Direct taxes, on the other hand, are specifically excluded from the border tax system and any border adjustment for such taxes would be viewed as an export subsidy or an import charge contravening GATT.[2] The logic behind this different treatment of the various taxes lies in the premise that taxes borne by the factors of production should reside in the country of origin and that taxes borne by the ultimate consumer should reside in the country of destination. Therefore, the entire border adjustment system is based upon the assumption that direct taxes are always fully shifted backward to the factors of production and that indirect taxes are always fully shifted forward into the final price of a good.

Examination of Economic Logic of Border Tax System

Under the above assumption of tax shifting, imported goods, without tax equalization charges, would be at a price advantage vis-a-vis home-produced goods to the extent that the exporting country had a lesser rate of indirect taxation. Conversely, without tax rebates a country with a relatively high rate of indirect taxation would be at a competitive disadvantage in world markets relative to countries with a lower rate of indirect taxation.

Second, without border adjustments goods moving in international trade would be taxed doubly: once in the country of origin and once in the country of destination, both tax levies being paid by the consumer in the country of destination. Thus, the foreign consumer would make a contribution to the exchequer of the country of origin. Furthermore, world market prices would be raised by the amount of the tax and the volume of trade would be likely to shrink.

Thus, if the assumption of full reflection in final prices of indirect taxes and zero reflection in prices of direct taxes holds true, the current system of border tax adjustments indeed serves to neutralize the trade effects of different national tax systems. However, the current system is open to two basic and related questions:

1. Is the current practice of classifying certain taxes as "direct" and others as "indirect" a correct reflection of actual conditions?

and

2. Given such classification, are shifting assumptions correct?

Distinction Between Direct and Indirect Taxes

Indirect taxes are generally defined as taxes on consumption, while direct taxes are defined as those levied on income. However the distinction on the basis of these definitions has become more and more cloudy over time. The only area where there seems to be clear agreement is with regard to personal income taxes, which are classified as "direct"

[2] The distinction between "direct" and "indirect" taxes is, in fact, not made explicit in the GATT regulations, but flows from interpretation of and amendments to the relevant provisions.