission's basic recommendations was that the U.S. government should initiate a major new round of trade negotiations.

> The Commission believes that the time has come to begin immediately a major series of international negotiations:
>
> -- to cope effectively with urgent international economic problems; and
>
> -- to prepare the way for the elimination of all barriers to international trade and capital movements within 25 years.
>
> The negotiations should be launched at the highest political level through a joint initiative by the United States, Western Europe, and Japan.[144]

The Williams Commission's call for new trade negotiations was influential in laying the ground for the Tokyo Round of GATT trade negotiations that was launched in 1974.

In preparations for the Tokyo Round, Congress developed and set out the negotiating objectives for the United States. In the Trade Act of 1974, Congress identified the reform of the GATT border tax adjustment rules as a negotiating objective.

> Sec. 121. Steps to be taken toward GATT revisions; authorization of appropriations for GATT.
>
> (a) The President shall, as soon as practicable, take such action as may be necessary to bring trade agreements heretofore entered into, and the application thereof, into conformity with principles

[144] *United States International Economic Policy In An Interdependent World*: Report to the President submitted by the Commission on International Trade and Investment Policy (July 1971, Washington, D.C.) at 10.

> promoting the development of an open, nondiscriminatory, and fair world economic system. The action and principles referred to in the preceding sentence include, but are not limited to, the following –
>
> * * *
>
> (5) the revision of GATT articles with respect to the treatment of border adjustments for international taxes to redress the disadvantage to countries relying primarily on direct rather than indirect taxes for revenue needs.[145]

The House report explained the purpose of this negotiating objective.

> Section 121 of the bill directs the President to take action to bring trade agreements previously entered into in conformity with principles promoting the development of open, nondiscriminatory trade and commerce. Such action is to include, but is not limited to, ... the revision of GATT articles with respect to the treatment of border adjustments for internal taxes, ...
>
> * * *
>
> Your committee also believes that GATT provisions on tax adjustments in international trade should be revised to ensure that they will be trade neutral. Present provisions permit adjustments on traded goods for certain indirect taxes but not for direct taxes. The committee expects that the President will seek such modification of present rules as would remove any disadvantage to countries like the United States relying primarily on direct taxes and put all countries on an equal footing.[146]

In the Tokyo Round, the United States sought, but was unsuccessful in achieving its negotiating objective of reforming GATT rules relating to border tax adjustments. In the initial stages of the Tokyo Round, the rebate of indirect taxes was a "high-profile issue" as the United States tried to establish a link between countervailing duties and rebates of indirect taxes.[147] For

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145 Trade Act of 1974, Section 121, Pub.. L. 93-618, 88 Stat. 1978, 1986; 19 U.S.C. § 2131.

146 House Rep. No. 93-571, 93d Cong., 1st Sess. 6, 27 (1973); *see also* the corresponding Senate report, S. Rep. No. 93-1298, 93d Cong., 2d Sess. 19, 23-24, 84 (1974).

147 *See, e.g.*, Gilbert R. Winham, *International Trade and the Tokyo Round Negotiation* (Princeton University Press, 1986) at 171.

example, in a submission to the negotiating subgroup on subsidies and countervailing duties regarding problems encountered in the areas of subsidies and countervailing duties, the United States noted:

> Tax practices
>
> Current GATT rules on subsidies and countervailing duties have specific provisions that deal with various tax practices. The United States believes that new rules on subsidies and countervailing duties must also contain provisions that deal with the impact of varying tax practices on international trade.[148]

The U.S. effort met resistance and consequently fell short. As noted by one commentator, U.S. efforts were half-hearted and not aggressively pursued.

> In response to this congressional directive the U.S. negotiators raised the question in a perfunctory way, but "as soon as the negotiators were seriously under way, the insistence of the United States that the direct tax/indirect tax rule be changed was quietly dropped" because the U.S. negotiators believed that it was so deeply rooted in the tax laws of other countries that it was by then nonnegotiable.[149]

Another historian summarized the situation as follows:

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[148] *Subsidies and Countervailing Duties, Submission of the United States*, MTN/NTM/W/43/Add.6 (31 May 1976) at 5.

[149] Bruce E. Clubb, *United States Foreign Trade Law*, Vol. 1, at 475-76 (1991), *citing and quoting* Richard R. Rivers & John D. Greenwald, *The Negotiation of a Code on Subsidies and Countervailing Measures: Bridging Fundamental Policy Differences*, 11 LAW & POL'Y INT'L BUS 1447, 1458 (1979). Rivers & Greenwald noted:

> Whatever the merits of the U.S. case in economic terms (and there is a good body of opinion to the effect that the basis for the GATT distinction is artificial), the whole question was a nonissue because it was nonnegotiable. In broad terms, only two solutions were possible. Either the rebate of direct taxes would be permitted, and this would have made a mockery of the notion of tighter disciplines over subsidies, or the rebate or remission of indirect taxes would have to be prohibited or limited. But no country was about to agree to a major overhaul of its domestic tax structure in order to satisfy U.S. negotiating objectives in the MTN.

Id.

> The U.S. attempt to negotiate indirect-tax rebates and border taxes in connection with countervailing duties got nowhere in the Tokyo Round. For the EC and others, it was a nonnegotiable issue because it would have required nothing less of national governments than to alter their domestic tax structures fundamentally in order to accommodate trade with one other country. The matter was effectively put to rest by a ruling of the U.S. Supreme Court in the Zenith case in June 1978. The Zenith Corporation had requested the Court to rule that indirect-tax rebates on imported electronic products constituted a foreign subsidy for the purpose of U.S. countervail legislation, which would have required that countervailing duties be levied on these products. The Court rejected this interpretation. Had the case gone the other way, the implications would have been enormous, and according to a published estimate of U.S. Treasury officials it would effectively have increased U.S. protectionism by more than it had been reduced during the entire history of the GATT.[150] [151]

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[150] *See, e.g.*, Gilbert R. Winham, *International Trade and the Tokyo Round Negotiation* (Princeton University Press, 1986) at 171 n. 3.

[151] In the *Zenith* case, the U.S. Customs Court had found that the remission of the Japanese Commodity Tax on a number of consumer electronic products exported from Japan that would have been imposed had the products been sold within Japan bestowed a "bounty or grant" within the purview of the countervailing-duty statute. *Zenith Radio Corp. v. United States*, 430 F. Supp. 242 (Cust. Ct. 1977). The U.S. Court of Customs and Patent Appeals subsequently reversed the decision of the Customs Court, 562 F.2d 1209 (CCPA 1977), and the U.S. Supreme Court affirmed the CCPA, 437 U.S. 443 (1978).

The decision of the Customs Court in 1977 finding that the remission of the Japanese commodity tax on certain exported products constituted a countervailable subsidy under U.S. law brought forth vociferous objection from Japan at the GATT and a Working Party was established at Japan's request to address the issue. In making its request, Japan stated:

> It must be said that the ruling by the United States Customs Court and the subsequent United States action that is in violation of established rules, is bound to cause serious effects not only to exports of Japanese electronic products to the United States but to world trade in general as many contracting parties to GATT presently exempt exported products from internal consumption taxes or refund such taxes.

United States - Suspension of Customs Liquidation Regarding Certain Japanese Consumer Electronic Products, Communication from Japan, L/450 (16 May 1977) at 2 (para. 4).

In the Working Party, Japan asserted that the practice of exempting exported products from domestic consumption taxes was in full accord with the Articles of the GATT, in particular with Article XVI:4 and the note to Article XVI. Japan further argued that the imposition of countervailing duties by the U.S. on Japanese consumer electronic products "would constitute a *prima facie* case of nullification or impairment of benefits accruing to Japan under the General Agreement." *Report of the Working Party on the United States/Zenith Case*, L/4508 (6 June 1977) at 2 (para. 8).

The European Community fully supported Japan in the Working Party.

At the end of the Tokyo Round in 1979, not only had the U.S. failed to have the issue of border tax adjustments taken up and addressed,[152] but the Tokyo Round adopted a plurilateral Subsidies Code (to which the U.S. was a signatory) that included an Illustrative List of Export Subsidies, as well as definitions of direct and indirect taxes.[153] The Subsidies Code Illustrative List basically incorporated and expanded on the list of export subsidies identified in the 1960 GATT Working Party Report.

1960 Working Party Illustrative List	1979 Subsidies Code Illustrative List
(c) The remission, calculated in relation to exports, of direct taxes or social welfare charges on industrial or commercial enterprises.	(e) The full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.
(d) The exemption, in respect of exported goods, of charges or taxes, other than charges in connexion with importation or indirect taxes levied at one or several stages on the same goods if sold for internal consumption; or the payment, in respect of exported goods, of amounts exceeding those effectively levied at one or several stages on these goods in the form of indirect taxes or of charges in connexion with importation or in both forms.	(g) The exemption or remission in respect of the production and distribution of exported products, of indirect taxes in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption.
	(h) The exemption, remission or deferral of prior stage cumulative indirect taxes on goods or services used in the production of exported products in excess of the exemption, remission or deferral of like prior stage cumulative indirect taxes on goods or services used in the production of like products when sold for domestic consumption; provided, however, that prior stage cumulative indirect taxes may be exempted,

> In support of the view that the rebates of the commodity taxes were consistent with GATT provisions he {i.e., the EC representative} quoted excerpts from the United States Administration Brief to the Court of Customs and Patent Appeals to the effect that the United States Treasury had since 1898 followed an interpretation that remission of such taxes was not countervailable and believed that this view was consistent with international rules. If the Court's decision were upheld, the resulting situation would, in his view, underline the disequilibrium existing between the obligations of contracting parties in this area.

Report of the Working Party on the United States/Zenith Case, L/4508 (6 June 1977) at 3 (para. 11).

[152] One observer noted: "Issues relating to subsidization through tax systems were not systematically examined in the Tokyo Round." Rodney deC. Grey, *Some Notes on Subsidies and the International Rules*, included in *Interface Three: Legal Treatment of Domestic Subsidies* (1984) at 66.

[153] GATT, Agreement on Interpretation and Application of Articles VI, XVI And XXII of the General Agreement on Tariffs and Trade (1979) ("Subsidies Code").

1960 Working Party Illustrative List	1979 Subsidies Code Illustrative List
	remitted or deferred on exported products even when not exempted, remitted or deferred on like products when sold for domestic consumption, if the prior stage cumulative indirect taxes are levied on goods that are physically incorporated (making normal allowance for waste) in the exported product.

With respect to item (h) of the 1979 List above, it was noted that "paragraph *(h)* does not apply to value-added tax systems and border-tax adjustment in lieu thereof; the problem of the excessive remission of value-added taxes is exclusively covered by paragraph *(g).*"[154]

In addition, note 1 to the 1979 Subsidies Code Illustrative List contained definitions of direct and indirect taxes and other relevant terms:

> For the purpose of this Agreement:
>
> The term "direct taxes" shall mean taxes on wages, profits, interest, rents, royalties, and all other forms of income, and taxes on the ownership of real property;
>
> The term "import charges" shall mean tariffs, duties, and other fiscal charges not elsewhere enumerated in this note that are levied on imports;
>
> The term "indirect taxes" shall mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges;
>
> "Prior stage" indirect taxes are those levied on goods or services used directly or indirectly in making the product;
>
> "Cumulative" indirect taxes are multi-staged taxes levied where there is no mechanism for subsequent crediting of the tax if the goods or services subject to tax at one stage of production are used in a succeeding stage of production;
>
> "Remission" of taxes includes the refund or rebate of taxes.[155]

[154] 1979 Subsidies Code, Annex - Illustrative List of Export Subsidies, at Note 3.

[155] 1979 Subsidies Code, Annex - Illustrative List of Export Subsidies, at Note 1.

Thus, the Tokyo Round resulted in the reaffirmation of both the existing prohibition of exemption and remission of direct taxes for exports and the allowance of exemption and remission of indirect taxes for exports.

N. Omnibus Trade and Competitiveness Act of 1988 – For the Uruguay Round, Congress Again Identifies Revision of Border Tax Adjustment Rules as a U.S. Negotiating Objective

Although previous U.S. efforts to change the GATT border tax adjustment rules (e.g., the 1968-70 GATT Working Party and the Tokyo Round), in establishing trade negotiating objectives for the Uruguay Round negotiations, Congress again listed border tax reform as a negotiating goal. In the Omnibus Trade and Competitiveness Act of 1988, Congress identified "border taxes" as one of the principal negotiation objectives of the U.S., stating:

> Border Taxes.—The principal negotiating objective of the United States regarding border taxes is to obtain a revision of the GATT with respect to the treatment of border adjustments for internal taxes to redress the disadvantage to countries relying primarily for revenue on direct taxes rather than indirect taxes.[156]

Explaining the purpose of the border tax objective in the context of improving the GATT Agreement, the Senate Finance report noted that it was renewing a trade objective first set out in the Trade Act of 1974:

> *Improvement of GATT*
>
> Section 105(b)(2) contains a number of specific objectives with the aim of bringing existing trade agreements, including the application and enforcement of those agreements, into conformity with principles promoting the development of an open,

[156] Omnibus Trade and Competitiveness Act of 1988, Pub. L. 100-418, Title I, Sec. 1101, Aug. 23, 1988, 102 Stat. 1121; 19 U.S.C. § 2901(b)(16).

> nondiscriminatory, and fair world trading system. These include, but are not limited to, the following:
>
> * * *
>
> (12) Border tax adjustments.—This provision renews a provision of the 1974 Trade Act calling for the revision of the GATT with respect to the treatment of border adjustments for internal taxes to redress the disadvantage to countries relying primarily for revenue on direct taxes, such as income taxes, rather than on indirect taxes, such as value-added taxes. The Committee believes that GATT provisions on tax adjustments in international trade should be revised to assure that they will be trade neutral. Present provisions permit adjustments on traded goods for certain indirect taxes but not for direct taxes. To the extent that indirect taxes are not fully passed through to the consumer in the country of manufacture, the remission of the full amount of assessed indirect taxes on exportation constitutes an unfair advantage to those who export. Similarly, absent the unlikely event of a full pass-through of tax, the imposition of an indirect tax on imports constitutes an additional and unfair burden on those who export to that country. American exporters, for example would have to absorb another nation's indirect taxes as well as our nation's direct taxes. The Committee expects that the President will seek such modification of present rules as would remove any disadvantage to countries like the United States relying primarily on direct taxes and put all countries on an equal footing.[157]

The issue of border tax adjustments was proposed for negotiations at the Uruguay Round. The Secretariat's checklist of issues for negotiation described this proposal:

> There is growing doubt in some quarters that the Code's treatment of border tax adjustments (that is, the assumption that non-excessive remission of indirect taxes on exported products is trade-neutral) reflects the true economic effect of such adjustments. Accordingly, the Agreement's current treatment of this practice should be re-examined.[158]

[157] Senate Report No. 100-71, 100th Cong., 1st Sess. 39-41 (1987).

[158] Negotiating Group on Subsidies and Countervailing Measures, *Checklist of Issues for Negotiations, Note by the Secretariat*, MTN.GNG/NG10/W/9/Rev.4 (12 December 1988) at 24.

Despite being identified by Congress as a U.S. negotiating objective in the Uruguay Round and despite being raised at the negotiations, the U.S. did not achieve a revision of the GATT rules regarding border tax adjustments. In fact, one of the Uruguay Round agreements was the Agreement on Subsidies and Countervailing Measures (ASCM), which revised and replaced the 1979 Subsidies Code. Like the 1979 Subsidies Code, the ASCM contained an Illustrative List of Export Subsidies. This list was basically the same illustrative list carried over from the Subsidies Code.[159] The differences are highlighted in the table below.

1979 Subsidies Code Illustrative List	1994 SCM Agreement Illustrative List
(e) The full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.	(e) The full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.
(g) The exemption or remission in respect of the production and distribution of exported products, of indirect taxes in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption.	(g) The exemption or remission in respect of the production and distribution of exported products, of indirect taxes in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption.
(h) The exemption, remission or deferral of prior stage cumulative indirect taxes on goods or services used in the production of exported products in excess of the exemption, remission or deferral of like prior stage cumulative indirect taxes on goods or services used in the production of like products when sold for domestic consumption; provided, however, that prior stage cumulative indirect taxes may be exempted, remitted or deferred on exported products even when not exempted, remitted or	(h) The exemption, remission or deferral of prior stage cumulative indirect taxes on goods or services used in the production of exported products in excess of the exemption, remission or deferral of like prior stage cumulative indirect taxes on goods or services used in the production of like products when sold for domestic consumption; provided, however, that prior stage cumulative indirect taxes may be exempted, remitted or deferred on exported products even when not exempted, remitted or

[159] See WTO Agreement on Subsidies and Countervailing Measures, Annex I (Illustrative List of Export Subsidies) at paragraphs (e), (g), and (h). The SCM Illustrative List, like the Subsidies Code, also noted that "paragraph (h) does not apply to value-added tax systems and border-tax adjustments in lieu thereof; the problem of the excessive remission of value-added taxes is exclusively covered by paragraph (g)." *Id.* at Note 60. Annex II, Guidelines on Consumption of Inputs in the Production Process, was a new addition to the ASCM that was not previously included in the Subsidies Code. The reference in paragraph (h) to inputs consumed in the production process was defined as "inputs physically incorporated, energy, fuels and oil used in the production process and catalysts which are consumed in the course of their use to obtain the exported product." *ASCM* at Note 61.

1979 Subsidies Code Illustrative List	1994 SCM Agreement Illustrative List
deferred on like products when sold for domestic consumption, if the prior stage cumulative indirect taxes are levied on goods that are physically incorporated (making normal allowance for waste) in the exported product.	deferred on like products when sold for domestic consumption, if the prior stage cumulative indirect taxes are levied on inputs that are consumed in the production of the exported product (making normal allowance for waste). This item shall be interpreted in accordance with the guidelines on consumption of inputs in the production process contained in Annex II.

Thus, at the end of the Uruguay Round in 1994, the existing GATT/WTO rules on border tax adjustments had again been affirmed.

O. Trade Act of 2002 – For the Doha Round, Congress Once More Identifies Reform of Border Tax Adjustment Rules as a U.S. Negotiating Objective

In 2002, in conjunction with the passage of "fast track" legislation and the ongoing Doha Round negotiations, the issue of border tax adjustments was again prominently included in the trade negotiating objectives established by Congress. In the Trade Act of 2002, Congress identified "border taxes" as a key focus for reform through trade negotiations.

> The principal negotiating objective of the United States regarding border taxes is to obtain a revision of the WTO rules with respect to the treatment of border adjustments for internal taxes to redress the disadvantage to countries relying primarily on direct taxes for revenue rather than indirect taxes.[160]

The Senate Finance report indicated that one purpose of this negotiating objective was to address the WTO Appellate Body's finding that the U.S. tax treatment of Foreign Sales Corporations constituted a prohibited export subsidy and was thus inconsistent with WTO rules.

[160] Trade Act of 2002, Pub. L. 107-210, Div. B, Title XXI, Sec. 2102, Aug. 6, 2002, 116 Stat. 994, 1001; 19 U.S.C. § 3802(b)(15).

The principal negotiating objective regarding border taxes directs negotiators to seek a revision of WTO rules that will eliminate the current disadvantage to countries, such as the United States, that rely primarily on direct taxes (such as income taxes), rather than indirect taxes (such as sales and value-added taxes), and that tax income on a worldwide rather than a territorial basis. Rulings adopted by the WTO Dispute Settlement Body have found that the WTO Agreement on Subsidies and Countervailing Measures prohibits provisions in the United States Internal Revenue Code that exempt from taxation certain income from export transactions. By contrast, provisions under the laws of other countries that exempt export sales income from indirect taxes or remit to exporters taxes previously imposed might not be prohibited even though they provide similar relief to that afforded by the Internal Revenue Code.

In the matter of United States – Tax Treatment for "Foreign Sales Corporations," the WTO Appellate Body recognized the sovereign right of every country to set its own taxation rules. At the same time, the Appellate Body reached decisions concerning the Foreign Sales Corporation provisions of the Internal Revenue Code (and, more recently, the Extraterritorial Income Exclusion Act of 2000 provisions) that severely constrain the sovereign right of the United States to set its own rules of taxation for foreign source income earned in export transactions. Under the Appellate Body's interpretations, it would be difficult for the United States, consistent with WTO rules, to maintain its 'worldwide' approach to international taxation while ensuring that U.S. producers are not at a competitive disadvantage compared with producers in jurisdictions that take a 'territorial' approach to international taxation.

In short, WTO subsidy rules as interpreted by dispute settlement panels and the Appellate Body give rise to a disparity that favors territorial tax jurisdictions over worldwide tax jurisdictions. The view of the Committee is that this disparity must be corrected, in order to preserve the sovereign right of every country to choose its own rules of taxation. Accordingly, the objective on border taxes directs the President to pursue this correction in the recently launched round of WTO negotiations. It is the Committee's expectation that in eliminating the existing disparity, the President will avoid a result that would place U.S. workers and companies

> now benefiting from the Extraterritorial Income Exclusion Act of 2000 at a competitive disadvantage.[161]

At the Doha Round negotiations, in accordance with Congress' negotiating objectives, the U.S. has made at least one attempt to raise the issue of border tax adjustments. The U.S. has raised the issue in the context of the rules negotiations and discussions about subsidy disciplines. In a submission, the U.S. pointed out that different tax systems have a distorting effect and create unfair disadvantages:

> Taxation
>
> The Subsidies Agreement disciplines direct and indirect taxes differently. Under the existing Agreement, it is more likely that direct tax concessions related to export activity will be found to be export subsidies, and therefore inconsistent with the Agreement, than would export-related concessions on the payment of indirect taxes. The United States recognizes that this distinction has existed in the GATT/WTO subsidy rules for some time. Nonetheless, the United States believes that an essential part of the work of the Rules Group should be to work toward greater equalization in the treatment of various tax systems that, at least with regard to their subsidy-like effects, have only superficial differences. The current distinction risks ignoring the potential trade-distorting effect that certain practices involving indirect taxes may have on trade, and may unfairly disadvantage competitors operating under a direct taxation system.[162]

Other than this initial effort of the U.S. to engage a discussion on the border tax adjustment issue, it appears that no other submissions or discussions have occurred at the Doha Round on this issue.

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[161] Senate Report 107-139, 107th Cong., 2d Sess. 35-36 (2002).

[162] *Subsidies Disciplines Requiring Clarification and Improvement*, Communication from the United States, TN/RL/W/78 (19 March 2003) at 4.

P. Multiple U.S. Efforts to Partially Compensate for the Inequity of GATT Border Tax Rules Have Been Thwarted by GATT and WTO Dispute Settlement Decisions

Although U.S. efforts over the last 40 years to revise the GATT rules on the border adjustability of indirect and direct taxes have not succeeded, the U.S. has repeatedly enacted legislation intended to relieve the tax burden on U.S. exporters and which has attempted to compensate, at least partially, for the inequities of the border tax adjustment rules. Each time, however, the U.S. legislation has been challenged at the GATT or WTO and found to be inconsistent with GATT/WTO rules.

First, in 1971, Congress created the Domestic International Sales Corporation (DISC) through which a U.S. company could partially defer taxes on export earnings.[163] The legislative history to the DISC indicates that one of the purposes (although not the primary purpose) of the DISC was to alleviate, to some degree, the competitive trade disadvantages faced by U.S. exporters due to the direct-indirect tax treatment disparity under GATT.[164] The House Ways and Means Committee Report stated:

> {Y}our committee believes that it is important to provide tax incentives for U.S. firms to increase their exports. This is important not only because of its stimulative effect but also to remove a present disadvantage of U.S. companies engaged in export activities through domestic corporations. Presently, they are treated less favorably than those which manufacture abroad

[163] *See* Revenue Act of 1971, Pub. L. No. 92-178, Title V, 85 Stat. 497 (1971).

[164] *See* Congressional Research Service Report: *A History of the Extraterritorial Income (ETI) and Foreign Sales Corporation (FSC) Export Tax-Benefit Controversy* (November 9, 2004): "In addition to countering deferral, DISC was designed to offset what were perceived to be tax advantages provided by foreign countries to their own exporters. *** Another perceived advantage for foreigners was the 'border tax adjustments' provided by countries that make extensive use of value- added taxes (VATs)." The CRS Report is available at http://www.taxhistory.org/thp/readings.nsf/cf7c9c870b600b9585256df80075b9dd/d1e0dcc337b8048385256f860068159e?OpenDocument.

> through the use of foreign subsidiary corporations. United States corporations engaging in export activities are taxed currently on their foreign earnings at the full U.S. corporate income tax rate regardless of whether these earnings are kept abroad or repatriated. In contrast, U.S. corporations which produce and sell abroad through foreign subsidiaries generally can postpone payment of U.S. tax on these foreign earnings so long as they are kept abroad.
>
> In addition, other major trading nations encourage foreign trade by domestic producers in one form or another. Where value added taxes or multistage sales taxes are used to any appreciable extent, the practice is to refund taxes paid by the exporter at the time of export and to impose these taxes on importers. In the case of income taxes as well, however, most of the major trading nations have features in their tax laws which tend to encourage exports. Both to provide an inducement for increasing exports and as a means of removing discrimination against those who export through U.S. corporations, your committee's bill provide a deferral of tax where corporations meeting certain conditions–called Domestic International Sales Corporations–are used.[165]

The Senate Finance Committee Report provides the same statement of purposes.[166]

In February 1972, the European Communities requested consultations regarding the U.S. DISC legislation, claiming that it constituted a prohibited export subsidy under GATT Article

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[165] House Report No. 92-533, 92nd Cong., 1st Sess. (September 29, 1971), *reprinted in* 1971 U.S.C.C.A.N. 1825, 1872.

[166] Senate Report No. 92-437, 92nd Cong., 1st Sess. (November 9, 1971), *reprinted in* 1971 U.S.C.C.A.N. 1918, 1996.

See John H. Jackson, *The Jurisprudence of International Trade: The DISC Case in GATT*, 72 AM. J. INT'L L. 747, 751, fn. 13 (1978): "The Administration justified the 1971 DISC legislation to Congress as a response to European border tax adjustment actions." *See also* Thomas W. Anninger, *DISC and GATT: International Trade Aspects of Bringing Deferral Home*, 13 HARV. INT'L L. J. 391, 415 (1972), which notes: "Nevertheless, it is argued, even if DISC does violate {GATT} XVI(4) it represents a justifiable effort to compensate for the competitive disadvantage American products suffer in relation to the products of nations employing value-added taxes because such taxes are subject to border adjustments whereas the United States corporate income tax is not." Anninger further notes that the U.S. made this argument before the Fiscal Committee of the OECD: "The delegate for the United States indicated that the DISC was contemplated in the light of the fact that European countries were able under GATT rules to rebate taxes on export and charge them on import in respect of their general consumption taxes while the United States had no such general consumption taxes and was therefore at a disadvantage." *Id.* at 415, fn. 103, *citing Note on Discussion of the DISC Proposal at the 35th Session of the Fiscal Committee*, OECD, DAF/FC/70.7 (June 12, 1970).

XVI.[167] At the same time, the United States challenged the tax systems of Belgium, France, and the Netherlands, claiming that their maintenance of "territorial" tax systems provided prohibited export subsidies insofar as they exempted sales subsidiaries located outside their territories from corporate income tax earned on export earnings.[168] In May 1973, the consultations having been fruitless, both the EC and the U.S. filed formal complaints.[169] In July 1973, the GATT Council decided to establish a single panel to examine both the EC and U.S. complaints.[170] The panel, which issued its reports in November 1976, found that both the U.S. DISC legislation and the income tax practices of Belgium, France, and the Netherlands constituted export subsidies in contravention of GATT Article XVI:4."[171]

Following issuance of the panel reports, although the U.S. was willing to accept all four reports, the EC would accept only the DISC decision, and, as a result, adoption of the reports was blocked by both the U.S. and the EC.[172] At the negotiations on the Tokyo Round Subsidies Code (concluded in 1979), the U.S. made a major concession by agreeing to accept the EC's

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167 *See* John H. Jackson, *The Jurisprudence of International Trade: The DISC Case in GATT*, 72 AM. J. INT'L L. at 761.

168 *See* John H. Jackson, *The Jurisprudence of International Trade: The DISC Case in GATT*, 72 AM. J. INT'L L. at 761.

169 *See* John H. Jackson, *The Jurisprudence of International Trade: The DISC Case in GATT*, 72 AM. J. INT'L L. at 761; GATT, *GATT Activities in 1973* (Geneva 1974) at 58-59.

170 *See United States Tax Legislation (DISC)*, Report of the Panel presented to the Council of Representatives on 12 November 1976 (L/4422) at para. 1, *reprinted in* 23 BISD 98-114 (1977); *Income Tax Practices Maintained by France*, Report of the Panel presented to the Council of Representatives on 12 November 1976 (L/4423) at para. 1, *reprinted in* 23 BISD 114-127 (1977); *Income Tax Practices Maintained by Belgium*, Report of the Panel presented to the Council of Representatives on 12 November 1976 (L/4424) at para. 1, *reprinted in* 23 BISD 127-136 (1977); *Income Tax Practices Maintained by the Netherlands*, Report of the Panel presented to the Council of Representatives on 12 November 1976 (L/4425) at para. 1, *reprinted in* 23 BISD 137-147 (1977).

171 *See* GATT, *GATT Activities in 1976* (Geneva 1977) at 77-81; 23 BISD at 112-113, paras. 67-69, 74 (U.S.); 23 BISD at 125-126, paras. 50-53 (France); 23 BISD at 135-136, paras. 37-40 (Belgium); 23 BISD at 145-146, paras. 37-40 (Netherlands).

172 *See* John H. Jackson, *The Jurisprudence of International Trade: The DISC Case in GATT*, 72 AM. J. INT'L L. at 777; GATT, *GATT Activities in 1981* (Geneva 1982) at 52-55.

"territorial tax systems as applied to export sales ... provided that the United States could take advantage of a similar system for its own exports."[173] In 1981, following the conclusion of the Tokyo Round, the U.S. and the EC reached an Understanding regarding their tax legislation disputes and the GATT Council adopted the four panel reports subject to the Understanding.[174]

Second, in 1984, based on the Understanding and the Tokyo Round Subsidies Code, Congress repealed the DISC program and replaced it with the Foreign Sales Corporation (FSC).[175] The FSC was intended to be functionally equivalent to the DISC but to be compatible with the GATT.[176] The FSC was in force for 13 years before the European Communities, despite the 1981 Understanding, decided in 1997 to mount a challenge to the FSC at the WTO.[177] Like the GATT panel's finding regarding the DISC, a WTO dispute panel found in October 1999 that the FSC constituted a prohibited export subsidy in contravention of Article 3.1(a) of the

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[173] Gary C. Hufbauer, *The Foreign Sales Corporation Drama: Reaching the Last Act?*, International Economics Policy Brief No. PB02-10 (November 2002) at 4; available at http://www.iie.com/publications/pb/pb02-10.pdf.

[174] *See Tax Legislation* (L/5271), *reprinted in* 28 BISD 114 (1982); GATT, *GATT Activities in 1981* (Geneva 1982) at 52-55. The Understanding stated: "The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income." 28 BISD 114.

[175] Deficit Reduction Act of 1984, Pub. L. 98-369, Title VIII, 98 Stat. 494, 985-1003 (1984). *See* Gary C. Hufbauer, *The Foreign Sales Corporation Drama: Reaching the Last Act?*, International Economics Policy Brief No. PB02-10 (November 2002) at 4.

[176] *See United States — Tax Treatment for "Foreign Sales Corporations"*, Report of the Panel, WT/DS108/R (8 October 1999) at para. 4.176.

[177] *See* WT/DS108/1 (28 November 1997) (European Communities' request for consultations).

Agreement on Subsidies and Countervailing Measures.[178] The Appellate Body affirmed the panel's decision in February 2000.[179]

Third, in April 2000, the U.S. announced that, while it would comply with the WTO rulings regarding the FSC, it also intended to ensure that "U.S. exports are not disadvantaged in relation to their foreign counterparts."[180] As a replacement to the FSC, in November 2000, Congress enacted the Extraterritorial Income Exclusion Act (ETI).[181] Immediately thereafter, the EC sought consultations at the WTO and subsequently challenged the ETI by requesting a WTO dispute panel.[182] In August 2001, a WTO panel found that the ETI, like the predecessor tax systems DISC and FSC, was a prohibited export subsidy.[183] The Appellate Body affirmed the ETI panel in January 2002.[184]

Finally, in October 2004, in response to the ETI decisions at the WTO, Congress repealed the ETI in the American JOBS Creation Act (JOBS Act).[185] While the JOBS Act repealed the ETI tax benefits it also permitted certain benefits to continue over a transitional period. In November 2004, the EC sought consultations at the WTO regarding the U.S. law's transition

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178 *See United States — Tax Treatment for "Foreign Sales Corporations"*, Report of the Panel, WT/DS108/R (8 October 1999) at paras. 7.130 and 8.1.

179 *See United States — Tax Treatment for "Foreign Sales Corporations"*, Report of the Appellate Body, WT/DS108/AB/R (24 February 2000) at para. 177.

180 *See* Congressional Research Service Report: *A History of the Extraterritorial Income (ETI) and Foreign Sales Corporation (FSC) Export Tax-Benefit Controversy* (November 9, 2004) at fn. 27, *citing* U.S. Ambassador to the World Trade Organization Rita Hayes, as quoted in BNA Daily Tax Report, April 10, 2000, p. G-1.

181 FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. 106-519, 114 Stat. 2423 (2000).

182 *See United States — Tax Treatment for "Foreign Sales Corporations"*, Recourse to Article 21.5 of the DSU by the European Communities, Report of the Panel, WT/DS108/RW (20 August 2001) at para. 1.6.

183 *See United States — Tax Treatment for "Foreign Sales Corporations"*, Recourse to Article 21.5 of the DSU by the European Communities, Report of the Panel, WT/DS108/RW (20 August 2001) at paras. 8.75 and 9.1(a).

184 *See United States — Tax Treatment for "Foreign Sales Corporations"*, Recourse to Article 21.5 of the DSU by the European Communities, Report of the Appellate Body, WT/DS108/AB/RW (14 January 2002) at para. 256(b).

185 *See* American Jobs Creation Act of 2004, Pub. L. 108-357, Title I, 118 Stat. 1418, 1423-1429 (2004).

provisions, and in January 2005, the EC requested a panel.[186] The WTO established a dispute panel in February 2005. In September 2005, the JOBS panel ruled that the transitional provisions of the JOBS Act were inconsistent with WTO rules in that they maintained the prohibited FSC/ETI export subsidies.[187] Although the U.S. appealed the panel's decision, the Appellate Body affirmed the panel in February 2006.[188]

Thus, all legislative attempts by the Congress to at least partially offset, through provision of export tax benefits, the disparities and trade disadvantages to U.S. exporters that flow from the border tax adjustment rules have been overturned by GATT and WTO dispute panels.

III. LEGISLATIVE EFFORTS TO REFORM THE U.S. TAX SYSTEM TO ADDRESS THE DISCRIMINATORY TRADE EFFECTS OF THE DIFFERENTIAL TREATMENT OF INDIRECT AND DIRECT TAXES HAVE NOT BEEN SUCCESSFUL

The previous section reviewed how the differential treatment of direct and indirect taxes under GATT/WTO rules came about, and how such disparate treatment gradually came to be recognized as a major disadvantage to U.S. producers and exporters in competing with producers and exporters from countries that impose border-adjustable indirect taxes, such as value added taxes. The prior section also reviewed how the growing concerns of the U.S. Government about

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186 *See United States — Tax Treatment for "Foreign Sales Corporations"*, Second Recourse to Article 21.5 of the DSU by the European Communities, Report of the Panel, WT/DS108/RW2 (30 September 2005) at paras. 1.7-1.8.

187 *See United States — Tax Treatment for "Foreign Sales Corporations"*, Second Recourse to Article 21.5 of the DSU by the European Communities, Report of the Panel, WT/DS108/RW2 (30 September 2005) at paras. 7.65 and 8.1.

188 *See United States — Tax Treatment for "Foreign Sales Corporations"*, Second Recourse to Article 21.5 of the DSU by the European Communities, Report of the Appellate Body, WT/DS108/AB/RW2 (13 February 2006) at para. 100(b).

the U.S. balance of payments deficit and of the business community about the negative trade effects of increased use of value-added taxes in Europe brought about calls to negotiate revisions to the GATT rules concerning the treatment of direct and indirect taxes. Recognizing that an alternative way to level the commercial playing field for U.S. producers and exporters would be to reform U.S. tax laws, many proposals have been put forward in Congress over the past thirty years to restructure the U.S. tax system to either wholly or partially replace non-border-adjustable income-based taxes with border-adjustable consumption based taxes. To date, however, none of the proposals have succeeded.

Even prior to the trade problems caused by the differential treatment of direct and indirect taxes under GATT/WTO rules, there were efforts in Congress to introduce consumption-based taxes in the United States. Examples include the following:

- The years after World War I saw a general call for tax reform, including "substantial pressure to adopt a national sales tax to replace the excess profits tax and the high surtaxes on individual income."[189] In the early 1920s, Thomas S. Adams, a Yale economics professor and special advisor to the Treasury Department proposed

[189] *See* Steven A. Bank, *The Progressive Consumption Tax Revisited*, 101 MICH. L. REV. 2238, 2242 (May 2003). Interestingly, scholars have noted that the value-added tax originated, in concept and theory, in the United States.

> Concerning the origin of the VAT, Lindholm wrote, "the roots of the value-added tax are embedded in U.S. economic theory and data." The U.S. has imported most of its taxes. For example, the income tax was imported from England, the inheritance tax from France, the sales tax from Spain and Holland, and the property tax from China and Europe. However, if adopted in the U.S., the VAT would not be an imported tax. The idea goes back to the 1920s when gross national product (GNP) data was first gathered. U.S. economists proposed the VAT out of a desire for a neutral tax that would generate substantial revenues without seriously distorting the resource allocation function of the free market system. The VAT is conceptually a tax on GNP, the market value of all final products produced in the economy. When U.S. economists provided the statistics making it possible to calculate GNP and measure current production activity, the VAT became the next logical step.

Steve C. Wells, *Lessons for policy makers from the history of consumption taxes*, THE ACCOUNTING HISTORIANS JOURNAL (June 1999), *citing* Richard W. Lindholm, *The Economics of VAT* (1980; Lexington, MA: Lexington Books) at 24-25, 119-120. (The Wells article is available at http://findarticles.com/p/articles/mi_qa3657/is_199906/ai_n8842319).

adoption of a form of VAT.[190] In 1921, bills were proposed in Congress to enact a national sales tax and a graduated rate spendings tax, but both proposals failed.[191]

- In 1932, the Hoover Administration proposed a manufacturers' excise tax (in effect, a national sales tax), and the bill that emerged from the House Ways and Means Committee recommended a 2.25% manufacturers' excise tax on all items except food.[192] Opposition in the House, however, defeated the sales tax provision.[193]

- In 1934, an article in Social Research by Gerhard Colm, a U.S. government tax expert, explained and recommended a value-added tax. Favorable reaction to the proposal eventually led in 1940 to Senator O'Mahoney of Wyoming introducing a bill that, although unsuccessful, called for a federal VAT.[194]

- In 1942, in an effort to reduce consumer spending and control inflation during World War II, Treasury Secretary Morgenthau introduced a spendings tax of 10% on all consumer goods and services, plus a progressive surtax on all expenditures over $1,000, but Congress was not receptive to the proposal.[195]

- In 1951, a sales tax was unsuccessfully proposed as a means to fund increased defense spending.[196]

In the 1960s, the European Communities decided to adopt and harmonize value-added taxes. This decision, in addition to stimulating U.S. efforts to negotiate changes to the GATT's

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190 *See* Steven A. Bank, *The Progressive Consumption Tax Revisited*, 101 MICH. L. REV. at 2241 (May 2003); Ray A. Knight & Lee G. Knight, *Tax harmony in the European Community Leaves much to be desired*, THE TAX EXECUTIVE (July-August 1991) (available at http://findarticles.com/p/articles/mi_m6552/is_n4_43/ai_11070753); Steve C. Wells, *Lessons for policy makers from the history of consumption taxes*, THE ACCOUNTING HISTORIANS JOURNAL (June 1999).

191 *See* Steven A. Bank, *The Progressive Consumption Tax Revisited*, 101 MICH. L. REV. at 2242-2244 (May 2003).

192 *See* Tax Analysts–Tax History Project: *The Republican Roots of New Deal Tax Policy* (available at http://www.taxhistory.org/thp/readings.nsf/cf7c9c870b600b9585256df80075b9dd/dc6a3f1baa03052a85256dfe005981fb?OpenDocument)*; see also* Steve C. Wells, *Lessons for policy makers from the history of consumption taxes*, THE ACCOUNTING HISTORIANS JOURNAL (June 1999).

193 *See* Tax Analysts–Tax History Project: *The Republican Roots of New Deal Tax Policy*.

194 *See* Steve C. Wells, *Lessons for policy makers from the history of consumption taxes*, THE ACCOUNTING HISTORIANS JOURNAL (June 1999), *citing* Richard W. Lindholm, *A New Federal Tax System* (1984; New York: Praeger Publishers) at 121.

195 *See* Steven A. Bank, *The Progressive Consumption Tax Revisited*, 101 MICH. L. REV. at 2246-2249 (May 2003); *see also* Steve C. Wells, *Lessons for policy makers from the history of consumption taxes*, THE ACCOUNTING HISTORIANS JOURNAL (June 1999).

196 *See* Steve C. Wells, *Lessons for policy makers from the history of consumption taxes*, THE ACCOUNTING HISTORIANS JOURNAL (June 1999), *citing* Donald R. Kennon & Rebecca M. Rogers, *The Committee on Ways and Means: A Bicentennial History 1789-1989* (Washington, DC: Government Printing Office, 1989).

differential treatment of direct and indirect taxes, gave rise to interest in enacting a value-added tax in the United States. Some examples of such interest include:

- In 1966, the Committee for Economic Development, a nonprofit business organization, proposed that the VAT be used to finance the Vietnam War and prevent inflation, and that the VAT be continued after the war to reduce corporate income taxes.[197]

- In 1970, President Nixon's Task Force on Business Taxation studied the value-added tax. Although the Task Force did not recommend immediate adoption of a VAT, it noted that if additional federal revenues were necessary in the future, a value-added tax should be considered. Although the Treasury Department was directed to prepare a VAT proposal, no proposal was presented to Congress.[198]

- In 1972, President Nixon requested the Advisory Commission on Intergovernmental Relations to study "whether a Federal value added tax is the best substitute for residential school property taxes."[199] The Commission concluded that "a massive new Federal program designed specifically to bring about property tax relief is neither necessary nor desirable," and that "direct Federal intervention was not necessary."[200]

- In 1979-80, Representative Ullman, Chairman of the House Ways and Means Committee, introduced tax reform legislation that would have imposed a 10% value-added tax on the sale of property or the performance of a service within the United States as well as on imports into the United States.[201] The VAT was intended to reduce the federal deficit and eliminate the corporate income tax. As an indirect tax, Chairman Ullman's VAT would have been border adjustable under GATT rules.

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197 *See* Tax Foundation, *A Value-Added Tax for the United States? – Selected Viewpoints* (1979) at 3, *citing* Committee for Economic Development, *A Better Balance in Federal Taxes on* Business, A Statement by the Research and Policy Committee (New York: April, 1966); available at http://www.taxfoundation.org/news/show/1875.html. *See also* Steve C. Wells, *Lessons for policy makers from the history of consumption taxes*, THE ACCOUNTING HISTORIANS JOURNAL (June 1999).

198 *See* Tax Foundation, *A Value-Added Tax for the United States? – Selected Viewpoints* (1979) at 2; Hoffman F. Fuller, *The Tax on Added Value*, U. ILL. L.F 269, 293 (1972: No. 2); Steve C. Wells, *Lessons for policy makers from the history of consumption taxes*, THE ACCOUNTING HISTORIANS JOURNAL (June 1999).

199 Advisory Commission on Intergovernmental Relations, *The Value-Added Tax and Alternative Sources of Federal Revenue* (Washington, D.C., August 1973) at ii; *see also* Tax Foundation, *A Value-Added Tax for the United States? – Selected Viewpoints* (1979) at 2.

200 Advisory Commission on Intergovernmental Relations, *The Value-Added Tax and Alternative Sources of Federal Revenue* (Washington, D.C., August 1973) at iii; Tax Foundation, *A Value-Added Tax for the United States? – Selected Viewpoints* (1979) at 2.

201 Tax Restructuring Act of 1979 (H.R. 5665); Tax Restructuring Act of 1980 (H.R. 7015).

- In 1985, Senator Roth introduced the Business Transfer Tax Act of 1985, which was described as a "'consumption-based' value-added tax."[202] The Tax Foundation noted concerning the Roth proposal: "A business transfer tax could serve several purposes, including a whole new look of tax reform, relief from income taxation, help with the trade deficit, reduction of the budget deficit and as an alternative to the minimum tax--which is exactly why it is getting attention. . . . Like all value-added taxes, the BTT would be considered an indirect tax for purposes of international trade. Under the GATT rules, indirect taxes can be imposed on imports and rebated on exports, while direct taxes, such as income taxes, cannot. Hence, the trade angle."[203]

A review of proposed legislation introduced in the 101st through the 109th Congresses (1989-2006) shows numerous proposals to reform U.S. tax laws to replace or reduce income taxes with border-adjustable indirect taxes, such as value-added taxes and retail sales taxes. This demonstrates the persistent congressional recognition of, and interest in resolving, the competitive disadvantage of the GATT/WTO differential treatment of direct and indirect taxes. The following table presents a sampling of legislative tax reform proposals introduced in the 101st through 109th Congresses that would impose VAT or other border-adjustable consumption taxes.

Selected Examples of Proposed Legislation to Restructure U.S. Tax Laws to Impose Value-Added or Other Consumption-Based Taxes That Would Be Border-Adjustable

Proposed Legislation	Bill No.	Sponsor	VAT & Other Consumption-Related Tax Proposals
Deficit and Debt Reduction Act of 1989 (February 23, 1989)	S. 442 (101-1)	Hollings	Would impose a value added tax (5%) to any sale or importation of property or any performance of services in the U.S. by a person engaging in a business or in a commercial-type transaction. The VAT would be zero-rated for exports of property. The VAT would go to a Deficit Reduction Trust Fund to be used exclusively to reduce the public debt.

[202] *See* Tax Foundation, *The Uses of a Business Transfer Tax* (Working Paper, December 20, 1985) at 1; available at http://www.taxfoundation.org/files/wp5-19851220.pdf.

[203] *See* Tax Foundation, *The Uses of a Business Transfer Tax* (Working Paper, December 20, 1985) at 1.

Selected Examples of Proposed Legislation to Restructure U.S. Tax Laws to Impose Value-Added or Other Consumption-Based Taxes That Would Be Border-Adjustable			
Proposed Legislation	**Bill No.**	**Sponsor**	**VAT & Other Consumption-Related Tax Proposals**
Tax Reform and Competitiveness Act (February 6, 1990)	S. 2084 (101-2)	Hollings	Would impose a value added tax (5%) on any sale or importation of property or any performance of services in the U.S. by a person engaging in a business or in a commercial-type transaction. The VAT would be zero-rated for exports of property.
National Health Insurance Act (January 3, 1991)	H.R. 16 (102-1)	Dingell	Would impose a value added tax of 5% on the sale of property in the U.S., the performance of services in the U.S., and the importing of property into the U.S. by a business in a commercial-type transaction. The VAT would be zero-rated for exports of property. The VAT would go to a National Health Care Trust Fund to be used only to make expenditures to carry out the program of health benefits under the National Health Insurance Act.
Deficit and Debt Reduction Act of 1991 (January 14, 1991)	S. 169 (102-1)	Hollings	Would impose a value-added tax of 5% on any sale or importation of property or any performance of services in the U.S. by a person engaging in a business or in a commercial-type transaction. The VAT would be zero-rated for sales of property and services exported from the U.S. for use or consumption outside the U.S. The VAT would go to a Deficit Reduction Trust Fund to be used exclusively to reduce the public debt.
Uniform Business Tax Act of 1991 (August 1, 1991)	H.R. 3170 (102-1)	Schulze	Would impose a flat 9% corporate tax on domestic receipts of U.S. businesses and on all imports crossing the U.S. border. "This simple, low-rate business tax is border-adjustable. Therefore, it does not apply to export sales; thereby helping to make American-made goods less expensive and more competitive in international markets. Conversely, the UBT does apply to imports; thereby assuring that foreign-made goods will no longer be able to compete in U.S. markets on a virtually tax-free basis." Cong. Rec. at E2903 (Aug. 2, 1991) (remarks of Rep. Schulze).
Value Added Tax Impact Assessment Act of 1992 (February 19, 1992)	H.R.4263 (102-2)	Wise	Would require the Secretary of the Treasury to study and report to the Congress on a value added tax.
Foreign Income Tax Rationalization and Simplification Act of 1992 (May 27, 1992)	H.R. 5270 (102-2)	Rostenkowski	Would require the Secretary of the Treasury to conduct a study of administrative and compliance issues related to a value added tax.

Selected Examples of Proposed Legislation to Restructure U.S. Tax Laws to Impose Value-Added or Other Consumption-Based Taxes That Would Be Border-Adjustable			
Proposed Legislation	**Bill No.**	**Sponsor**	**VAT & Other Consumption-Related Tax Proposals**
Foreign Income Tax Rationalization and Simplification Act of 1992 (May 27, 1992)	H.R. 5270 (102-2)	Rostenkowski	Would require the Secretary of the Treasury to conduct a study of administrative and compliance issues related to a value added tax.
Health Choice Act of 1992 (June 30, 1992)	H.R.5514 (102-2)	Dingell	Would impose a value added tax of 5% on the sale of property in the U.S., the performance of services in the U.S., and the importing of property into the U.S. by a business in a commercial-type transaction. The VAT would go to a Health Choice Trust Fund.
National Health Insurance Act (January 5, 1993)	H.R. 16 (103-1)	Dingell	Would impose a value added tax of 5% on the sale of property in the U.S., the performance of services in the U.S., and the importing of property into the U.S. by a business in a commercial-type transaction. The VAT would be zero-rated for exports of property. The VAT would go to a National Health Care Trust Fund to be used only to make expenditures to carry out the program of health benefits under the National Health Insurance Act.
Deficit and Debt Reduction and Health Care Financing Act of 1994 (May 23, 1994)	S. 2134 (103-2)	Hollings	Would impose a value added tax of 5% on the sale of property or services in the U.S. and the import of property or services for use or consumption in the U.S. The VAT would be zero-rated for sales of property and services exported from the U.S. for use or consumption outside the U.S. The VAT would go to a Deficit Reduction and Health Care Reform Trust Fund with 80% of the revenues from the VAT used to reduce the public debt and 20% to carry out Federal health care reform programs.
Comprehensive Tax Restructuring and Simplification Act of 1994 (June 7, 1994)	S. 2160 (103-2)	Danforth/ Boren	Would repeal the corporate income tax, cut the payroll tax, and impose a business activities tax (BAT) of 14.5% on business-related sales of property & services and on imports of property & services. Exports of property & services are excluded from "gross receipts." The BAT is a subtraction-method tax that would be border-adjustable. "The international trend is to rely heavily on some form of a national, border -adjustable consumption tax. However, unlike all our major trading partners, and 80 countries in total, the United States has not adopted a consumption tax which is border -adjustable --that is, tax is rebated on exports and levied on imports. Thus, we are penalizing ourselves. To illustrate, a U.S. manufacturer must bear the full cost of U.S. corporate income taxes and payroll taxes, regardless of whether it exports its goods or sells them domestically. However, those exported goods will face a second tax on reaching the border of a country that has a value-added tax [VAT]. In a sense, the exports are taxed

Selected Examples of Proposed Legislation to Restructure U.S. Tax Laws to Impose Value-Added or Other Consumption-Based Taxes That Would Be Border-Adjustable			
Proposed Legislation	**Bill No.**	**Sponsor**	**VAT & Other Consumption-Related Tax Proposals**
			twice, rather than once as the products with which they compete. Exporters from VAT countries, however, have the VAT rebated on all their exports to the United States and face little or no new taxes, other than tariffs, when the products enter the United States. This discrimination is a penalty we inflict on ourselves by ignoring the advantages of a border -adjustable consumption tax. If the United States replaces some or all of current business taxes with border -adjustable taxes, the playing field would be leveled considerably." Cong. Rec. at S6523 (June 7, 1994) (statement of Sen. Danforth).
National Health Insurance Act (January 4, 1995)	H.R. 16 (104-1)	Dingell	Would impose a value added tax of 5% on the sale of property in the U.S., the performance of services in the U.S., and the importing of property into the U.S. by a business in a commercial-type transaction. The VAT would be zero-rated for exports of property. The VAT would go to a National Health Care Trust Fund to be used only to make expenditures to carry out the program of health benefits under the National Health Insurance Act.
Deficit and Debt Reduction and Health Care Financing Act of 1995 (January 18, 1995)	S. 237 (104-1)	Hollings	Would impose a value added tax of 5% on the sale of property or services in the U.S. and the import of property or services for use or consumption in the U.S. The VAT would be zero-rated for sales of property and services exported from the U.S. for use or consumption outside the U.S. The VAT would go to a Deficit Reduction and Health Care Reform Trust Fund with 80% of the revenues from the VAT used to reduce the public debt and 20% to carry out Federal health care reform programs.
Unlimited Savings Allowance (USA) Tax Act of 1995 (April 25, 1995)	S. 772 (104-1)	Domenici/ Nunn	Would replace corporate income tax with a cash flow business tax (a subtraction-method VAT); would replace individual income tax with a consumed-income tax; would impose an import tax of 11% of the customs value of all property entered into the U.S. for consumption, use or warehousing. "Another very important feature is that our USA Tax System puts U.S. companies on the same footing with our competitors. The USA business tax is territorial--meaning it applies to all sales on U.S. soil no matter where the business is headquartered--and it is border adjustable. "We want to encourage exports, and we do in this proposal. We exclude the proceeds from export sales from taxation by rebating the tax on goods exported for sale abroad. And when a company, foreign or U.S. owned, manufactures abroad and sells to the United States market, the company is, through the operations of a new import tax, taxed

Selected Examples of Proposed Legislation to Restructure U.S. Tax Laws to Impose Value-Added or Other Consumption-Based Taxes That Would Be Border-Adjustable			
Proposed Legislation	**Bill No.**	**Sponsor**	**VAT & Other Consumption-Related Tax Proposals**
			essentially the same as if the factory were located in the United States. That is border adjustability, the tax is rebated on exports and added to imports, which is exactly the situation American exporters to Europe and Japan face today. We believe our business tax will place American companies and workers on an equal and level playing field." Cong. Rec. at S5669 (April 25, 1995) (statement of Sen. Nunn). "I would like to highlight another key feature of the USA plan, its treatment of imports and exports. With respect to competitiveness, the USA business tax levels the international playing field for American business by implementing a territorial and border adjustable tax. All goods, whether produced here or abroad, sold in the United States will bear the same US tax burden, while U.S. exports will not carry the cost of U.S. taxes when sold abroad." Cong. Rec. at S11634 (Sept. 28, 1996) (statement of Sen. Nunn).
National Retail Sales Tax Act of 1996 (March 6, 1996)	H.R. 3039 (104-2)	Schaefer	Would repeal income, estate, gift, and certain excise taxes. Would impose a 15% tax on use, consumption or enjoyment in the U.S. of any property or service produced or rendered within or without the U.S. Would prohibit imposing tax on any property or service: (1) purchased for resale; (2) purchased to produce property or services; or (3) exported from the U.S. for use, consumption or enjoyment outside of the U.S.
Revenue Restructuring Act of 1996 (September 11, 1996)	H.R. 4050 (104-2)	Gibbons	Would replace individual and corporate income taxes, and Social Security and Medicare taxes, with a 20% value added tax imposed on any sale of property in the U.S. by a business, the performance of services in the U.S. by a business, or the export of property or services from the U.S. in connection with a business. This bill does not zero rate exports but the VAT would be border-adjustable. The bill notes that one of the fundamental principles of tax restructuring is that "any reform proposal should be border-adjustable and promote the competitiveness of American companies." "The value-added tax would be adjusted at the international border. In the case of exports, the adjustment would be made by excluding gross receipts from exports of goods and services from business gross receipts. Business purchases would include the cost of goods and services used to produce exported goods and services, thereby refunding to the exporter the value-added tax embedded in the price of those goods and services. In the case of imports, the adjustment would be made by excluding

Selected Examples of Proposed Legislation to Restructure U.S. Tax Laws to Impose Value-Added or Other Consumption-Based Taxes That Would Be Border-Adjustable			
Proposed Legislation	**Bill No.**	**Sponsor**	**VAT & Other Consumption-Related Tax Proposals**
			purchases of imported products or services in computing the amount of business purchases. There are also provisions that would refund the value-added tax to persons (such as tourists) making nonbusiness purchases of property in the United States for use outside the United States. There would be a tax on nonbusiness imports of property or services into the United States." Cong. Rec. at E1573 (Sept. 11, 1996) (statement of Rep. Gibbons).
National Health Insurance Act (January 7, 1997)	H.R. 16 (105-1)	Dingell	Would impose a value added tax of 5% on the sale of property in the U.S., the performance of services in the U.S., and the importing of property into the U.S. by a business in a commercial-type transaction. The VAT would be zero-rated for exports of property. The VAT would go to a National Health Care Trust Fund to be used only to make expenditures to carry out the program of health benefits under the National Health Insurance Act.
Resolution (January 21, 1997)	S. Res. 16 (105-1)	Lugar	Expressing the sense of the Senate that the income tax should be eliminated and replaced with a national sales tax.
Resolution (April 10, 1997)	H. Res. 111 (105-1)	Hefley	Expressing the sense of the House that the income tax should be eliminated and replaced with a national sales tax.
National Retail Sales Tax Act of 1997 (April 15, 1997) (June 19, 1997)	H.R. 1325 H.R. 2001 (105-1)	Schaefer	Would repeal income, estate, gift, and certain excise taxes. Would impose a 15% tax on use, consumption or enjoyment in the U.S. of any property or service produced or rendered within or without the U.S. Would prohibit imposing a tax on any property or service purchased for: (1) a business purpose in an active trade or business; or (2) export from the U.S. for use or consumption outside of the U.S.
Simplified USA Tax Act of 1998 (October 5, 1998)	H.R. 4700 (105-2)	English	Would replace corporate income tax with a cash flow business tax (a subtraction-method VAT); would replace individual income tax with a consumed-income tax; would impose an import tax of 11% of the customs value of all property entered into the U.S. for consumption, use or warehousing.
National Health Insurance Act (January 6, 1999)	H.R. 16 (106-1)	Dingell	Would impose a value added tax of 5% on the sale of property in the U.S., the performance of services in the U.S., and the importing of property into the U.S. by a business in a commercial-type transaction. The VAT would be zero-rated for exports of property. The VAT would go to a National Health Care Trust Fund to be used only to make expenditures to carry out the program of health benefits under the National Health Insurance Act.

Selected Examples of Proposed Legislation to Restructure U.S. Tax Laws to Impose Value-Added or Other Consumption-Based Taxes That Would Be Border-Adjustable			
Proposed Legislation	**Bill No.**	**Sponsor**	**VAT & Other Consumption-Related Tax Proposals**
Simplified USA Tax Act of 1999 (January 6, 1999)	H.R. 134 (106-1)	English	Would replace corporate income tax with a cash flow business tax (a subtraction-method VAT); would replace individual income tax with a consumed-income tax; would impose an import tax of 11% of the customs value of all property entered into the U.S. for consumption, use or warehousing.
Resolution (January 19, 1999)	S. Res. 24 (106-1)	Lugar	Expressing the sense of the Senate that the income tax should be eliminated and replaced with a national sales tax.
National Retail Sales Tax Act of 1999 (April 15, 1999) (May 27, 1999)	H.R. 1467 H.R. 2001 (106-1)	Tauzin	Would repeal income, estate, gift, and certain excise taxes. Would impose a 15% tax on use, consumption or enjoyment in the U.S. of any property or service produced or rendered within or without the U.S. Would prohibit imposing a tax on any property or service purchased for: (1) a business purpose in an active trade or business; or (2) export from the U.S. for use or consumption outside the U.S.
Deficit and Debt Reduction and Social Security Solvency Act of 1999 (July 15, 1999)	S. 1376 (106-1)	Hollings	Would impose a value added tax of 5% on the sale of property or services in the U.S. and the import of property or services for use or consumption in the U.S. The VAT would be zero-rated for sales of property and services exported from the U.S. for use or consumption outside the U.S. The VAT would go to a Debt Reduction and Social Security Solvency Trust Fund to reduce Federal debt and to ensure the solvency of the Social Security System.
National Health Insurance Act (January 3, 2001)	H.R. 16 (107-1)	Dingell	Would impose a value added tax of 5% on the sale of property in the U.S., the performance of services in the U.S., and the importing of property into the U.S. by a business in a commercial-type transaction. The VAT would be zero-rated for exports of property. The VAT would go to a National Health Care Trust Fund to be used only to make expenditures to carry out the program of health benefits under the National Health Insurance Act.
Simplified USA Tax Act of 2001 (January 3, 2001)	H.R. 86 (107-1)	English	Would replace corporate income tax with a cash flow business tax (a subtraction-method VAT); would replace individual income tax with a consumed-income tax; would impose an import tax of 11% of the customs value of all property entered into the U.S. for consumption, use or warehousing.
Individual Tax Freedom Act of 2001 (August 2, 2001)	H.R. 2717 (107-1)	Tauzin	Would repeal income, estate, gift, and certain excise taxes. Would impose a 15% tax on use, consumption or enjoyment in the U.S. of any property or service produced or rendered within or without the U.S. Would prohibit imposing a tax on any property or service purchased for: (1) a business

Selected Examples of Proposed Legislation to Restructure U.S. Tax Laws to Impose Value-Added or Other Consumption-Based Taxes That Would Be Border-Adjustable			
Proposed Legislation	**Bill No.**	**Sponsor**	**VAT & Other Consumption-Related Tax Proposals**
			purpose in an active trade or business; or (2) export from the U.S. for use or consumption outside the U.S.
National Health Insurance Act (January 7, 2003)	H.R. 15 (108-1)	Dingell	Would impose a value added tax of 5% on the sale of property in the U.S., the performance of services in the U.S., and the importing of property into the U.S. by a business in a commercial-type transaction. The VAT would be zero-rated for exports of property. The VAT would go to a National Health Care Trust Fund to be used only to make expenditures to carry out the program of health benefits under the National Health Insurance Act.
Simplified USA Tax Act of 2003 (January 8, 2003)	H.R. 269 (108-1)	English	Would replace corporate income tax with a cash flow business tax (a subtraction-method VAT); would replace individual income tax with a consumed-income tax; would impose an import tax of 11% of the customs value of all property entered into the U.S. for consumption, use or warehousing.
War Financing Act of 2003 (January 9, 2003)	S. 112 (108-1)	Hollings	Would impose a value added tax of 1% on the sale of property or services in the U.S. and the import of property or services for use or consumption in the U.S. The VAT would be zero-rated for sales of property and services exported from the U.S. for use or consumption outside the U.S. The VAT would go to a War Financing Trust Fund to be used exclusively to fund America's war effort.
Individual Tax Freedom Act of 2004 (April 2, 2004)	H.R. 4168 (108-2)	Tauzin	Would repeal income tax, estate and gift taxes, and certain excise taxes. Would imposes a national sales tax equal to 15% of gross payments for use, consumption or enjoyment in the U.S. of any taxable property or service, whether produced or rendered within or without the U.S. Would allow exemptions from such tax for property or services purchased for a business purpose in an active trade or business or for export for use or consumption outside the U.S.
Resolution (July 7, 2004)	H. Res. 705 (108-2)	English	Urges the President to resolve the disparate treatment of direct and indirect taxes presently provided by the WTO. The resolution stated: Whereas the World Trade Organization does not permit direct taxes, such as the corporate income tax, to be rebated or reduced on exports; Whereas indirect taxes, such as a value added tax, can be and are rebated on exports in other countries; Whereas the distinction by the World Trade Organization between direct and indirect taxation is arbitrary and may induce economic distortions among nations with disparate tax systems; and

Selected Examples of Proposed Legislation to Restructure U.S. Tax Laws to Impose Value-Added or Other Consumption-Based Taxes That Would Be Border-Adjustable			
Proposed Legislation	**Bill No.**	**Sponsor**	**VAT & Other Consumption-Related Tax Proposals**
			Whereas United States firms pay a high corporate tax rate on their export income and many foreign nations are allowed to rebate their value added taxes, thereby giving exporters in nations imposing value added taxes a competitive advantage over American workers: Now, therefore, be it Resolved, That the President— (1) within 120 days after the convening of the 109th Congress, and annually thereafter, should report to Congress on progress in pursuing multilateral and bilateral trade negotiations to eliminate the barriers described in section 2102(b)(15) of the Trade Act of 2002; and (2) within 120 days after convening the 109th Congress, should report to Congress on— (A) proposed alternatives to the disparate treatment of direct and indirect taxes presently provided by the World Trade Organization; and (B) other proposals for redressing the tax disadvantage to United States businesses and workers, either by changes to the United States corporate income tax or by the adoption of an alternative, including— (i) assessing the impact of corporate tax rates, (ii) a system based on the principal of territoriality, and (iii) a border adjustment for exports such as is already allowed by the World Trade Organization for indirect taxes.
National Health Insurance Act (January 4, 2005)	H.R. 15 (109-1)	Dingell	Would impose a value added tax of 5% on the sale of property in the U.S., the performance of services in the U.S., and the importing of property into the U.S. by a business in a commercial-type transaction. The VAT would be zero-rated for exports of property. The VAT would go to a National Health Care Trust Fund to be used only to make expenditures to carry out the program of health benefits under the National Health Insurance Act.
Fair Tax Act of 2005 (January 4, 2005)	H.R. 25 (109-1)	Linder	Would impose a 23% national retail sales tax to replace individual and corporate income taxes, payroll taxes, self-employment taxes, and estate and gift taxes.
Fair Tax Act of 2005 (January 24, 2005)	S. 25 (109-1)	Chambliss	(Companion bill to H.R. 25) Would impose a 23% national retail sales tax to replace individual and corporate income taxes, payroll taxes, self-employment taxes, and estate and gift taxes.
Tax Simplification Act of 2005 (March 23, 2005)	S. 1099 (109-1)	Shelby	Would impose a flat consumption tax in place of individual and corporate income taxes, and estate and gift taxes

Selected Examples of Proposed Legislation to Restructure U.S. Tax Laws to Impose Value-Added or Other Consumption-Based Taxes That Would Be Border-Adjustable			
Proposed Legislation	**Bill No.**	**Sponsor**	**VAT & Other Consumption-Related Tax Proposals**
Flat Tax Act of 2005 (April 15, 2005)	S. 812 (109-1)	Specter	Would impose a flat rate consumption tax to replace individual and corporate income taxes, and estate and gift taxes.
Savings for Working Families Act of 2005 (October 26, 2005)	S. 1921 (109-1)	DeMint	Would impose an 8.4% national retail sales tax and an 8.4% business tax (subtraction-method VAT) to replace individual and corporate income taxes, and estate and gift taxes.
Simplified USA Tax Act of 2006 (February 8, 2006)	H.R. 4707 (109-2)	English	Would replace corporate income tax with a cash flow business tax (a subtraction-method VAT). Would replace individual income tax with a consumed-income tax. Would impose an import tax equal to 11% of the customs value of all property entered into the U.S. for consumption, use or warehousing; would impose a tax equal to 11% of the cost of all services treated as imported into the U.S. during the taxable year of the service recipient. "The other key component of SUSAT that will make American business more competitive is that it is border adjustable. In other words, SUSAT would end the perverse practice unique among our trading partners of taxing our own exports. All export sales income is exempt and all profits earned abroad can be brought back home for reinvestment in America without penalty. "Because of a 12 percent import adjustment, all companies that produce abroad and sell back into U.S. markets will be required to bear the same tax as companies that both produce and sell in the United States. This policy would finally take away the bias in favor of imports built into our current tax structure, which, in my view, contributes to our record trade deficit that continues to rise to record-breaking levels." Cong. Rec. at H242 (Feb. 14, 2006) (statement of Rep. English).
National Health Insurance Act (January 4, 2007)	H.R. 15 (110-1)	Dingell	Would impose a value added tax of 5% on the sale of property in the U.S., the performance of services in the U.S., and the importing of property into the U.S. by a business in a commercial-type transaction. The VAT would be zero-rated for exports of property. The VAT would go to a National Health Care Trust Fund to be used only to make expenditures to carry out the program of health benefits under the National Health Insurance Act.

Particular statements by individual senators and representatives who have introduced VAT or other consumption-based tax proposals reflect the degree of congressional interest in addressing the problem of border taxes, such as the following examples:

- Upon introducing his Debt and Deficit Reduction Act of 1989, Senator Hollings stated:

> A VAT would also serve to reduce the United States huge trade deficit. After all, many of those nonnecessities are luxury consumer goods imported from abroad. Even more important, under international agreements, a VAT is the only kind of tax that can be legally rebated on exported items. In other words, when Mercedes-Benz exports a car to the United States, the German Government rebates the VAT to the manufacturer; this saves Mercedes-Benz on its tax bill, and it makes German cars less expensive and more competitive on the United States market. As Lester Thurow, dean of the business school at MIT, says: The rules of international trade are structured to make you stupid if you don't have a value added tax.[204]

- Rep. Schulze, in explaining the uniform Business Tax Act of 1991, stated:

> Before American-made goods can again become truly competitive, we must first have a competitive tax system. Other countries with which we compete in world trade have adopted tax systems of the modern variety that work to their advantage. They exempt from tax the foreign-made goods they sell into our economy and impose tax on the American-made goods we sell into their economies. Indeed, with the recent additions of Canada and Japan, border-adjustable taxes have become the international norm among countries that understandably seek to serve their own best interests.
>
> In contrast, we in the United States do just the opposite. As a general rule, we tax the income that our own companies receive from manufacturing goods in the United States that they sell abroad. On the other hand, as a practical matter, we do not tax foreign companies on the amount they receive from manufacturing goods abroad that are sold in the U.S. markets. Recent data from the Commissioner of Internal Revenue show that foreign-owned

[204] *Congressional Record* at S1665 (February 23, 1989) (statement of Sen. Hollings).

> subsidiaries--operating in the United States right along-side our own companies--each year receive about $600 billion from sales in U.S. markets of goods manufactured abroad by their foreign-parent corporations. Yet, as a group, they pay no U.S. income tax. By and large, that tax-free status is not because they are evading taxes. Rather, it is because the present U.S. business tax system does not require payment of tax on the amount foreigners receive from manufacturing goods abroad even though sold here.
>
> By conforming the U.S. tax system to the international norm of border-adjustable taxes, the UBT will eliminate these present tax biases that work against American-made goods and U.S. jobs in favor of foreign manufacturers and their employees. Under the UBT, exports of American-made goods will be exempt and imports of foreign-made goods will be taxed.[205]

- Senator Lugar, upon introducing his resolutions in 1997 (S. Res. 16) and 1999 (S. Res. 24) that the income tax should be eliminated and replaced with a national sales tax, stated that one reason to do so was to correct the double taxation faced by U.S. exporters.

> American exports would also benefit from the enactment of a national sales tax. We must adopt a tax system that encourages exports. Most of our trading partners have tax systems that are border adjustable. They are able to strip out their tax when exporting their goods. In comparison, the income tax is not border adjustable. American goods that are sent overseas are taxed twice--once by the income tax and once when they reach their destination. In comparison, the national sales tax would not be levied on exports. It would place our exports on a level playing field with those of our trading partners.[206]

- Representative Phil English repeatedly has introduced a Simplified USA Tax bill. The bill specifically notes that it would serve the strategic interests of the United States by providing a "fair opportunity" for U.S. business to "compete in the global marketplace" in that the tax would be border-adjustable—imposed on imports and rebated on exports.

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[205] *Congressional Record* at E2903 (August 2, 1991) (remarks of Rep. Schulze).

[206] *Congressional Record* at S564 (January 21, 1997) (statement of Sen. Lugar); *Congressional Record*, S719 (January 19, 1999) (same statement).

> (4) FAIR OPPORTUNITY TO COMPETE IN THE GLOBAL MARKETPLACE— The Simplified USA Tax serves the strategic interests of the United States in international markets as follows:
>
> (A) Border adjustable tax-
>
> (i) AMERICAN-MADE EXPORTS- Goods and services produced in the United States can be sold into world markets free of tax.
>
> (ii) FOREIGN-MADE IMPORTS- Goods and services imported into the United States bear a fair and proportionate share of the tax burden in the United States.
>
> (iii) LEVELING THE INTERNATIONAL PLAYING FIELD- Border adjustments for exports and imports are consistent with international standards and practice.[207]

Although none of the foregoing legislation tax proposals have been enacted, it is notable that Rep. English's resolution (H. Res. 705), urging the President to resolve the disparate treatment of direct and indirect taxes presently provided by the WTO, did pass the House on July 14, 2004 by a vote of 423 to 1. In the debate on the resolution, Rep. English focused on both changing the international rules at the WTO and changing the U.S. tax system to make it internationally competitive.

> {W}hile this may not be the first time that we have discussed the issue of competitive trade disadvantage on the floor of the House that U.S. companies are facing, this may be the time that we are most clearly focusing on the contribution to that problem created by the American tax system.
>
> Congress and the administration need to push our trading partners to adjust the rules to level the playing field for American workers and American companies; and today's resolution helps do that by focusing on the disadvantage actually built into the World Trade Organization rules, a disadvantage imposed upon our Tax Code, allowing our competitors what amounts to a $120 billion advantage over American companies.
>
> For the past 30 years, the WTO has said that, while the EU members and other trading partners can and do exempt from tax

[207] *See, e.g.*, H.R. 4707, section 101(c)(4) (introduced February 8, 2006).

their exports to the U.S., we must fully tax our exports to them. As our manufacturers and other critical industries begin to recover from the recession, it is imperative that we address this inequity. Otherwise, we risk undermining one of the key drivers of economic growth, our export sector, and we also put at risk those companies that are competing within our domestic market by fostering upon them a significant competitive disadvantage.

Right now, WTO rules recognize the U.S. corporate income tax to be a so-called direct tax. Under the WTO rules, so-called "indirect taxes," value-added tax or retail sales tax or any other consumption-type tax, can be rebated on exports going out from the home country and imposed on imports coming in from foreign countries, but such adjustments cannot be made for direct taxes when goods and services cross international borders.

This is a distinction that has no grounding in economic reality and simply puts us at a competitive disadvantage. It is a crucial inequity for U.S. taxpayers and producers. Confronting it head on will go a long way to boost American competitiveness in the global market. That is why the resolution before us declares that this distinction is arbitrary and it results in a competitive disadvantage for businesses and works with a border-adjustable system, such as all value-added tax systems.

Looking to the future, this resolution should serve as a roadmap for reforming our international tax rules to allow U.S. products to compete in the global marketplace. This should be done in a way that exports American goods and services, not American jobs.

The resolution asks the President to report to Congress on two matters within 120 days of the convening of the 109th Congress. As required by the Trade Act of 2002, the United States Trade Representative is charged with considering how to eliminate trade barriers put up by the U.S.'s direct tax system in pursuing trade negotiations. Thus, first, the resolution asks for the President to provide a progress report on these barriers and how they can be eliminated. Second, it resolves that the President should report on proposed alternatives to the disparate treatment of the direct/indirect distinction as well as domestic proposals redressing the taxes disadvantage to the U.S.

Under the resolution, the President is asked to consider the impact of reducing the corporate rate, of implementing a territorial tax system, as well as the impact of a border-adjustable system as already allowed under the WTO rules. A comprehensive report on

> the issues would be an enormous help to the Congress and to any administration in putting into bold relief the improvements needed to international tax rules as well as our tax system as it stacks up against the systems of the rest of the world.
>
> The reason we must look at this issue more deeply is because it impacts on our economy in such a fundamental way. While we are certainly in a period of robust economic recovery, there is more we can do to sustain long-term growth. As evidenced by the $550 billion trade deficit I referenced earlier, we have become a Nation of importers. We need once again become a Nation of exporters; and as a Nation of exporters, we would see a thriving job market and a thriving manufacturing sector.
>
> In the absence of some kind of border tax adjustments for exports of American-made goods to correspond to the export rebates under VAT systems, there will continue to be a disincentive to produce goods in the United States. In effect, our tax system is creating all of the incentives to send our good-paying jobs offshore. This must be corrected, and this resolution is a step in the right direction.[208]

Although value-added tax proposals have been made repeatedly over the past thirty years, none have been successful. Proponents of a VAT have cited to numerous positive elements but opposition to a VAT has also been vocal and persistent. Arguments for and against imposing value-added taxes in the United States have commonly cited to such positive and negative elements or characteristics of a VAT as the following.

VAT Positives	VAT Negatives
▪ Stable, predictable revenue base because based on consumption ▪ Neutral effect because applied to all types of businesses ▪ Businesses have incentive to control costs ▪ Encourages savings ▪ Potential to raise substantial revenue at low tax rate	▪ Regressive ▪ Results in excessive spending ("money machine") ▪ Lacks a countercyclical balance ▪ Harmful to new and marginal businesses ▪ Creates administrative complexities ▪ Tends to increase inflation ▪ Acts as a "hidden tax"

[208] *Congressional Record* at H5672-5673 (July 14, 2004) (statement of Rep. English concerning H. Res. 705).

VAT Positives	VAT Negatives
▪ Simple to administer; potentially self-enforcing ▪ Reduces current obstacles to exports by allowing border-adjustability (VAT rebates) ▪ Provides a better balanced tax system	▪ Intrudes on state and local sales taxes ▪ Does not create incentives or reduce disadvantages for exports
Sources: *A Value-Added Tax for the United States?: Selected Viewpoints* (Tax Foundation, Inc., 1979); U.S. General Accounting Office, *Value-Added Tax Issues for U.S. Tax Policymakers* (September 1989) (GAO/GGD-89-125BR).	

Enactment of a VAT, even given its advantages in addressing the border tax problem, has faced difficult political hurdles because there is opposition to a VAT from both conservative and liberal viewpoints. On one hand, conservatives oppose a VAT because they view it as a as a "hidden" tax as well as a "money machine" that will stimulate government expenditures. On the other hand, liberals focus on the regressive nature of a VAT and oppose it because they believe it will unfairly and disproportionately affect people with lower incomes who must spend a greater percentage of their income on consumption. The Economic Report of the President summarizes the opposition to VAT:

> Critics of consumption taxes often argue that they are *regressive*, that is, they represent a higher proportion of the income of lower-income families.
>
> * * *
>
> VATs have not received serious consideration in the United States. Similar to the sales tax, VATs are viewed as regressive, at least when annual income is used as the measure of ability to pay. Critics of the VAT are not mollified by the fact that it is possible to impose lower VAT rates on commodities such as food. Another concern is that VAT tax rates would tend to increase over time as has occurred in Europe because the VAT is such an efficient and largely hidden tax.[209]

[209] *2005 Economic Report of the President* at 80, 85-86.

IV. CHINA'S TAX SYSTEM AND ITS USE OF DIRECT AND INDIRECT TAXES

A. Background

In January 1, 1994, China implemented a reformed commercial and industrial tax system. Six tax regulations were implemented simultaneously, including the Value Added Tax (VAT), consumption tax, business tax, enterprise income tax, resource tax and land VAT, together with the revised Individual Income Tax.[210] According to a March 2005 paper prepared by the Tax Policy Department of the Ministry of Finance in the People's Republic of China:

> VAT is the major source of fiscal revenue for the Government of China, particularly the central government. In 2002, the revenue from VAT is 814.1 billion Yuan, accounting for 47.61% of the state total tax revenue of the year, which is the first biggest tax in China.[211]

Indeed, China's VAT continues to provide roughly half of the country's tax revenue.

When it was implemented in 1994 as part of the overall tax reforms, China's VAT system differed from systems that exist in Europe and elsewhere. Under those systems, the VAT is consumption-oriented, that is, most of the VAT is borne by the ultimate consumer. Intermediate producers and suppliers collect and pay only a fraction of the VAT and are allowed to deduct the amount of VAT they pay on their purchases. By contrast, under China's system, no deductions

[210] Beijing Local Taxation Bureau, *Overview of China's Current Tax System*; available at http://english.tax861.gov.cn/zgsky/zgsky01.htm.

[211] China Ministry of Finance, Tax Policy Department, *Briefing of VAT Under China's Tax System*, a Paper submitted at the VAT Conference of International Tax Dialogue, Rome, March 2005, at 1.

for VAT were allowed on purchases of fixed assets, resulting in a system wherein the VAT was production-oriented.[212]

China's VAT system imposed different tax rates depending on the nature of the goods or services in question and whether the taxpayer is a "normal" or "general" taxpayer or a "small" taxpayer (*i.e.*, essentially, a small business).[213] For most goods or services, the rate established in 1994 was 17%, with a lesser rate of 13% for certain items, and, for businesses categorized as small-scale taxpayers the tax rate was set at 6% (for production of goods) or 4% (for wholesale or retail business).[214] The items entitled to a lower VAT rate of 13% included:

- Grains and edible vegetable oil;
- Tap water, heating, air conditioning, hot water, coal gas, liquefied-gas, natural gas, methane gas, and coal and charcoal products for household use;
- Books, newspapers and magazines;
- Feeds, chemical fertilizers, agricultural chemicals, agricultural machinery and plastic film for farming; and

[212] *See* Anthony M. Fay, *China's Conversion to a Consumption-Oriented VAT Regime*, Tax Notes International, Practitioner's Corner, August 23, 2004, at 3. The VAT Law defines "fixed assets" broadly. "Under Article 19 of the regulations of the VAT Law, fixed assets include: machines, machinery, and means of transportation with useful lives exceeding one year; other equipment, tools, and utensils related to production and operation; and articles with a unit value exceeding CNY 2,000 and a useful life in excess of two years that do not form part of the principal production and operating equipment. That definition captures virtually all capital equipment acquired for production, regardless of whether the equipment is purchased domestically or imported." *Id*. at 3-4.

[213] *See Trade Policy Review – People's Republic of China; Report by the Secretariat*, WT/TPR/S/161/Rev.1 (26 June 2006) at p. 102, para. 134 & fn. 110 ("A small-scale taxpayer is one whose accounting system is not sufficiently developed to calculate accurately the output and input VAT and thus VAT payable. They include taxpayers with total sales of less than Y 1 million engaged in the production of goods or taxable services, and those engaged in the production of goods or taxable services, which is the major part of their business operation, as well as in wholesaling or retailing; or those with total sales of less than Y 1.8 million engaged in wholesaling or retailing. Individuals, non-corporate businesses, and enterprises with infrequent taxable activities are also considered to be small-scale taxpayers.").

[214] *See Trade Policy Review – People's Republic of China; Report by the Secretariat*, WT/TPR/S/161/Rev.1 (26 June 2006) at p. 116, para. 191; *see also id*. at para. 134 & fn. 110.

- Other goods identified by the State Council (agricultural products, mining of metals, mining of non-metals).[215]

There also were a number of products that were completely exempted from VAT. These included:

- Self-produced agricultural products sold by agricultural producers;
- Contraceptive medicines and devices;
- Antique books;
- Imported instruments and equipment to be used directly in scientific research, experiment and education;
- Imported materials and equipment given as gratuitous aid by foreign governments and international organizations;
- Equipment and machinery required to be imported under contract processing, contract assembly and compensation trade;
- Articles imported directly by organizations for the disabled for special use by the disabled; and
- Sales of goods which have been used by the sellers.[216]

"Taxable services" subject to the 17% rate included processing, repairs and replacement services.

For taxpayers who exported, the VAT rate was 0%.[217] Such taxpayers could also apply for a refund of VAT they paid on the items that they exported. China allowed rebates on exports at various rates -- 17%, 13%, 11%, 8% and 5% -- depending on the type of product exported.[218]

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[215] *See Trade Policy Review – People's Republic of China; Report by the Secretariat*, WT/TPR/S/161/Rev.1 (26 June 2006) at p. 116, para. 192.

[216] *See Interim Regulations of the People's Republic of China on Value-added Tax* (adopted by the State Council on 26 November 1993 and effective 1 January 1994) at Article 16; s*ee* also *Trade Policy Review – People's Republic of China; Report by the Secretariat*, WT/TPR/S/161/Rev.1 (26 June 2006) at p. 116-117, para. 192.

[217] *See Interim Regulations* at Article 2.

[218] *See Trade Policy Review – People's Republic of China; Report by the Secretariat*, WT/TPR/S/161/Rev.1 (26 June 2006) at p. 117, para. 193.

Enterprises that purchase products from small-scale taxpayers and export them are allowed VAT rebates of 5% or 6%.[219]

Taxpayers subject to either the 13% or 17% rate calculated their payable tax by subtracting the amount of tax they paid on inputs from the amount of tax owed on outputs. The tax owed on outputs was the sales amount times the applicable rate. Taxpayers dealing in goods and/or services with different tax rates were required to calculate the applicable rates separately for each good or service.[220] If the applicable rates were not calculated separately, then the highest rate would be owed for all items or services.

In the case of taxpayers engaged in importing goods, the VAT was based on "the composite assessable price and the tax rates set forth in Article 2 of [the] Regulations, without tax credit deducted."[221] The "composite assessable price" equaled the imported product's dutiable value plus the customs duty plus the Consumption Tax. The payable tax was the composite assessable price times the applicable VAT rate.[222]

B. Recent Amendments to the Chinese VAT System

In January 2004, China's State Administration of Taxation issued Circular No. 143, which set in place a pilot program for a consumption-oriented VAT system. Entitled *Circular of the State Administration of Taxation on Carrying out the Work of Determination of Enterprises*

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219 *See Trade Policy Review – People's Republic of China; Report by the Secretariat*, WT/TPR/S/161/Rev.1 (26 June 2006) at p. 102, para. 134 & fn. 111 ("The 5% rate applies on all exports subject to a VAT rebate rate of 5%; the 6% rate applies on all exports subject to a VAT rebate rates between 5% and 17% ("Circular on Adjusting the Export Rebate Rates").").

220 *See Interim Regulations* at Articles 3-5.

221 *See Interim Regulations* at Article 15.

222 *See Interim Regulations* at Article 15.

Whose Scope of VAT Deduction is to be Enlarged, it identified eight industries in certain northeastern regions of China which would be allowed to deduct the VAT paid on purchases of fixed assets. Those industries included:

- Equipment manufacturing;
- Petrochemical industry (including petroleum processing, coking plant, and nuclear fuel processing, chemical materials, and chemical production, pharmaceuticals, chemical fibers, rubber produce, and plastic);
- Metallurgy industry (including black metal smelting and rolling processing, and non-ferrous metal smelting and rolling processing industry);
- Shipbuilding industry;
- Auto manufacturing;
- Farm products processing (including textile, leather, coat and feather or eiderdown processing, timber processing and timber, bamboo, rattan, palm and grass produce, textile, clothing, shoes and caps manufacturing, furniture manufacturing, paper making and paper produce, handicrafts but excluding tobacco and alcohol);
- Military supplies manufacturing; and
- High-technology industries.[223]

Circular No. 143 does not set out detailed rules or regulations for the implementation of this new VAT system nor does it specify how long the system is to remain in effect. Rather, the Circular provides:

> The administrations of state taxation at all levels shall attach high importance to it, reach a common understanding, and make a concerted effort to ensure that the determination work be completed on schedule. Meanwhile, proper publicity and guidance shall be made known to the taxpayers."[224]

[223] *See* Circular 143, Annex 1. With regard to high technology industries, the Circular indicates that such industries are to be identified in accordance with the scope of high and new technology as prescribed in the documents of the Conditions and Measures for Determination of High and New Technology Enterprises in the State High and New Technology Development Zones (Guo Ke Fa Huo Zi [2000] No. 324), and the Conditions and Measures for the Determination of High and New Technology Enterprises Outside the State High and New Technology Development Zones (Guo Ke Fa Huo Zi [1996] No. 018). *Id.*

[224] *See* Circular 143, Section I.

Companies that fall within the scope of one of the eight industries in the regions are directed to complete a "Form for Determination of Enterprises Whose VAT Deduction Scope Is To Be Enlarged in accordance with the actual conditions of production and management of the enterprise, and apply for determination to the local administration of state taxation."[225] The Circular further provides:

> All levels of administrations of state taxation shall make determination in accordance with the Specific Scope of the Eight Industries in the Northeast Region temporarily. After the scheme for reshaping the VAT in northeast region has been approved by the State Council, the determination shall be made according to the scope prescribed specifically by the Ministry of Finance and the State Administration of Taxation. And marks shall be loaded in the database for tax collection administration and in the database of archives for the VAT ordinary taxpayers. In case it is difficult to make determination concerning certain enterprises during the process of determination, the tax authorities in charge may negotiate with the development and reform commission (or planning commission) of the corresponding level to determine.[226]

In September 2004, the State Administration of Taxation and the Ministry of Finance jointly issued Circular No. 156, entitled *Provisions on Expanding the Qualifications of Fixed Asset Input VAT Deductions in the Northeast Region*, which provides more detailed rules on the pilot VAT program for the eight industries in the selected regions. Circular 156 provides that, effective July 1, 2004, a qualified taxpayer could deduct the following types of input VAT that was paid on the acquisition of qualified fixed assets:

- Input VAT paid in connection with the purchase of qualified fixed assets, including the acceptance of donations or in-kind investment;
- Input VAT paid in connection with the purchase of goods or services needed for self-construction of qualified fixed assets by the taxpayer;

[225] *See* Circular 143, Section II.

[226] *See* Circular 143, Section III.

- Input VAT paid on qualified fixed assets acquired by the taxpayer through a financial leasing transaction that is subject to the VAT;
- Input VAT paid on transportation costs associated with the acquisition of qualified fixed assets.[227]

As one analyst concluded:

> VAT amounts to roughly half of China's tax revenue each year and accounts for a high percentage of the overall tax liabilities for many Chinese taxpayers. The high VAT burden is partly the result of the non-deduction treatment of fixed asset input VAT under China's current VAT system. It is estimated that this new change in the Chinese VAT system will significantly reduce such burden for businesses in the Northeast, making it less expensive for existing companies to upgrade their factories and machinery, and will provide a tremendous incentive for prospective investors to move to the region. If successful, the new VAT system will be eventually rolled out to the rest of China.[228]

In September 2006, the Ministry of Finance, the National Development and Reforms Commission, the Ministry of Commerce, the General Administration of Customs and State Administration of Taxation announced further revisions to China's VAT system. These entailed revisions in the VAT export refund rates, including elimination of the refund altogether for exports of certain products, decreases in the refund for exports of other products and, finally, increases in the refund for exports of other products.

Elimination of VAT Export Refund:

- All non-metallic products (except salt and cement) listed in Article 25 of import and export Tariff Regulation, coal, natural gas, olefin, bitumen, silicon, arsenic, stone materials, non-ferrous metals as well as certain scrap materials.

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[227] Ernst & Young China Update, *VAT Reform in Northeast Region* (October 2004). The changes announced in Circular 156 also include a number of restrictions on carrying over VAT deductions, the inapplicability of the deductions for fixed assets used in activities that are either not subject to VAT or are VAT-exempt, etc. *Id.*

[228] Ernst & Young China Update, *VAT Reform in Northeast Region* (October 2004).

- Metallic ceramic, 25 types of pesticide and their intermediary products, certain finished products of leather, lead-acid battery and mercuric oxide battery.
- Thin fleece of goat, charcoal, crosstie, cork products, certain processed primary wood products.

Reduction in the VAT Export Refund Rate:

- Refund rate for steel products under 142-tariff heading reduced from 11% to 8%.[229]
- Refund rate for ceramic products, certain finished products of leather and glass products reduced from 13% to either 11% or 8%.
- Refund rate for certain non-ferrous metallic materials has been reduced from 13% to either 5%, 8% or 11%.
- Refund rate for textile, furnishings, plastic, lighter, and specific wood products reduced from 13% to 11%.
- Refund rate for non-mechanically propelled vehicles and certain component parts reduced from 17% to 13%.

Increase in the VAT Export Refund Rate:

- The refund rate for significant technical equipments, certain IT products, and bio-medical products as well as certain "encouraged" high-tech products has been increased from 13% to17%.
- The refund rate for selected processed products made from agricultural products has been increased from 5% or 11% to 13%.[230]

The reason for these changes was explained by the authorities who made the announcement, as follows:

> Apart from attempting to address the issues of high consumption and high pollution in China, Chinese high favorable balance of trade also contributed to the revision of VAT export refund rate.

[229] In April 2007, China announced that it would eliminate the VAT export rebate on many types of finished steel, and reduce it to 5% for more high valued products (such as tinplate, colour coated, non-alloy steel forged bars, silicon steels, and most types of cold reduced coil (CRC), hot dipped galvanised (HDG) and stainless steel). The new rebate rates would apply to all products that cleared China Customs on or after April 15, 2007. *See Steel Business Briefing*, April 11, 2007.

[230] Lex Universal Global Virtual Law Connection, *Revision to the Chinese VAT Export Refund*; available at www.lexuniversal.com/en/articles/1674.

> The General Administration of Customs has announced that based on the trading data of August 2006, another record high trade surplus of US$18.8 billion was recorded in August 2006. This is the 28th consecutive month where favorable balance of trade was recorded.
>
> Facing with the continuing high favorable balance of trade that attracted critics from various parties, Mr. Bo Xilai, the Minister of the Ministry of Commerce, has indicated that China has been considering various ways to reduce the high favorable balance of trade. The recently announced revision of VAT export refund rates may be considered as one of China's efforts in addressing this issue.
>
> * * *
>
> The revision has raised the VAT cost for businesses exporting "high energy consumption and high polluting" products while eliminating or reducing the VAT cost on the exportation of goods that fall under the "high technology and other encouraged industries." At the same time, it is also hope that the revision could reduce the pressure on an upward revision of the Renminbi.[231]

In June 2007, China's Ministry of Finance and State Administration of Taxation jointly issued Circular 90 (*Notice Regarding the Adjustment in Export Reform Rate for Certain Commodities*, Cai Shui [2007] No. 90) which, beginning July 1, 2007, "would cut or eliminate export tax rebates for 2,831 commodities representing 37 percent of the total number of items listed on customs tax regulations."[232] The Ministry of Finance stated that the changes were intended "to suppress overheated export growth and ease frictions between China and its trade

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[231] Lex Universal Global Virtual Law Connection, *Revision to the Chinese VAT Export Refund*; available at www.lexuniversal.com/en/articles/1674.

[232] Xinhua, *China to adjust export rebate policy on 2,831 commodities* (June 20, 2007); available at http://www.gov.cn/english/2007-06/20/content_654972.htm. *See also* PriceWaterhouseCoopers, *China VAT Alert: Significant Changes to Export VAT Refund Rates* (June 2007) (available at http://www.pwc.com/extweb/service.nsf/docid/99E47F780C3E0C3280257307002F762A); Deloitte & Touche, *Important Changes to China's Value Added Tax (VAT) Export Refund Rates* (available at http://www.deloitte.com/dtt/alert/0,1001,cid%253D164350,00.html).

partners."[233] In particular, China is eliminating export tax rebates on "553 'highly polluting products that consume heavy amounts of energy and resources' such as salt, cement, and liquefied petroleum gas," and reducing rebates on "exports of 2,268 commodities which 'tend to cause trade frictions.'"[234] Following these changes, China's VAT rebate system will have 5 levels – 17%, 13%, 11%, 9%, and 5%.[235]

C. Concerns Regarding Chinese Manipulation of the VAT

Many of China's trading partners have expressed concerns that China has manipulated its VAT system in order to encourage exports of particular products and to restrict imports of other products. The Office of the United States Trade Representative (USTR) has cited concerns not only about how China's VAT is applied to imports but also how the system is administered generally.

> Application of China's single most important revenue source – the VAT, which ranges between 13 percent and 17 percent, depending on the product – continues to be uneven. Importers from a wide range of sectors report that, because taxes on imported goods are reliably collected at the border, they are sometimes subject to application of a VAT that their domestic competitors often fail to pay. * * * China's selective exemption of certain fertilizer products from the VAT has also operated to the disadvantage of imports from the United States.[236]

USTR has also addressed the VAT rebate program for exports.

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233 Xinhua, *China to adjust export rebate policy on 2,831 commodities* (June 20, 2007); available at http://www.gov.cn/english/2007-06/20/content_654972.htm.

234 Xinhua, *China to adjust export rebate policy on 2,831 commodities* (June 20, 2007); available at http://www.gov.cn/english/2007-06/20/content_654972.htm.

235 Xinhua, *China to adjust export rebate policy on 2,831 commodities* (June 20, 2007); available at http://www.gov.cn/english/2007-06/20/content_654972.htm.

236 USTR, *2006 National Trade Estimate Report on Foreign Trade Barriers*, at 100.

> China retains an active VAT rebate program for exports, although rebate payments are often delayed. In 2003, China announced the reduction of VAT rebates for exports by three percentage points partly in response to foreign complaints about an under-valued RMB. Although State Administration of Taxation officials reportedly plan to eliminate rebates eventually in order to increase tax revenues, China has continued this practice in order to spur domestic economic growth. In December 2004, for example, the Ministry of Finance (MOF) and the State Administration of Taxation issued a circular announcing an increase in the VAT rebate rate from 13 percent to 17 percent for the export of certain IT products, including integrated circuits, independent components, mobile telecommunication equipment and terminals, computers and periphery equipment, and numerical-controlled machine tools. In 2005, China adjusted the ratio of the share of the export VAT refund burden between the central and local governments, from 75-25 to 92.5-7.5. China also halted refunds for some products in high demand domestically in order to discourage their export. For example, China eliminated a 13 percent VAT rebate for exports of steel billets and ingots, although it maintained VAT rebates of 11 percent to 13 percent for more processed steel products.[237]

U.S. concerns regarding China's application of VAT policies are reviewed in greater detail in section VI.

V. IMPACT OF THE CHINESE VAT SYSTEM ON U.S.-CHINA TRADE FLOWS

Section I of this paper presented an estimate of the negative economic effect on U.S. exporters and producers of trade with countries that impose and border-adjust value-added taxes. China is one of the 137 countries in the world that impose value-added taxes. This section estimates the impact that China's application of its VAT policies on imports and exports has on U.S. exporters and producers. As reviewed in section IV, China imposes a standard import VAT rate of 17%, with a reduced rate of 13% on some items, and exemptions for others. China allows

[237] USTR, *2006 National Trade Estimate Report on Foreign Trade Barriers,* at 100.

rebates of exports at various rates -- 17%, 13%, 11%, 8% and 5% -- depending on the type of product exported. However, not all Chinese exports receive full rebates as VAT refunds are often only partial, and are subject to frequent change depending on the type of product, the cost of the refund, and China's application of its trade polices.[238]

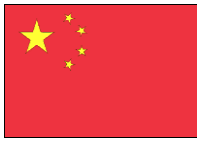
Notwithstanding the variations in China's application of its import and export VAT policies, one can reasonably estimate the economic impact of China's VAT policies on U.S. exporters and producers by calculating the VAT disadvantage based on China's standard VAT rates.

Assuming that China imposes a standard 17% VAT on imports and allows a VAT rebate of 13% for exports, the simple price effect is to increase the price of U.S. exports to China by $17 and to reduce the price of Chinese exports to the United States by $13, a result which disadvantages U.S. exporters in China and U.S. producers in the United States vis-à-vis competition with Chinese products.

VAT Impact on Price of U.S. Imports from China and U.S. Exports to China (Product Value = $100)

→ $117 →

← $87 ←



VAT = 0

VAT on imports = 17 %
VAT rebate on export = 13 %

- U.S. exports pay 17% VAT upon entering China
- China exports receive a rebate of VAT and pay no VAT upon entering the U.S.

[238] *See Trade Policy Review – People's Republic of China; Report by the Secretariat*, WT/TPR/S/161/Rev.1 (26 June 2006) at p. 117, para. 193.

Using 2006 trade data, and assuming that China imposes the standard VAT rate of 17% on imports and provides exports with a VAT rebate of 13%, a reasonable estimate of the total VAT disadvantage that U.S. exporters and producers experience in U.S.-China trade is as follows.

U.S.-China VAT Disadvantage: 2006[239]

Standard VAT Rates (%)	U.S. 2006Exports FAS value ($)	U.S. 2006Imports Customs value ($)	VAT Collected on U.S. Exports ($)	VAT Subsidy to U.S. Imports ($)
17 (import) 13 (export)	51,624,064,793	287,052,416,194	8,776,091,015	37,316,814,105
Total China VAT Disadvantage in 2006			**$46,092,905,120**	

As the table shows, Chinese goods exported to the United States received subsidies (*i.e.*, VAT rebates) approximating $37.3 billion, and exports of U.S. goods to China were disadvantaged with VAT assessments approximating $8.8 billion. In sum, the border adjustment of VAT competitively disadvantaged U.S. exporters and producers of goods vis-à-vis China by an estimated total of $46.1 billion in 2006. Only Mexico, whose VAT disadvantage was $46.7 billion, accounted for a larger individual country VAT disadvantage than China in 2006.

[239] Data sources for the table are: Import and export statistics from: U.S. Census Bureau, Foreign Trade Statistics (domestic exports and imports for consumption); VAT rates for China from: 2006 Customs Import Tariff Schedule of the People's Republic of China; *Trade Policy Review – People's Republic of China; Report by the Secretariat*, WT/TPR/S/161/Rev.1 (26 June 2006).

VI. DISPUTES AND ISSUES THAT HAVE ARISEN CONCERNING CHINA'S APPLICATION OF VALUE-ADDED AND OTHER INDIRECT TAXES ON SELECTED PRODUCTS

Moreover, China has not been satisfied with the advantages created by WTO rules on indirect taxation. Rather it has, for certain products, granted excessive rebates on exports or discriminated in the application of the VAT on imports versus domestic product. Such practices have resulted in the U.S. raising questions regarding possible violations by China of WTO obligations with respect to its application VAT and other indirect taxes and the launch of some dispute settlement proceedings.

In 2000, the year before China joined the WTO, the U.S. Trade Representative's (USTR) National Trade Estimate Report on Foreign Trade Barriers (NTE Report) noted that China's application of value-added taxes sometimes discriminated against imports.

> Imports are sometimes subject to discriminatory application of China's value-added tax (VAT), which ranges between 13 and 17 percent, depending on the product. While the VAT is collected on imports at the border, domestic producers either fail to pay the VAT or absorb the tax without passing it on to their customers and then receive loans to defray the company's losses.[240]

In the following year, 2001, the year that China joined the WTO, USTR's NTE Report again cited China for discriminatory application of value-added taxes.

> Management of the Chinese authorities' single most important revenue source – the value-added tax (VAT) – is, however, weak. Imports are sometimes subject to discriminatory application of the VAT, which ranges between 13 percent and 17 percent, depending on the product. In addition, while the VAT is collected on imports at the border, domestic producers often fail to pay the VAT. For example, when China re-imposed a 17-percent VAT on soybean meal in July 1999, soybean imports fell by over 50 percent.

[240] *See* USTR, *2000 National Trade Estimate Report on Foreign Trade Barriers*, at 44.

> Allegedly, domestic producers of crushed soybean meal apparently avoided the taxes and passed on the price advantage to buyers.[241]

In the process of China's accession to the WTO, a number of WTO Members were also concerned about China's apparent discriminatory use of value-added taxes. The Working Party Report states that these Members "expressed concern that some internal taxes applied to imports, including a value-added tax ("VAT") were not administered in conformity with the requirements of the GATT 1994, particularly Article III."[242] Article III imposes a national treatment obligation on Members. The Working Party Report further "noted that China appeared to permit the application of discriminatory internal taxes and charges to imported goods and services, including taxes and charges applied by sub-national authorities."[243] China responded to these concerns by confirming "that from the date of accession, China would ensure that its laws, regulations and other measures relating to internal taxes and charges levied on imports would be in full conformity with its WTO obligations and that it would implement such laws, regulations and other measures in full conformity with those obligations.[244]

Despite China's assurances before accession, a number of Members, including the United States, have raised concerns that, even after accession to the WTO, China continued to apply internal taxes, such as the VAT, on a number of products in a discriminatory manner. For example, in its first annual report on China's compliance with WTO commitments, USTR stated:

> Several U.S. industries have complained about the unfair operation of China's VAT system. Often, Chinese producers are able to avoid payment of the VAT on their products, either as a result of

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241 *See* USTR, *2001 National Trade Estimate Report on Foreign Trade Barriers*, at 46-47.

242 *Report of the Working Party on the Accession of China*, WT/MIN(01)/3 (10 November 2001) at para. 104.

243 *Report of the Working Party on the Accession of China*, WT/MIN(01)/3 (10 November 2001) at para. 104.

244 *Report of the Working Party on the Accession of China*, WT/MIN(01)/3 (10 November 2001) at para. 107.

> poor collection procedures, special deals or even fraud, while the full VAT still must be paid on competing imports. In discussions with Chinese officials on this issue, the United States has complained about the discriminatory treatment accorded to foreign products.[245]

In subsequent compliance reports and at the WTO, USTR has continued to question China's discriminatory application of indirect taxes, including VAT and consumption taxes, with respect to certain products. In the most recent 2006 compliance report, USTR again noted that some U.S. industries have continued to express concerns generally about the discriminatory operation of China's VAT system.[246] Some specific examples of such cases are reviewed in the following sections.

A. VAT on Semiconductors

In the second Trade Review Mechanism (TRM),[247] an annual review of issues related to China's WTO commitments, the United States formally raised the issue of China's discriminatory application of value-added taxes with respect to semiconductors. The United States posed the following questions to China.

> **Value-Added Tax Applied to Semiconductors**
>
> 2. Despite its national treatment obligations under Article III of GATT 1994, China applies a reduced VAT to integrated circuits designed or manufactured in China, while it charges the full 17 percent VAT on imported integrated circuits. In particular, pursuant to State Council Document 18 and subsequent measures,

[245] USTR, *2002 Report to Congress on China's WTO Compliance* (December 11, 2002) at 21.

[246] USTR, *2006 Report to Congress on China's WTO Compliance* (December 11, 2006) at 40-41.

[247] When China acceded to the WTO, its trade regime was not yet fully in compliance with WTO obligations and requirements. Consequently, China's Protocol of Accession established a Transitional Review Mechanism (TRM) to review the progress of China's compliance with, and implementation of, its terms of accession. *See Protocol on the Accession of the People's Republic of China*, WT/L/432 (23 November 2001) at Article 18. Beginning in 2002, the TRM was to be conducted annually for eight years, with a final review in the tenth year. To date, the WTO has conducted five TRM reviews.

> China provides for partial refunds of the VAT paid on integrated circuits manufactured and/or designed in China, but provides no refund of the VAT paid on imported integrated circuits unless they were designed in China.
>
> (a) Please explain the reasons for the differential treatment.
>
> (b) Please explain how the difference in the treatment of imported versus domestic products under these measures is consistent with Article III of GATT 1994.[248]

In response, China argued that its VAT polices regarding semiconductors were valid under GATT Article III:8(b) and VAT rebates were, in essence, subsidies to domestic producers. The United States did not agree with this assessment and asked China to explain its argument.[249]

In its 2003 report on China's WTO compliance, USTR noted that China uses VAT policies "to encourage domestic production in a number of industrial and agricultural sectors," including semiconductors.[250] USTR stated that, in the case of semiconductors, China provided

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[248] Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol on the Accession of the People's Republic of China, *Questions from the United States to China concerning Market Access*, G/MA/W/51 (13 October 2003) at 2-3.

[249] In the Trade in Goods TRM review, the United States asked:

> Value-Added Tax Policies
>
> 2. During the transitional review before the Committee on Market Access, China attempted to justify its value-added tax (VAT) policies on integrated circuits by citing to Article III:8(b) of GATT 1994. Specifically, China argued that China's VAT rebates on integrated circuits were a kind of subsidy paid to domestic producers and therefore allowed by Article III:8(b). In the United States' view, several prior interpretations of Article III:8(b) contradict this argument, including, for example, the GATT panel report in *United States – Measures Affecting Alcoholic and Malt Beverages*, DS23/R (adopted 19 June 1992), and the WTO panel report in *Indonesia – Certain Measures Affecting the Automobile Industry*, WT/DS54/R (adopted 23 July 1998). Please explain how China supports its interpretation of Article III:8(b).

Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol on the Accession of the People's Republic of China, *Questions from the United States to China concerning Trade in Goods*, G/C//W/473 (17 November 2003) at 2.

[250] *See* USTR, *2003 Report to Congress on China's WTO Compliance* (December 11, 2003) at 7-8.

VAT rebates to domestic semiconductor producers and that this was an example of differential tax treatment that "raised serious WTO concerns."[251]

U.S. industry groups also were vocal in citing China's semiconductor VAT as inconsistent with its WTO obligation of national treatment.[252] For example, in 2003 comments to USTR regarding China's WTO compliance, the U.S. Council on International Business observed:

> The Chinese government imposes a 17 percent VAT on all domestically produced and imported semiconductors sold in China, but permits domestic semiconductor producers to obtain a rebate of the VAT paid in excess of 3 to 6 percent, depending on the circumstances. As a result, imported semiconductors are subject to a much higher effective VAT rate than are domestic semiconductors benefiting from the rebate. This discriminatory tax treatment is a clear violation of the national treatment obligation of Article III of the GATT 1994, and runs counter to explicit Chinese commitments in the Protocol of Accession and the Working Party Report on China's WTO Accession to bring its VAT into compliance with WTO rules.[253]

In its 2003 WTO compliance report, USTR specifically noted that it would "continue to press China" on the VAT issue and would "take further appropriate actions seeking elimination of China's differential tax treatment, including dispute resolution at the WTO, if necessary."[254] Subsequently, in February 2004, USTR indicated that it was actively preparing a WTO case against China's semiconductor VAT policy, but that it would give China "one last shot" to

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251 *See* USTR, *2003 Report to Congress on China's WTO Compliance* (December 11, 2003) at 7-8.

252 The Financial Times noted: "The Chinese tax has become the biggest international trade issue for the $70bn (£39bn, E57bn) US semiconductor industry, which fears the rebate is encouraging semiconductor production in China at the expense of US imports." Edward Alden, *US to file WTO complaint against China*, FINANCIAL TIMES, March 17, 2004; available at http://news.ft.com/servlet/ContentServer?pagename=FT.comStoryFT/FullStory&c=StoryFT&cid=1079419679859.

253 U.S. Council for International Business (USCIB), *Written Comments re China WTO Obligations*, September 10, 2003; available at http://www.uscib.org/%5Cindex.asp?documentID=2742.

254 *See* USTR, *2003 Report to Congress on China's WTO Compliance* (December 11, 2003) at 8.

resolve the matter.[255] On March 9, 2004, in testimony before the Senate Finance Committee, U.S. Trade Representative Robert Zoellick stated that the United States was moving closer to challenging China regarding its value-added tax on semiconductors, noting: "If they don't fix it very soon we're going to bring a case."

On March 18, 2004, the United States formally filed the first WTO case against China "regarding its discriminatory tax rebate policy for integrated circuits."[256] In its request for consultations with China, the United States summarized the issue as follows:

> China provides for a 17 per cent VAT on ICs. However, we understand that enterprises in China are entitled to a partial refund of the VAT on ICs that they have produced, resulting in a lower VAT rate on their products. China therefore appears to be subjecting imported ICs to higher taxes than applied to domestic ICs and to be according less favourable treatment to imported ICs.
>
> In addition, we understand that China allows for a partial refund of VAT for domestically-designed ICs that, because of technological limitations, are manufactured outside of China. China thus appears to be providing for more favourable treatment of imports from one Member than another, and discriminating against services and service suppliers of other Members.
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> * * *
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> The United States therefore believes that these measures are inconsistent with the obligations of China under Articles I and III of the GATT 1994, the Protocol on the Accession of the People's Republic of China (WT/L/432), and Article XVII of the GATS.[257]

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[255] *USTR Warns of China WTO Case on Semiconductor VAT if No Progress by April*, INSIDE US-CHINA TRADE, February 11, 2004. On March 9, 2004, in testimony before the Senate Finance Committee, USTR Zoellick stated that the United States was moving closer to challenging China regarding its value-added tax on semiconductors, noting: "If they don't fix it very soon we're going to bring a case." *See Zoellick Signals Clear Opposition to WTO Case on China Currency*, INSIDE US-CHINA TRADE, March 10, 2004.

[256] USTR press release 2004-22: *U.S. Files WTO Case Against China Over Discriminatory Taxes That Hurt U.S. Exports* (March 18, 2004).

[257] China - Value-Added Tax On Integrated Circuits, *Request for Consultations by the United States*, WT/DS309/1, G/L/675, S/L/160 (23 March 2004).

Following the U.S. request for consultations, several other WTO Members with an interest in the issue (*i.e.*, European Communities, Japan, Mexico, and Taiwan) requested to join the consultations.[258] China and United States held consultations on April 27, 2004 in Geneva, and bilateral meetings in Washington and Beijing.

On July 14, 2004, four months after the United States requested consultations, China and the United States informed the DSB that they had reached an agreement, which took the form of a Memorandum of Understanding. Pursuant to the agreement, China agreed to take the following actions.

> By 1 November 2004, China will amend the measures described in the US consultation request (WT/DS309/1) to eliminate the availability of VAT refunds to firms producing ICs in China on their domestic sales. The effective date of these amendments will be no later than 1 April 2005. Until the effective date of these amendments, VAT refunds will be available only to integrated circuit enterprises certified under the measures as of 14 July 2004 in respect of products so certified as of 14 July 2004.
>
> By 1 September 2004, China will issue a notice to revoke the measure described in the US consultation request (WT/DS309/1) that provides for VAT refunds on ICs designed in China but

[258] On March 26, 2004, the European Communities requested to join the consultations. *See* China - Value-Added Tax on Integrated Circuits, *Request to Join Consultations, Communication from the European Communities*, WT/DS309/2 (30 March 2004). On March 31, 2004, Japan requested to join the consultations. *See* China - Value-Added Tax on Integrated Circuits, *Request to Join Consultations, Communication from Japan*, WT/DS309/3 (1 April 2004). On April 1, 2004, Mexico and the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu requested to join the consultations. *See* China - Value-Added Tax on Integrated Circuits, *Request to Join Consultations, Communication from Mexico*, WT/DS309/4 (5 April 2004); China - Value-Added Tax on Integrated Circuits, *Request to Join Consultations, Communication from Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu*, WT/DS309/5 (5 April 2004). On April 28, 2004, China informed the DSB that it had accepted the requests of the European Communities, Japan and Mexico, but not Taiwan, to join the consultations. *See* China - Value-Added Tax on Integrated Circuits, *Acceptance by China of the Requests to Join Consultations*, WT/DS309/6 (28 April 2004).

> manufactured abroad. The effective date of revocation will be no later than 1 October 2004.[259]

Ten months after signing the MOU, on October 5, 2005, China and the United States informed the DSB that, inasmuch as the two countries agreed that the terms of the MOU had been successfully implemented, they also agreed that a "mutually satisfactory solution" to the matter of China's value-added tax on integrated circuits had been reached.[260]

B. VAT Treatment of Certain Fertilizers

The United States has repeatedly raised concern at the WTO about the discriminatory effect of China's VAT policy with respect to certain fertilizer products. In 2001, China began exempting phosphate fertilizers from VAT except for one type of fertilizer—diammonimum phosphate (DAP)—that was produced in and imported from the United States. In the first TRM, the United States noted that China's *Circular about VAT Exemption Policy for Certain Farming Materials* (No. 113/2001), which was jointly issued by the Ministry of Finance and the State Administration of Taxation on July 20, 2001, "exempts all phosphate fertilizers except diammonium phosphate (DAP) from China' s value-added tax (VAT)," but that "DAP, a product produced in the United States, competes with similar phosphate fertilizers produced in China, such as monoammonium phosphate (MAP)."[261] The United States pointed out that China's differential tax policy discouraged use of foreign-produced DAP in favor of domestically-

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[259] Memorandum of Understanding Between China and the United States Regarding China's Value-Added Tax on Integrated Circuits (July 14, 2004) (included as an attachment to China - Value-Added Tax on Integrated Circuits, *Joint Communication from China and the United States*, WT/DS309/7, G/L/675/Add.1, S/L/160/Add.1 (16 July 2004)).

[260] *See* China - Value-Added Tax on Integrated Circuits, *Notification of Mutually Agreed Solution*, WT/DS309/8, G/L/675/Add.2, S/L/160/Add.2 (6 October 2005).

[261] China's Transitional Review Mechanism, *Questions from the United States to China concerning Market Access*, G/MA/W/35 (20 August 2002) at Item 19.

produced MAP with which DAP competes.[262] The United States asked China to explain why it applied different tax treatment to these products and how the differences in treatment were consistent with its national treatment obligations under Article III of the General Agreement on Tariffs and Trade 1994.[263]

In the second TRM, the United States restated its national treatment concerns regarding China's differential VAT treatment of U.S.-produced DAP and domestic MAP, noting that it had "raised this issue with China on several occasions, both at the WTO and bilaterally."[264] In response, China claimed that its differential treatment of DAP and MAP was not in violation of national treatment obligations because DAP and MAP were not identical or similar goods, were not substitutable products, and were not competitive products.[265]

In each succeeding TRM review, the United States has continued to raise this issue and express its concern that China's differential VAT treatment of DAP and MAP is discriminatory and inconsistent with the principles of national treatment.[266] China, however, has continued to

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[262] China's Transitional Review Mechanism, *Questions from the United States to China concerning Market Access*, G/MA/W/35 (20 August 2002) at Item 19.

[263] China's Transitional Review Mechanism, *Questions from the United States to China concerning Market Access*, G/MA/W/35 (20 August 2002) at Item 19.

[264] Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol on the Accession of the People's Republic of China, *Questions from the United States to China concerning Market Access*, G/MA/W/51 (13 October 2003) at Item 3.

[265] Committee on Market Access, *Minutes of the Meeting Held on 20 October and 5 December 2003*, G/MA/M/35 (10 December 2003) at para. 7.13.

[266] *See* China's Transitional Review Mechanism, *Questions from the United States to China concerning Market Access*, G/MA/W/58 (31 August 2004) at para. 6; China's Transitional Review Mechanism, *Questions from the United States to China concerning Market Access*, G/MA/W/71 (6 September 2005) at para. 13; China's Transitional Review Mechanism, *Communication from the United States*, G/MA/W/78 (18 September 2006) at para. 6.

See also USTR, *2007 National Trade Estimate Report on Foreign Trade Barriers* at 85:

> In 2001, China began exempting all phosphate fertilizers except diammonium phosphate (DAP) from the VAT. DAP, a product that the United States exports to China, competes with

maintain that its differential VAT treatment of DAP and MAP is justified and that it "had currently no intention to change the system."[267]

C. Consumption Taxes on Various Products

China's consumption tax "applies to a range of consumer products, including spirits and alcoholic beverages, tobacco, cosmetics and skin and hair care preparations, jewelry, fireworks, rubber, motorcycles and automobiles."[268] In the first TRM, the United States noted its concern that China used different methods for calculating consumption taxes on domestic and imported products which resulted in higher taxes being imposed on imported products. In particular, the United States stated:

> Consumption Tax Applied to Imported Goods
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> Under the *Provisional Regulations on Consumption Tax*, which have been in effect since 1993 and have not been amended since China acceded to the WTO, China uses a different tax base to compute consumption tax for imported products and domestic products. For domestic products, the tax base for domestic products is the sales amount (apparently the ex factory price). (*Provisional Regulations*, Article 5.) This amount is multiplied by the consumption tax rate to derive the consumption tax due. In contrast, for imported products, Article 9 sets the tax base as the "composite assessable value," which is defined as (dutiable value + customs duty), divided by (1 – consumption tax rate). The resulting amount is then multiplied by the consumption tax rate to derive the consumption tax due.[269]

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other phosphate fertilizers produced in China, particularly monoammonium phosphate. Both the United States Government and U.S. producers have complained that China has employed its VAT policies to benefit domestic fertilizer production.

[267] Committee on Market Access, *Minutes of the Meeting Held on 4 October 2006*, G/MA/M/42 (14 November 2006) at para. 7.4.

[268] USTR, *2002 Report to Congress on China's WTO Compliance* (December 11, 2002) at 22.

[269] China's Transitional Review Mechanism, *Questions from the United States to China concerning Market Access*, G/MA/W/35 (20 August 2002) at Item 20.

The United States asked China to explain how this different tax treatment was consistent with national treatment requirements under GATT 1994.[270] In the second TRM, China answered that it used different tax formulas for imports and domestic products in order to equalize their tax treatment. In particular, China stated:

> In China, taxable value for the purpose of imposing consumption tax included a consumption tax factor, i.e.: taxable value = (cost + profit)/(1 - consumption tax rate). Such a calculation method applied to both imported goods and domestic goods. The consumption tax factor was put into the taxable value while calculating and levying consumption tax on either imported or domestic products. Due to such a method, the consumption tax factor was taken into account when the selling price of domestic products was being determined. Thus, since the taxable value of domestic products already included a consumption tax factor, the corresponding consumption tax was the taxable value multiplied by the tax rate. Since the import value of imported goods did not include a consumption tax factor, such a value was converted into a taxable value that contained a consumption tax factor. The consumption tax was then worked out based on the converted taxable value. Otherwise, the value of imported goods would not contain a consumption tax factor, while that of domestic goods would, which would lead to unfair treatment in relation to tax imposition on imported and domestic products.[271]

Although the United States has continued to claim that China's consumption tax regulations raise national treatment concerns and has repeatedly urged China to revise its regulations, China has not done so. Most recently, in the 2006 report concerning China's WTO compliance, USTR stated:

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[270] China's Transitional Review Mechanism, *Questions from the United States to China concerning Market Access*, G/MA/W/35 (20 August 2002) at Item 20.

[271] Committee on Market Access, *Minutes of the Meeting Held on 20 October and 5 December 2003*, G/MA/M/35 (10 December 2003) at para. 7.14.

> Consumption Taxes
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> National treatment concerns also continue to arise in connection with China's consumption tax regulations, which first went into effect in 1993 and apply to a range of consumer products, including spirits and alcoholic beverages, tobacco, cosmetics and skin and hair care preparations, jewelry, fireworks, rubber, motorcycles and automobiles. Under these regulations, China uses different tax bases to compute consumption taxes for domestic and imported products, with the apparent result that the effective consumption tax rate for imported products is substantially higher than for domestic products. Since China's accession to the WTO, the United States has raised this issue with China, both bilaterally and during the annual transitional reviews conducted by the WTO Committee on Market Access and the Council for Trade in Goods. To date, China has not revised these regulations. The United States will continue to pursue appropriate revisions of these regulations in 2007.[272]

D. Border Trade VAT Policy

Another VAT issue that has been raised repeatedly is China's VAT policy with respect to border trade with Russia. According to the USTR, "China maintains a Sino-Russia border trade policy, issued in 1996, that reduces the VAT by one-half for a number of products imported from Russia in certain border regions."[273] During the process of accession, some WTO Members "stated that it should be made clear that China would apply the requirements of the WTO Agreement and its other accession commitments throughout China's entire customs territory, including border trade regions, minority autonomous areas, Special Economic Zones ("SEZs"),

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[272] USTR, *2006 Report to Congress on China's WTO Compliance* (December 11, 2006) at 41. *See also* USTR, *2007 National Trade Estimate Report on Foreign Trade Barriers*, at 92-93:

> China's 1993 consumption tax system continues to raise concerns among U.S. exporters. Because China uses a substantially different tax base to compute consumption taxes for domestic and imported products, the tax burden imposed on imported consumer goods ranging from alcoholic beverages to cosmetics to automobiles is higher than for competing domestic products.

[273] Subsidies, *Request from the United States to China Pursuant to Article 25.8 of the Agreement on Subsidies and Countervailing Measures*, G/SCM/Q2/CHN/9 (6 October 2004) at para. 22.

open coastal cities, economic and technical development zones and other special economic areas and at all levels of government."[274] In response, China "confirmed that the provisions of the WTO Agreement ... would be applied uniformly," including in border trade regions.[275]

However, in its first China compliance report, USTR noted that "China continues to generate MFN and other concerns through the manner in which it provides preferential import duty and value-added tax (VAT) treatment to certain Russian products under the auspices of border trade."[276] In the second TRM, the United States noted that, although China had removed boric acid and twenty other products from the list of imports from border areas that could benefit from preferential treatment in the form of reduced import duties and/or VAT, "China nevertheless continues to provide preferential treatment to imports of other products from border areas."[277] The United States again asked China to "explain how this preferential treatment is consistent with China's WTO commitments, as set forth in Article I of GATT 1994 (most-favoured nation treatment), Part XIV of Annex 5A to China's Protocol of Accession (where China stated that it would eliminate preferential import duties for border trade) and Section 2(A) of China's Protocol of Accession (uniform administration of trade regime)."[278] China replied that it believed that its border trade polices were in compliance with its WTO commitments and MFN principles.

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274 *Report of the Working Party on the Accession of China*, WT/MIN(01)/3 (10 November 2001) at para. 71.

275 *Report of the Working Party on the Accession of China*, WT/MIN(01)/3 (10 November 2001) at para. 73.

276 USTR, *2002 Report to Congress on China's WTO Compliance* (December 11, 2002) at 21.

277 Transitional Review Mechanism in Connection With Paragraph 18 of the Protocol on the Accession of the People's Republic of China, *Questions from the United States to China concerning Trade in Goods*, G/C/W/473 (17 November 2003) at paras. 6-7.

278 Transitional Review Mechanism in Connection With Paragraph 18 of the Protocol on the Accession of the People's Republic of China, *Questions from the United States to China concerning Trade in Goods*, G/C/W/473 (17 November 2003) at para. 7.

> The WTO did not provide for the specific definition, forms and territorial scope of border trade, and only set forth a fundamental provision that "the provisions of this Agreement shall not be construed to prevent advantages accorded by any contracting party to adjacent countries in order to facilitate frontier traffic". Therefore, special preferential treatments for border trade were allowed by the WTO, and advantages and conveniences accorded by a contracting party to adjacent countries were not inconsistent with the basic principle of the WTO, i.e. MFN. China had committed in its accession protocol to apply WTO Agreements and the protocol across the whole customs territory including border trade areas, and would develop and implement laws, regulations and other measures in relation to trade in goods in a uniform, impartial and rational manner. Border trade policies had been uniformly implemented and enforced in the provinces and regions in border areas of China as an important part of China's foreign trade policies.[279]

In subsequent TRMs in 2004 and 2005, the United States restated its concern that China's border trade policy provided preferential treatment to imports of Russian products that was inconsistent with China's WTO commitments.[280] In the most recent 2006 TRM, the United States again urged China to eliminate its preferential border trade policy.

> In connection with transitional reviews in past years, the United States has expressed concern about imports from border areas that continue to benefit from preferential treatment in the form of reduced import duties and/or VAT pursuant to measures such as Bulletin No. 27 and Bulletin No. 39, issued by the General Administration of Customs on 1 May 2003 and 11 June 2003, respectively. In explaining its concerns, the United States has referenced China's WTO commitments, as set forth in Part XIV of Annex 5A to China's Protocol of Accession (where China stated that it would eliminate preferential import duties for border trade) and paragraph 2(A) of China's Protocol of Accession (where

[279] Report of the Council for Trade in Goods on China's Transitional Review, G/L/664 (4 December 2003) at para. 3.10.

[280] *See* Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol on the Accession of the People's Republic of China, *Questions from the United States to China*, G/C/W/499 (11 November 2004) at para. 10; Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol on the Accession of the People's Republic of China, *Questions from the United States to China*, G/C/W/530 (12 October 2005) at para. 10.

> China extended its obligations under the WTO Agreement and the commitments that it made in its Protocol of Accession to border trade regions as part of its commitment to apply uniformly its trade regime). Has China eliminated preferential border area treatment for any products during the past year? Does China have any plans to review its preferential treatment of imports from border areas?[281]

E. Assessment of VAT on Antidumping Duty

In the 2006 TRM, the United States raised the issue of China's formula for calculating antidumping duties and whether it improperly assessed VAT on the antidumping duty as well as on the entered value of the subject imported product. The United States explained:

> In recent anti-dumping determinations, BOFT {Bureau of Fair Trade} has published a formula for calculating the amount of anti-dumping duty collected upon entry at the port for products subject to anti-dumping measures, i.e., Deposit Amount = (Duty Paid Price x AD Deposit Rate) x (1 + import VAT rate). It is the United States' understanding that this formula assesses the value added tax (VAT) on the anti-dumping duty in addition to the entered value of the merchandise. Please explain whether BOFT in fact instructs the Customs Administration to collect VAT on the anti-dumping duty and, if so, which provision of the Anti-Dumping Agreement allows for this action.[282]

In response to the concern of the United States, the Chinese delegate stated that:

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[281] Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol on the Accession of the People's Republic of China, *Questions from the United States to China*, G/C/W/560 (6 November 2006) at para. 21. *See also* USTR, *2007 National Trade Estimate Report on Foreign Trade Barriers*, at 87:

> China's border trade policy continues to generate MFN and other concerns. China provides preferential import duty and VAT treatment to certain products, often from Russia, apparently even when those products are not confined to frontier traffic as envisioned by Article XXIV of GATT 1994. China addressed some of these concerns in 2003 when it eliminated preferential treatment for boric acid and 19 other products. Nonetheless, it appears that large operators are still able to take advantage of border trade policies to import bulk shipments across China's land borders into its interior at preferential rates. In addition, U.S. industry reports that China continues to use border trade policies to provide preferential treatment for Russian timber imports, to the detriment of U.S. timber exporters.

[282] Transitional Review Mechanism in Connection With Paragraph 18 of the Protocol on the Accession of the People's Republic of China, *Questions from the United States to China*, G/ADP/W/459 (5 October 2006) at para. 9.

> {I}t was his personal understanding that, under the existing or current textual framework in China, the tariff which included duties in the cases of anti-dumping, safeguards and others ***was*** subject to VAT in China. China recalled that the Anti-Dumping Agreement itself did not have very clear provisions on this particular issue, and was willing to exchange further views with Members on this matter.[283]

In reply, the United States drew China's attention to Article 18.1 of the Antidumping Agreement which provided that "no specific action against dumping of exports can be taken except in accordance with this agreement."[284] The United States stated that "application of the VAT rate to a number which included the dumping duty meant that, by virtue of an affirmative finding of dumping, the result would not only be the amount of duty owed, i.e. the dumping duty, but that there would be the secondary effect of an increase in the amount of the VAT."[285] Thus, the United States believes that China's assessment of VAT on the antidumping duty constitutes a "clear example of a specific action against dumping inconsistent with the provisions of the agreement, in particular Article 18.1."[286]

F. VAT Refund on Imported Capital Equipment Used for Production of Products for Export

In October 2004, in a submission to the WTO Committee on Subsidies and Countervailing Measures, the United States identified eleven Chinese programs that "may provide subsides contingent upon export performance, which are prohibited under Article 3.1(a)

[283] Committee on Anti-Dumping Practices, *Minutes of the Regular Meeting Held on 25-26 October 2006,* G/ADP/M/31 (2 April 2007) at para. 87 (emphasis in original).

[284] Committee on Anti-Dumping Practices, *Minutes of the Regular Meeting Held on 25-26 October 2006,* G/ADP/M/31 (2 April 2007) at para. 93.

[285] Committee on Anti-Dumping Practices, *Minutes of the Regular Meeting Held on 25-26 October 2006,* G/ADP/M/31 (2 April 2007) at para. 93.

[286] Committee on Anti-Dumping Practices, *Minutes of the Regular Meeting Held on 25-26 October 2006,* G/ADP/M/31 (2 April 2007) at para. 93.

of the SCM Agreement."[287] One of the subsidy programs identified was the provision of VAT refunds on imported capital equipment that is used to manufacture products for export.

> Enterprises that import capital equipment used exclusively to produce export products are eligible to receive a full refund of customs duties and VAT on the imported capital equipment. Enterprises receive 20 per cent of the tax refund each year the equipment is used exclusively for export production, resulting in a full tax refund at the end of a five-year period. Enterprises that wish to receive this tax refund are investigated every year for five consecutive years to verify that the equipment is used only for export production.[288]

In February and April 2007, the United States requested consultations with China regarding this measure.[289] After the consultations did not resolve the issue, the United States requested establishment of a dispute settlement panel.[290]

G. VAT Rebate on Purchases of Domestic Machinery and Equipment by FIEs

In October 2004, in a submission to the WTO Committee on Subsidies and Countervailing Measures, the United States identified two Chinese programs that "may provide subsides that are contingent upon the use of domestic over imported goods, which are prohibited under Article 3.1(b) of the SCM Agreement."[291] One of these subsidy programs was the

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[287] Subsidies, *Request from the United States to China Pursuant to Article 25.8 of the Agreement on Subsidies and Countervailing Measures*, G/SCM/Q2/CHN/9 (6 October 2004) at para. 1.

[288] Subsidies, *Request from the United States to China Pursuant to Article 25.8 of the Agreement on Subsidies and Countervailing Measures*, G/SCM/Q2/CHN/9 (6 October 2004) at para. 8.

[289] *See* China – Certain Measures Granting Refunds, Reductions or Exceptions from Taxes and Other Payments, *Request for Consultations by the United States*, WT/DS358/1 (7 February 2007) at 3 (last bullet); China – Certain Measures Granting Refunds, Reductions or Exceptions from Taxes and Other Payments, *Request for Further Consultations by the United States, Addendum*, WT/DS358/1/Add.1 (2 May 2007) at 3 (last bullet).

[290] *See* China – Certain Measures Granting Refunds, Reductions or Exceptions from Taxes and Other Payments, *Request for the Establishment of a Panel by the United States*, WT/DS358/13 (13 July 2007) at 3 (No. 9).

[291] Subsidies, *Request from the United States to China Pursuant to Article 25.8 of the Agreement on Subsidies and Countervailing Measures*, G/SCM/Q2/CHN/9 (6 October 2004) at para. 13.

provision of VAT rebates on purchases of domestic equipment by foreign-invested enterprises (FIEs).

> Pursuant to the *Notice of the Trial-Implementation Measures for the Administration of Tax Refund on Domestic Equipment Purchased by Enterprises with Foreign Investment*, issued by the State Administration of Taxation on August 20, 1999, a full VAT rebate is provided to manufacturers that purchase domestically made machinery and equipment. This incentive will be available through the end of 2010.[292]

In February and April 2007, the United States requested consultations with China regarding this measure.[293] After the consultations did not resolve the issue, the United States requested establishment of a dispute settlement panel.[294]

H. VAT Rebate for Domestic Equipment Purchases by FIEs Engaged in Particular Projects

In the fifth TRM, the United States noted that China provided VAT rebates to foreign-invested enterprises (FIEs) if they purchased equipment from domestic sources but that China did not provide similar rebates for equipment purchased from foreign sources.

> On 24 July 2006, SAT and NDRC jointly issued the *Trial Measures for the Administration of Tax Rebate on Domestically Manufactured Equipment in Foreign-Invested Projects*. This measure provides for VAT rebates in connection with purchases of domestically manufactured equipment by foreign-invested enterprises engaged in transportation or residential project construction or the exploration and development of offshore

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[292] Subsidies, *Request from the United States to China Pursuant to Article 25.8 of the Agreement on Subsidies and Countervailing Measures*, G/SCM/Q2/CHN/9 (6 October 2004) at para. 14.

[293] *See* China – Certain Measures Granting Refunds, Reductions or Exceptions from Taxes and Other Payments, *Request for Consultations by the United States*, WT/DS358/1 (7 February 2007) at 1 (1st bullet); China – Certain Measures Granting Refunds, Reductions or Exceptions from Taxes and Other Payments, *Request for Further Consultations by the United States, Addendum*, WT/DS358/1/Add.1 (2 May 2007) at 2 (1st bullet).

[294] *See* China – Certain Measures Granting Refunds, Reductions or Exceptions from Taxes and Other Payments, *Request for the Establishment of a Panel by the United States*, WT/DS358/13 (13 July 2007) at 1 (No. 1).

> petroleum. Domestically manufactured equipment refers to equipment produced in China that is classified as a fixed asset, as well as to accessories and parts listed in the equipment procurement contract. No VAT rebate is available in connection with purchases of imported equipment under this measure.[295]

The United States questioned whether China's differential treatment of imported versus domestic products with respect to VAT rebates was consistent with the national treatment principles of Article III of GATT 1994.[296]

In July 2007, the United States requested establishment of a dispute settlement panel with respect to certain Chinese "measures granting refunds, reductions or exceptions from taxes and other payments." In the request, the United States identified this VAT measure as inconsistent with the SCM Agreement when read in connection with the measure described in section G above.[297]

I. Agricultural VAT Policies

A report by the U.S. Department of Agriculture (USDA) states that, with respect to agricultural products, China assesses a value-added tax but also maintains a number of VAT exemptions "both to promote certain sectors and because it is 'impractical' for Chinese farmers, often poorly educated and with very small land holdings, to keep track of purchase and sales

[295] Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol on the Accession of the People's Republic of China, *Questions from the United States to China*, G/C/W/560 (6 November 2006) at para. 10.

[296] Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol on the Accession of the People's Republic of China, *Questions from the United States to China*, G/C/W/560 (6 November 2006) at para. 10.

[297] *See* China – Certain Measures Granting Refunds, Reductions or Exceptions from Taxes and Other Payments, *Request for the Establishment of a Panel by the United States*, WT/DS358/13 (13 July 2007) at 1 (No. 1).

VAT."[298] The report also found that China's VAT exemption policies regarding agriculture result in lower effective VAT rates being applied to domestic versus imported products to the disadvantage of imported agricultural products.[299]

China's exceptions to the VAT for the agricultural industry fall into five categories: farm inputs, farm sales, processor imputed VAT, processor exempted products, and import product exemption. Except for the import product exemption, imports do not benefit from any of these VAT exceptions. The USDA found:

> The impact is that there is an applied VAT and an effective VAT where the applied VAT is applicable to imports and the effective VAT is applicable to domestic products, adjusting for the VAT exceptions. The {USDA's} analysis finds that where the applied VAT is 13 percent, the effective VAT on domestic products varies between 3.23 and 6.23 percent. While the effective VAT will vary depending on, among other things, market prices, profit margins and marketing costs, there is a disparate impact on imports, making these VAT exemptions inconsistent with the World Trade Organization's principles of "National Treatment."[300]

The USDA also found that, given the difference between applied and effective VAT rates for agricultural products, any VAT rebate (based on applied VAT rates) received upon export of the agricultural product that exceeded the effective VAT rate would be an export subsidy.

> To promote exports, including agriculture-based exports, many are entitled to a VAT rebate. For many agricultural products the rebate is based on an indexed prices [sic] instead of market prices which can serve as an export subsidy. . . . Exclusive of indexing,

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[298] USDA Foreign Agricultural Service, *VAT Protections: The Rest of the Story*, GAIN Report No. CH7018 (March 19, 2007) at 3; the USDA report is available at http://home.stat-usa.gov/agworld.nsf/505c55d16b88351a852567010058449b/870268e1bf623a19852572a500776821/$FILE/CH7018.PDF.

[299] USDA Foreign Agricultural Service, *VAT Protections: The Rest of the Story*, GAIN Report No. CH7018 (March 19, 2007) at 3.

[300] USDA Foreign Agricultural Service, *VAT Protections: The Rest of the Story*, GAIN Report No. CH7018 (March 19, 2007) at 3.

> because the VAT rebate is based on the applied VAT, the difference between the applied VAT and the effective VAT effectively is an export subsidy. . . . {W}here the effective VAT is 3.23 or 5.8 percent, depending on whether the exporter buys from a farmer (or from government stocks), or from a commercial trader, the effective export subsidy is between 7.2 and 9.77 percent.[301]

VII. POTENTIAL UNILATERAL, BILATERAL AND MULTILATERAL ACTIONS THAT COULD BE TAKEN TO ELIMINATE BORDER TAX DISCRIMINATION OF U.S. EXPORTERS AND PRODUCERS

The foregoing sections of this paper reviewed the competitive and economic disadvantages that U.S. exporters and producers experience as a result of the differential treatment of direct and indirect taxes under international trade rules, and examined past U.S. efforts to address and resolve the problem. Having reviewed the issue and prior attempts to eliminate the discrimination to U.S. exporters and producers, the question presented is what actions could be taken now, either unilaterally, bilaterally or multilaterally, to correct the trade disadvantages that result from the international rules that permit border adjustment of indirect taxes but not of direct taxes? Without expressing a preference for, or estimating the likelihood of success of, any particular action, the following is a broad range of potential actions that could be considered in an effort to resolve the problem of disparate border tax treatment.

[301] USDA Foreign Agricultural Service, *VAT Protections: The Rest of the Story*, GAIN Report No. CH7018 (March 19, 2007) at 5.

Unilateral	Bilateral	Multilateral
▪ Congress could reform the U.S. tax system to include indirect taxes such as VAT and other consumption-based taxes that would be border adjustable under current international trade rules ▪ Congress could enact the Border Tax Equity Act of 2007 (H.R. 2600). This bill, introduced on June 6, 2007, would authorize imposition of a tax on imports from any country that employs indirect taxes and grants rebates of the same upon exports. In addition, the bill would allow compensatory payments to eligible U.S. exporters to neutralize the discriminatory effect of such indirect taxes paid by such exporters if the U.S. trade negotiating objectives with respect to the equalization of border tax treatment of direct taxes are	▪ The U.S. could negotiate agreements with individual VAT-system countries that would govern border tax adjustments of direct and indirect taxes in bilateral trade. Such provisions could include: o Less than full rebates of indirect taxes o Agreement that VAT country would not increase border adjustment even when indirect tax rates are increased	▪ The U.S. could attempt to negotiate changes to GATT/WTO agreements so as to treat direct and indirect taxes equally – that is, either allow imposition of direct taxes (such as income taxes) on imports and rebates of direct taxes on exports, or eliminate the preferential border adjustment treatment accorded to indirect taxes under current trade rules. [302]

[302] Professor Hausman believes that equalizing trade rules is the "more realistic" and "more economically rational" approach:

> {G}iven the lack of any economic basis for the current distinction applied under WTO rules, it is unclear why the United States should be required to adapt its tax system to comply with outmoded international legal constructs.
>
> While also presenting certain challenges, changing international rules to apply consistent treatment to various national tax systems would appear both the more realistic and more economically rational approach -- particularly given that ongoing WTO talks as part of the "Doha Development Round" would appear to provide a forum to negotiate such changes. Consistent economic treatment could be accomplished either by eliminating border adjustment for all taxes (including both direct and indirect), or permitting adjustment for all taxes. The complexity of determining appropriate border adjustments for direct taxes (such as the corporate income tax), as well as the potentially undesirable reward to high tax jurisdictions under a system allowing adjustment of all taxes, suggests that elimination of any border adjustments may be the preferable course. Moreover, this outcome would allow goods and services to trade with the smallest number of distortions at the border, and promote the flow of imports and exports. While additional analysis is warranted in this regard, the fundamental need to eliminate the existing distortions should be a high priority of economic policy.

Jerry Hausman, *An Economic Analysis of WTO Rules on Border Adjustability of Taxes* (May 2006).

Unilateral	Bilateral	Multilateral
not met in WTO negotiations. ▪ Congress could enact legislation authorizing the imposition of import taxes on services and allowing rebates of the same on exports. Currently, no WTO rules prohibit the taxing of imported services or the rebating of such taxes on exported services.		