

amount of the tax, and an equal border adjustment is necessary to prevent the tax from handicapping exports or giving a competitive advantage to imports.

In fact, product taxes are not always fully shifted to the purchaser, while other taxes which do not qualify under the GATT rule (income taxes and payroll taxes, for example) may be partly or entirely shifted. Tax shifting obeys no simple, hard-and-fast rules; it depends on the market situation. Border adjustments may therefore have a considerable effect on international competition.

Despite its shaky theoretical base, the GATT rule, when it was adopted in 1947, was in line with current practice and served to distinguish traditional border tax adjustments from other kinds of export subsidies and import charges which the GATT outlawed. Moreover, in 1947, the significance of border adjustments was minor. Tariffs were much higher than now, and indirect taxes were less comprehensive. Today, however, the trade-diverting effects of border adjustments can hardly be overlooked.

This complex issue has been brought to a head by the decision of five Common Market members and several other European countries to change from gross turnover taxes to value-added taxes on the French model. The change will mean increased border adjustments. This is because, under the gross turnover tax, border adjustments have been based on an estimated tax burden which is substantially less than the actual burden of the tax. Under the value-added tax, the border adjustment will be higher because it will be at the same rate as the domestic tax.

For example, when on January 1, 1968, Germany substituted a value-added tax of 10 per cent for a gross turnover tax of 4 per cent, the border adjustment was raised from around 6 per cent to 10 per cent. Austria, Belgium, Italy and the Netherlands are even raising their export rebates and import charges under their existing turnover taxes in advance of the contemplated shift to value-added taxes.

These increases in European border adjustments will tend to reduce European imports and to increase European exports. How large the effect will be—overall and for particular countries and products—is impossible to say. It will depend on how the tax change affects domestic prices. To the extent that domestic prices are raised, some of the trade-diverting effect of the increase in border adjustments is offset. Overall, there will undoubtedly be some trade diversion. For the changeover does not involve a general increase in tax burden, which would raise the aver-

age level of European prices.

It is tempting to argue that border adjustments should simply be outlawed, since it is impossible to make a workable and fair distinction between taxes that are shifted and those that are not. But any attempt to unscramble the border adjustment omelet at this late date would stand no chance of acceptance in Europe. Moreover, border adjustments which have been in effect for a considerable time have had their effect on international competition and trade balances. They have been adjusted to through movements in relative price levels and exchange rates. This cannot be said for recent and prospective changes in border adjustments, however.

The U.S. Administration has considered adopting a system of border taxes. The difficulty is that, aside from a handful of Federal excise taxes (some of which already involve border adjustments), very few U.S. taxes are levied on products that move in international trade or on materials incorporated into such products. Moreover, adoption by the United States of such border taxes would probably lead countries like Japan and Canada to do the same. The final result could be a competitive escalation of border taxes from which no nation would benefit.

At the end of April, the United States approached GATT with a proposal that no further changes be made in present border adjustments, pending a study by GATT. The U.S. spokesman suggested that changes in border adjustments ought to be considered in the light of this country's balance-of-payments position. A country with a persistent payments surplus ought not to raise border adjustments, even though GATT rules would allow it. The study itself should aim at determining whether the present rules should be changed or whether a code defining how the rules are to be applied should be adopted.

The U.S. Responsibility

Because the United States is the largest trading nation and has assumed leadership in international trade policy, other countries look to us to set the pace. What we do this year about import quotas and import surcharges will largely determine whether a trading system characterized by declining tariffs and a minimum of quantitative restrictions—a system whose basic tendency is toward greater freedom of international competition—will continue, or whether the world will now slide back into trade warfare and economic isolationism. Without active U.S. support, the liberal trading system which has served the world so well cannot long survive.

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