TOPIC III

VALUE ADDED TAX: ADMINISTRATIVE PROBLEMS INVOLVED IN THE TRANSITION FROM A SINGLE STAGE OR TURNOVER TAX TO VALUE ADDED TAX

SALES TAX ADMINISTRATION

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I. DIFFERENT WAYS OF IMPLEMENTING A SALES TAX SYSTEM

In order to solve administrative problems arising from the implementation of a sales tax system, especially if this implies replacing a similar tax system, it is necessary to first clarify some aspects as regards terminology and economy.

The term "general tax on sales or on transactions" is used to indicate a group of taxes of different technical structures, but which have a fundamental characteristic in common, they tend to affect in one or more ways the productive cycle of all manufactured goods and, eventually, of all services, except in those well-defined cases in which these taxes are levied at the time a transfer is made.

Three types of sales tax systems can be implemented:

1) A multi-stage cumulative sales tax on the total value (cascade tax) that affects all sales of goods and/or services rendered.

   This sales tax system can be implemented by means of two different techniques. Either the taxpayer pays the tax on each one of the sales transactions and charges the tax to the buyer by including it in the invoice, separately from the sales price (by placing tax stamps on the invoices or by paying taxes on the basis of each operation duly documented by each invoice), or he pays taxes periodically (say,for example, every two months) on the basis of the information derived from his accounting records on the volume of sales for the established period, without charging the tax on the invoice; in this case the tax is included in the sales price.

2) A single-stage tax consisting of the imposition of a tax on a product or service at a single stage of production, for example, at the time of purchase by the ultimate consumer. In this case, the ideal

system from the point of view of simplicity, is that of imposing the tax on the product when it passes from the retailer to the final consumer.

3. A multi-stage, non-cumulative, value added tax. This is a multi-stage tax since -as in the first case- it is paid by all those involved in any stage of the production or distribution of the goods. However, it does not have cumulative effects since it is based on the added value of the product at each stage of its production and distribution, from the raw material stage to its finished stage. Since the total of the values added at the different stages of the processes of manufacture and distribution is equal to the total value of the goods purchased by the consumer, the tax allows for taxation at different stages on the different constituents of the value of the goods and, thus, on the total value of the goods without gaps in taxation or double imposition as could be the case of the tax levied on final prices at a rate equal to the value added rate.

   The value added tax can be imposed through different methods and these differences in method are not dependent on different concepts of the tax but rather on the specific objectives pursued by the legislator in what concerns revenue (hence the tendency to expand the taxable base to include elements which are not part of the net product).

   Economic policy considerations also influence the enforcement of the tax, as well as tax equity considerations (the latter may restrict the scope of enforcement through the granting of exemptions for given sectors, or through special calculation methods which are not strictly in agreement with the economic and statistical concept of value added).

   There are two essential methods for the enforcement of value added taxes: taxation by addition and taxation by difference or tax credit.

   (a) Value added tax calculated by addition

   The taxable base is formed by the total results assigned by the corporation to the various production factors: salaries, interest, profits and income, which are the portion of the added value contributed by the individuals. Naturally, in order to avoid double taxation, it is necessary to deduct from the total paid by the corporation, the total collected

by the corporation from other corporations (but not that derived from family groups). Thus, at the national level, the global taxable income is arrived at through the total income derived from production factors.

The advantage offered by this tax system is the fact that it can be based on an existing determination of income derived from the imposition of direct taxes whenever there is an effective tax on real income in the country which is, of course, to undergo certain necessary corrections (e.g. integration of data with exempted income).

(b) Value added tax calculated by substraction or by means of a credit system

This allows for calculation of the tax by means of the method currently used for statistical surveys, in a manner similar to that used for the calculation of national income.

Two different systems may be used in accordance with the base on which it is calculated: actual base (the more exact method), or financial base.

(b.1) On an actual base - Taxation on an actual base consists of substracting from the actual production of each corporation in the course of a year, -regardless of whether this production is sold or stored for future use-, the amount of expenses incurred in acquiring goods, products and parts from other corporations to be introduced in the production cycle for the same year, plus the portion of the overall multi-annual costs (fixed asset depreciation) that may be assigned to the production for the same year. This means variations in stock are neither positive nor negative elements in arriving at the added value for the year.

(b.2) On a financial base - This method consists of substracting from the sales for a given year, whether the products are part of the production for the same year or not, the value of all purchases made by the corporation in the course of the same year; i.e. the taxable added value is arrived at by substracting from the sales made within a given year (regardless of whether the products sold are part of the production for the same year or of reserve stock manufactured in

previous years) the purchases for merchandise and goods for the same year (even if they are not used in the production cycle for the same year and are destined to increase reserves of raw materials above production requirements).

The difference between the two systems consists of the fact that, with the first system (on an actual base) stock reserves are included in the tax: those to be used in the production process (i.e. raw materials or semi-manufactured goods purchased) may not discount the tax paid by other corporations until they have been used in the production cycle; those beyond the production cycle (i.e. products manufactured by the corporation but not yet sold) may not discount the tax until they are sold and therefore the tax included in the products will not be reimbursed by the purchasing enterprises. With the financial base system, on the other hand, reserves are tax exempt since all taxes on purchases are shifted to the respective sales tax and the tax is therefore charged to sales made in the same fiscal year.

The method of tax credit on the actual base is of difficult implementation since it is necessary to carefully follow the production cycle in order to identify the quantity and quality of each one of the added and finished products. It requires an adequate industrial accounting system from the companies.

The tax credit system on a financial base offers the advantage of not requiring that companies make advance tax payments to the State on reserves in-stock and, therefore, does not curtail the financial possibilities of taxpayers, allowing for them to allocate these funds to production.

Whatever the system chosen, a problem arises as to what to do with investments over several years or fixed assets. In this connection, there are three possibilities.

i) Deduction of taxes paid on fixed assets may be prohibited, as is the case of the French tax in its initial application (value added tax levied on the gross value of installations) with subsequent double taxation on this type of assets.

ii) It may be deducted from sales on an annual basis,-not the tax paid on the total value of the installations but the portion of the tax corresponding to the annual amortization (tax on the net value of assets).

iii) The total taxes paid on expenditures made on installations may be deducted in the course of the year in which the expenditures are actually made, on the basis of the principle of deduction of expenditures in the year in which they were actually incurred (tax on the net value of installation expenditures).

The method usually adopted is that explained under iii) above since it makes the tax more of a neutral tax and reduces the financial pressure on enterprises. With this method, both stock reserves and existing installations do not pay the tax.

Another type of problems arise in the determination of the taxable base. To this effect, the method of deduction from the taxable base or that of deduction tax by tax may be adopted. In other words, we may deduct the tax on purchases from the tax on sales and assess the tax liability on the resulting difference, or we may deduct the assessed tax on purchases from the assessed tax on sales.

Both of these methods would have the same effects on the hypothesis that there were no exemptions or differential rates. Whenever some stage or sector benefits from a reduced rate or from an exemption, with the first method the exemption or reduction is definitely consolidated in the benefited sector while, with the second method, it becomes a mere shifting of the lower tax paid at a given stage to the following stage where the benefit is recovered (unless the exemption or differential rate should be established at the last stage).

II. FACTORS LEADING TO A SELECTION OF ENFORCEMENT METHODS

Several factors may lead the legislator to select a given method for enforcement of the tax. We will discuss some of the more important among them.

1. Simplicity in the enforcement of the tax

It may be said that the cumulative multi-stage tax on the total value is the one offering less difficulties in enforcement. Its legal definition and determination of the taxable base leave no room for important problems in interpretation, particularly if the rate is a standard rate and taxation applies to all goods without exemptions. The determination of the taxable base on which to apply the tax rate does not give rise to problems since it is imposed on the total price.

Tax collections are also simpler since this type of sales tax does not require complicated calculations, and each of the taxable transactions can be isolated from the others. Stamps can be placed on invoices or direct payments may be made to the Treasury and a certification of the payment made can appear on each invoice.

Since in the single-stage tax rate differentiations are made in accordance with the type of taxable goods, it may present difficulties in its enforcement on goods of an uncertain or doubtful type. This problem can be easily solved by limiting the differentiation to a small number of rates or by grouping the different taxable categories into broad sectors.

Value added tax is no doubt the most difficult to enforce. While the two previous taxes can be assessed for each transaction with their value appearing on the invoice, value added tax can only be enforced on the basis of accounting records. Payment of this tax is made by corporations at fixed periods (usually on a monthly basis) by calculating for each period the difference between sales (or tax collected on sales) and puchases (or tax paid on purchases) and by assessing the tax on that difference.

Obviously, this data cannot be obtained without a good accounting system, and not all businesses have such systems, which should clearly indicate the sales and purchases made in the period. Therefore, for controls to be effective, it is definitely necessary to verify the sales volume, i.e. production, and this can only be done by carefully examining the production process.

On the other hand, accounting, when properly kept is a useful instrument for income tax assessment, since the volume of sales and purchases are the two main elements for the calculation of a corporation's profits, gross income and cost of purchases. This allows for a unification of assessment factors and for stricter fiscal controls.

Value added tax can offer other difficulties, particularly if it is enforced on the basis of the actual base system. Since purchases are to be deducted from the assessed tax on sales, there is a problem in identifying the amount to be deducted: should it be the purchases of all tangible and intangible goods, or only purchases of some of these goods. Furthermore, in connection with goods or services with a profit divided into several years, the problem is solved by deciding whether their total cost is to be credited to profits in the year in which the expenditure was made or by means of annual quotas in the course of the years in which the goods are used (detractions through installments). Another problem to be decided upon is whether variations in stock are to be taken into account, and therefore, whether or not controls are to be exercised over stock.

Value added tax, as shown by the French experience, becomes even more complex when exemptions are granted to certain sectors or when special systems or differential rates are established for given products. In these cases accounting is to be more comprehensive and complex and this also leads to difficulties in bookkeeping.

2. Incentives to tax evasion

A cumulative cascade tax levied on a very broad base (gross volume of all corporate sales) allows for a given income at a minimum rate of 2 to 4%. In this way, the temptation to evade the tax is more effectively controlled. On the other hand, the number of taxpayers is very high since all corporations are subject to the tax and therefore fiscal controls are spread over a vast number of taxpayers, which increases Tax Office-taxpayers relations but decreases efficiency. However, if buyers and sellers can be identified, as well as volume of sales and purchases for each one, cross verification of invoices through modern mechanized systems allows for the strenghthening of controls over tax evasion.

Single-stage tax requires a much higher rate (practically three times the previous one) to attain the same yield, thereby stimulating evasion. It is true that the number of taxpayers to be controlled is considerably reduced but, since it is practically impossible to follow the chain of production, fewer technical means are available for controls over taxpayers' sales. Therefore, it is contended that the possibilities of tax evasion in this type of tax are greater.

In value added tax, the nominal rate is much higher than that of the cumulative cascade tax, and is more or less similar to that of the single stage tax. However, as it is applied on the difference between sales and purchases, the taxable base is proportionally reduced and the incidence of the actual tax on the taxpayer is lower than the nominal rate. In general, it becomes similar to that of the cascade tax. Another factor is the fact that this tax originates conflicts between the interests of taxpayers and this acts against tax evasion since every businessman wishes to highlight and therefore record all purchases so as to increase as much as possible the amounts to be credited in assessing the taxable base and this acts as a disincentive to sales without invoice.

The above observation is to be taken cautiously whenever the last stage (retail sales) is exempt and the last taxable stage is subject to a high rate, or whenever at the last taxable stage a high single-stage tax is levied (system proposed for the Italian reform). In this case, the retailer may lose interest in obtaining invoices from his supplier who, in view of the high single-stage tax applicable to his sales, may be interested in reducing invoicing. This type of situation creates a stimulus contrary to the production process and diminishes his interest in requiring purchase invoices.

It should be noted that value added tax in itself does not provide for controls over corporations by means of the cross verification of invoices since taxpayers are to make a monthly statement of the global purchases and sales. If this cross verification is required, it will be necessary to provide that, at the end of each fiscal year, taxpayers submit a list of all their customers and suppliers to the Tax Office, with specification of annual volume of the transactions made with each one of them.

3. The Process of "Financial Illusion"

This process consists of making a false representation of facts and, mainly, of reducing -from the psychological point of view- the actual impact of the tax. A cumulative cascade tax allows for maximal financial illusion since it conceals taxes from the buyer by including them in the price when they have been collected at stages preceding his purchase.

Value added tax also allows for financial illusion since the taxpayer knows that the tax paid on purchases is not a burden for him because it is credited to the amount he will collect from his customers.

However, that illusion is remarkably reduced in a single-stage tax system, since the last taxpayer clearly sees the total amount of the tax burden he is to pay.

Discrepancies of an economic nature are more substantial in view of the distortions that may be detected in some of the above systems. From this point of view, it may be said that single stage tax and value added tax are certainly neutral or, at least, more neutral than cascade tax.

4. Differences in fiscal incidence

In theory, in a complete shift forward, cascade tax is uneven as regards the final price. The global tax burden included in the price is not only dependent on the tax rate but also -all things being equal- on the number of transactions the product is to undergo to complete its production cycle. However, even in an equal number of transactions the total burden varies in accordance with whether the added value is concentrated at the first or last stage of the production cycle. In the first case, for obvious reasons, the tax burden is higher than in the second case.

The other two types of tax are, on the other hand, equal and it can be said that the final incidence coincides with the nominal tax rate without giving room for non-desired inequalities.

5. Influence on industrial mergers

From what has been stated so far we may see that a cumulative cascade tax is a reward for industrial complexes since they can "skip" the tax on some of the stages. Thus, if a process of production is performed by a single corporation, while it is performed by two or more companies in other cases, the tax is lower for the first corporation because it skips some in-between stages which are taxed in the other case.

It is true that other tax regulations may stimulate opposite trends and may discourage corporate mergers although the market should require them, but it is also true that the tax under discussion can accumulate its effects to those of other taxes acting on similar trends (for instance, a tax on dividends may, in certain cases, encourage corporate mergers).

The need to avoid these trends and to place consolidated enterprises on an equal basis with other enterprises, has led legislators to adopt different solutions:

a) Different tax rates can be established for consolidated and non-consolidated corporations, either by increasing the tax rate payable by consolidated corporations or by decreasing the tax rate applicable to the others, or by imposing taxes on the stages performed by a single corporation as if they were actual transactions whenever an enterprise performs processes of production which would, as a general rule, be performed by different corporations. This principle inspired the Dutch "Omzetdastung" which considered all of the internal transactions performed within a consolidated enterprise taxable transactions.

   However, the existence of economic and legal conditions and the actual application of this type of discriminations, in view of resistance on the part of the interested sectors brings about difficulties that are not easily overcome.

b) An opposite solution to avoid artificial mergers of corporations, provides that "internal transactions" -therefore, tax exempt transactions- are those performed between separate companies that are subordinated to each other-parent company and subsidiary, the German "Organschaftstheorie"—.

   Single-stage tax and value added tax are, on the other hand, perfectly neutral since the tax is always proportional to the final price no matter which should be the deviation of the production cycle or the vertical integration processes.

6. Effects on international trade

For the products of one country not to have difficulties in the international market, it is necessary for them to be exported without the collection of internal tax since, otherwise, this would represent an additional cost that would interfere with their possibilities for competition abroad. Therefore, exemptions are to be granted at the time exports are made or reimbursements are to be made of the taxes that were incorporated to the goods at previous stages. For this reaaon, it is necessary for imported products exempt from indirect taxes in the country of origin, to pay a tax equal to that paid by similar goods produced in the domestic market. It is only by this procedure of reimbursing at the time an export is made and of collecting taxes on imports (procedures admitted by GATT agreements) that international competition is not disrupted.

However, for obvious reasons, the determination of the definite incidence of the tax on the final price is extremely complicated because the same product may have been acquired under different circumstances which will determine a different final incidence of the tax.

This difficulty in calculations brings about a series of problems in international trade when reimbursement of the tax is made on exported products or when compensatory duties are applied on imported products. No matter how careful the calculations, they can only be made for standard industries or on the basis of averages and consequently must admit plus or minus balances which represent actual rewards for exporters or additional taxes for importers.

Moreover, the system under review does not allow, within a common market, for the elimination of tax barriers between the member countries, because it subordinates reimbursements and taxation to the crossing of frontiers and to the respective controls.

Single-stage tax, on the other hand, does not give rise to these distortions because it is sufficient to establish exemptions on exported products for the tax to be neutral as regards international trade. In value added tax, exemptions on sales made abroad allow through their own mechanism, for a total reimbursement of the tax paid at previous stages.

7. Effects on economic development

Value added tax with a deduction of the tax on installations only affects consumer goods and does not give room for double taxation on the machinery used for the production process. Cumulative cascade tax discriminates between industries heavily relying on capital and those in which manpower prevails. Thus, technologically advanced industry is more heavily taxed and the tax acts as a barrier for economic development.

But there is more to be said. Cumulative cascade tax, in view of the fact that it is incorporated to the price, is to be advanced by the corporation until the product is placed on the market. Therefore, the corporation is to advance to the Treasury the tax incorporated to goods in stock and to the value of installations. Part of its capital is therefore used to pay a tax that is only to be reimbursed with the winding up of the corporation.

On the other hand, value added tax calculated on the basis of the system of tax credit allows for each company,

in extreme situations, to immediately recover (through the transfer made to the buyer)the tax on purchases without having to advance any money. And this is not all. Since payment of the tax to the Treasury due to "difference between both taxes" takes place once a month, with a tolerance of up to 5 to 10 days in payment, the value added tax collected by the purchaser is retained by the company for an average of another 15 days. In other words, value added tax enables the company to finance its own tax commitments as calculated on the added value for the period on which it is levied.

However, as regards economic development, another consideration is to be made. Although value added tax (as compared to cumulative cascade tax which taxes cost of fixed assets twice) does not discriminate against heavily capitalized companies, it does discriminate against new industries as compared to existing ones and against companies working to their full capacity as compared to stagnant corporations.

In fact, we have observed that where the tax on investments is credited in the same period in which the installation is made, the system is not operative.

The method of credit on the tax paid on installations consists of deducting the amount immediately after each tax assessment (e.g., in the course of the month immediately following that of installation).

For the tax to be reimbursed to the company, it is assumed that the company will sell in the same period at least an amount of goods of the same value as its purchases, and this is so whether the method of credit base by base or credit tax by tax is employed. At first, a new company invests heavily and on these expenses the supplier debits the tax but, for a more or less extended period of time, it is not able to complete its own production processes and consequently, does not attain a sales volume on which it can credit the tax on purchases. And in this case the corporation pays the tax.

Existing corporations may have the same problem when trying to expand operations since an increase in purchases for their industrial development will surpass the value of their sales.

This type of situation is found more frequently than one would surmise and especially when the company is not as large as to make an adequate rotation in the renewal of its equipment or is making large investments.

This negative effect that could lead to an accumulation of the tax can be easily solved by means of regulations that should allow, for example, at the end of a fiscal year for a reimbursement of the tax paid in excess that has not been offset by tax credits on sales.

8. Administrative problems: identification of the taxpayer

In an accurate enforcement of the tax, it is necessary for the law to provide for certain formal obligations the taxpayer is to comply with, either at the onset of his activities or in the course of their development. This is not only aimed at the assessment of his tax liability but also at allowing the Treasury to exercise the necessary controls to guarantee exact and timely payment of this liability.

The first problem has to do with the identification of the taxpayer. This means that every individual who initiates an activity that may make him responsible for tax payments is to notify tax administration within a relatively brief term, on the date of initiation of his activities as well as on all other relevant data (domicile, name of the corporation, legal representative, etc.) so that he may be entered into the taxpayer registry. The same type of return is to be filed whenever changes are made on the initial data filed, as well as when the company ceases in its activities. It is wise to foresee the likelihood of a corporation owning more than one company. In this case, it would be logical for the taxpayer to be able either to register them separately provided each enterprise keeps separate books.

In the case of a value added tax system it is especially necessary for tax administration to control monthly payments and returns by means of mechanized equipment. Therefore, tax administration after having registered the taxpayer in a special registry is to assign each one a code number to each tax in order to facilitate the utilization of mechanized devices. The taxpayer is to be informed of this registration number as soon as possible and this number is to appear on all invoices issued by him as well as on the letterheads of stationery used for correspondence so that the number may be known not only to the Treasury but also to third parties engaging in business transactions with the taxpayer.

In practice, this knowledge is of use for single-stage taxes or for value added taxes whenever there are differential rates at those stages in which the product is sold to someone who is not a taxpayer or when the wholesale or retail

stages are tax exempt. In these cases, the seller is to be able to know whether the buyer is a taxpayer or not.

For these controls to be more efficient, it is necessary for the local electronic centers required for the operations and controls over taxable transactions of outside areas to be linked to a mechanized nationwide control center, in order to control corporations which are in business outside their own districts.

The registry on value added taxpayers is to be unified -or at least- coordinated with the respective income tax registry so as to keep as complete a directory as possible on all actual and potential taxpayers; to this effect, the code number of each taxpayer must be the same for all taxes. At the same time, it would be advisable for each code number to be used at other non-fiscal agencies, for instance, for social security. This would mean that the national electronic center and, whenever possible, also local ones could be used for all taxes. This would lead to economy and adequate coordination of all fiscal controls.

9. Business accounting systems

The basis of any sales tax is an invoice -or equivalent document- certifying a transfer in ownership or the rendering of a service, besides payment of the price and wherever relevant, the applicable tax.

In a cascade or cumulative tax the sales invoice is sufficient for the assessment of the tax and the usual bases for assessment of the tax are: either the monthly (or periodical) volume of sales made or services rendered, or the value of each of the invoices.

In the first case, invoices received or issued, duly kept and progressively numbered to prevent fraud in assessment of the tax, are to be entered in a ledger. At the end of the established period (one month, for example) the totals for all invoices are added up and the tax is assessed on the total so that payment may be made to the Treasury. In this case, the seller to recover the tax that does not appear separately on each invoice is to increase his sales price in accordance with the following formula:

$$\frac{Tn \times 100}{100 - Tn}$$

the result of which is that the actual rate is higher than the nominal rate.

In the second case, the tax is assessed on each invoice. If the amount of the tax is relatively low, it can be paid by means of tax stamps placed on the invoice. If the tax is higher, periodic payments may be made to the Treasury -for example every five days- on the tax owed on invoices issued on those days. In this case, each invoice is to show the total tax owed on them and when payment is made, a list of the invoices covered by the payment is to be attached. The list should give the data required to identify the buyer and his respective registration number. When these lists are sent to the electronic center it is possible, at the end of the year, to know the global volume of sales for each taxpayer. This allows for a verification as to whether there are any discrepancies with other elements available on the financial situation of the enterprise.

To facilitate eventual tax audit, the taxpayer is also to keep copies of his invoices, progressively numbered and entered into a chronological ledger.

In both of these procedures (assessment on the basis of books and assessment on the basis of the invoices issued) bookkeping of purchase invoices is required since they are a very valuable aid for audit, not only in what concerns the taxpayer but also in what concerns the suppliers and customers who have issued the invoices and should post them in their own accounting books.

As regards value added tax (we have limited ourselves to the hypothesis of credit tax by tax) the problem is different. It cannot be assessed on the basis of invoices insofar as the tax for which the seller debits his client is an essential factor for the tax assessment but it is not the only factor: it represents his gross liability. He has already paid the supplier a part of this tax through the charges made on the invoices for his purchases. Therefore, he must enter in a ledger, under different columns, the tax he has collected from his clients and the tax he has paid to his suppliers for his own purchases. The difference between the two totals that is to be calculated at certain periods (e.g. every month) represents his net tax liability which is to be paid to the Treasury under the established terms. Invoices in this type of system are not required for assessment purposes but are mere instruments for controls and documentation of the accounting entries made. Invoices on purchases are indispensable to show the tax paid and therefore represent the deductions to which the taxpayer is entitled. For this reason, it is essential for the taxpayer to keep purchase invoices to that effect. The issuance of invoices also plays an important role in what concerns

the interests of the client since this is the only way he can deduct the portion of the tax to which he is entitled and also represents a valuable aid for tax audit.

In any case, invoices to be used for audit purposes are to include the following information: name, address and registration number of the seller and purchaser; amount and commercial description of the goods sold; type and importance of the services rendered; price and tax. Obviously, the different credit operations through payment of advances substitute the invoice and must fulfil all of the requisites established for invoices.

As regards value added tax, it is essential to keep a ledger on sales and purchases which should indicate under separate columns the amount of the tax and the reference numbers of sale and purchase invoices in numerical order. These sale and purchase invoices may be of use for cross verifications between companies aimed at the establishment of whether the purchase invoices of one company (representing a tax credit for this company making the purchase) were adequately recorded by the seller.

However, these sporadic controls over invoices are very difficult and slow, particularly if the two companies are located at geographically distant sites and under the jurisdiction of different administrative units.

If we take internal administrative controls as a basis it is necessary to periodically review each sale and purchase invoice as well as the indication of seller and buyer, and the inspector is to then visit the buyer or seller companies to verify whether these invoices have been properly recorded. The work involved in this is obviously enormous and, even when it is carried out by means of limited samples, it could turn out to be scarcely effective as compared with the work involved.

More efficient and less cumbersome controls are those of requiring that the enterprises, at a given date after the closing of the fiscal year, file with the tax office a list of their purchasers and sellers which is to include all the necessary information, including registration number, total amount of purchases or sales made in the course of the year and amount of tax. This list need not include the names of those buyers making very small purchases.

This information when fed to the electronic computer allows for rapid controls over the purchases and sales of each company by means of cross verification and therefore immediately reveals the existence of tax evasion or tax fraud.

In what refers to accounting methods themselves, with the exception of a chronological ledger on the tax collected on sales invoices or paid out on purchase invoices and the requirement that these invoices be kept, there are no other specific accounting requirements. Each company is to keep the normal accounting books required for an assessment of the company's income.

The chronological ledger is to show the different operations and their respective taxes, divided by categories and in accordance with the different rates or as exempted production, exports and non-taxable operations.

In this connection, one principle is of utmost importance. An essential element for the assessment of value added tax is the invoicing of sales and purchases since the difference between the taxes calculated on these elements indicates the tax liability. Sales invoicing is at the same time a most important factor as regards gross profits for income tax purposes, while purchase invoicing is part of production costs. Therefore, in view of the validity of the same elements for the calculation of both of these taxes, it is necessary for the return filed on these elements to be the same for both taxes, although it is to include the necessary corrections that may allow for the inclusion or exclusion of certain minor amounts which may or may not be the same for both taxes. This single return must be followed by a single determination of the tax. This is the only manner in which to prevent that a company sell in one year 100 for value added tax purposes and 90 or 110 for income tax purposes. There must be uniformity in the return, in assessment and liability and uniformity in the obligation to keep accounting books and records. This is the only way to simplify audit tasks for tax administration.

10. Payment of the tax and filing of the return

The tax is to be paid to Tax Administration periodically. Usually, this period is of one month and the amount owed is calculated on the basis of the difference between the tax paid during that period on sales and the tax paid on purchases for the same period.

The tax payment is made periodically on the basis of a provisional monthly return on which the global taxable amount and the tax liability are calculated if there are differential rates or exemptions to be taken into consideration, the values for these are to be declared separately. This provisional return is necessary in order to avoid that

the taxpayer should pay his taxes in arrears at the end of the year -not necessarily incurring in evasion or fraud- by making a final return that should make up for deficiencies in payments that should have been made in previous months.

If tax administration, in exercising controls over the payments made by a company realizes that payments are abnormally low for some month, the fact may lead to an investigation of the reasons underlying the slump. Decreases in payments may be due to: decreases in sales, seasonal factors, a sudden increase in purchases -particularly due to large installation expenditures concentrated over a brief period- or to other reasons. The provisional monthly return allows for an opinion to be formed on the legitimacy of the variations in payment and therefore on the need for further investigation and controls.

The final return on the annual balance that is to be filed together with the income tax return is to be a consolidated statement on monthly returns and payments and is to link this data with the global data on the entire year. An annual consolidated statement is necessary not only because it is to include a list of the customers and suppliers with indication of the volume of the transactions made with them, but also because the final adjustments are to be made at this time, -viz., reduction of the taxable base on account of uncollectible credits for the period, although these credits may pertain to operations concluded in previous periods (obviously, if credits shown as being uncollectible are later collected, the necessary adjustments are to be made); annulment of invoices due to cancellation of contracts or to returns of merchandise; discounts made at the end of the year; and in general, any other facts accounting for variations in the monthly tax liability that are stated at the end of the year.

It should be noted that loss of merchandise in stock does not entitle to adjustments on the tax liability since the tax paid at the time of the purchase has been immediately reimbursed. Fines for arrearage are not included since these are part of the added value of the enterprise. Discounts granted to clients even whenever they are subject to certain conditions (e.g., a minimum volume of purchases) and which were not granted at the time of payment of the tax may also give room for adjustments. Thus, containers to be returned and not invoiced but debited as a loss may give room for adjustments.

Naturally, these corrective entries on assessed items may also imply fiscal consequences for the other party involved. Thus, discounts granted to customers on the assumption that their purchases for the year will exceed a given amount, reduce sales invoices and-therefore- a tax adjustment is required on the tax due by the seller and on the tax credited to the buyer. However, these adjustments may be made by means of a single statement which may be documented through an exchange of correspondence between the corporations which is to include all information on the transaction. This debit statement is to be recorded as an invoice.

Corrective entries are to be listed separately on the annual return. The annual return is to also be used for requests for reimbursement of taxes paid in excess in the course of the year which have not been offset by the tax on purchases, unless the taxpayer should prefer to renounce immediate reimbursement and wish to request an offsetting of his tax credit against future liabilities.

Annual returns are also necessary on the assumption that, since exemptions are granted on given goods or since the last stage may be exempt, an enterprise selling part of its production in tax exempt goods and part in taxable goods, may originate a problem of pro-rata in taxes as foreseen by the European Economic Community. This situation which is substantially a deviation of the system is solved by granting a credit on the tax on purchases only for the amount of taxable sales (including exempted exports) without granting tax credit on the purchases for the goods later to be sold tax-free. In other words, a company buys goods for 1000 on which it has paid 100 (10% rate) on the added value. With these goods it obtains 2000 worth of finished products on 1600 of which (i.e. 80%) there is a tax liability of 160 while on the remaining 400 (i.e. 20%) there are exemptions. The amount of tax owed by the taxpayer, on the basis of the system under review, is not 60 (equal to 160 minus 100) but 80 (160 minus 80) since it is 80% of 100. Compensations for taxes paid on purchases for consumer goods can also be made on a monthly basis in view of the autonomy of the monthly calculations and the simplicity of the operation, but the results obtained are different from those obtained when the calculation is made on an annual basis.

However, if the industrialized goods have a multi-annual duration, compensations are to be made at the end of the year. For instance, if there is an installation costing 100,000 which will have a useful life of 10 years and which is to be used to produce both tax exempt and taxable goods, the tax

on 10,000 is only credited in the amount of taxable goods it produces. Since the unit will be used for production over several years, it is necessary for us to find the ratio between tax exempt goods and taxable goods for the entire multi-annual period. A method that may be adopted is the following: at the beginning of the fiscal year a hypothetical ratio may be established on the basis of an approximate appraisal -which may be data on exempted and taxable goods for the previous year. If we assume this ratio is of 50% in the month of purchase, half of the tax is credited, e.g. 5,000, because we assume that the asset has only produced that amount of taxable goods. Subsequently, the same ratio is found for each year and, on this basis, the balance between the assumed ratio and the actual annual ratio is found for the course of the duration of the investment. If the installation worth 100,000 has a useful life of five years, the amount of tax for each year is of 2,000. If in those five years, taxable goods represent 60, 50, 40, 30 and 45% of global invoicing, the company is to pay a balance of 200 (10% on 2,000) for the first year; nothing for the second year; it will have the right to the reimbursement of 200 (10% of 2,000) for the third year; the right to the reimbursement of 400 (20% on 2,000) for the fourth year and the company will have to pay 100 (5% of 2,000) for the fifth year. The duration of the investment can, by agreement, be made shorter than the useful life of the installation so as to limit these offsetting operations in all cases to a maximum of 4 or 5 years.

11. Small taxpayers and agricultural taxpayers

Small taxpayers and craftsmen offer specific characteristics. In the first place, it seems that for this group the transfer of the tax to the buyer becomes more difficult especially because the ratio between value added tax and the value of sales is particularly high. Secondly, the size of the companies makes bookkeeping very expensive and, therefore, not convenient from an economic viewpoint. The problem is to be examined separately for each type of enterprise.

If the enterprise in question is a retail businessman it is obviously difficult to require that he issue sales invoices in view of the scarce amount of transactions they usually have; cash registers and other unilateral means of sale registration may be effective or not in accordance with the specific environment. If there is no high degree of fiscal consciousness the validity of these means is questioned and the same can be said of small commercial enterprises, small industries, craftsmen and professionals.

In all of these cases, accounting is to be as simple as possible and tax assessments are to be based on income and disbursements instead of on a more sophisticated accounting system. It is difficutlt to require that these taxpayers keep adequate accounting systems with balance sheets, inventories and other complex requirements. The most that can be required is maintenance of invoices on purchases made, of a journal on which purchases are recorded as well as the respective tax, -sales may be usually inferred from the daily volume of receipts-, and a pay roll for personnel. Since the businessman himself usually keeps the books in these small enterprises, the possibility of manipulations is extremely high. To avoid this, the following can be done:

A first possibility is that of granting tax exemptions for all retail businesses, so the tax is applicable at all stages with the exception of that of final sale to the consumer. Many potential taxpayers are thus eliminated and these would be paying very little tax and representing considerable work in collections. Here we find the first difficulty in that many industrialists also sell directly and only part of their production to the final consumer. Therefore, in order to avoid distortions, the taxable base of these industrialists also acting as part-retailers is to be reduced to exclude the portion of added value covering retail business. This can be done by reducing the value of these sales to a fixed percentage (for instance 20%). Another difficulty is encountered with other enterprises (craftsmen) and professionals who usually produce goods or render services directly to the consumer and, therefore, could be considered as retailers. This difficulty may be eliminated by extending to these activities the right assigned to retailers, viz, that of reducing the value of sales or services in the percentage established for producers.

However, if this course is followed, the only possible system that may be adopted is the "a forfait" system.

In this case it is necessary for the law to define the small taxpayer.

The less discriminating criteria that may be followed is that of the global volume of sales made or services rendered in the course of the year, on the basis of including in this category all those taxpayers with a global annual income not exceeding a given amount. Since these taxpayers are also subject to a system for assessment -and sometimes of imposition- that is different from the usual system, it

is necessary for the taxpayer to know from the start of the fiscal year whether he belongs to this category or not. To this effect, it will be necessary to refer to the previous year's business, although even this provision may not be enough since the taxpayer may have fluctuating invoice values and it would not be rational to have continuous changes in the assessment system. It would therefore seem logical to establish a double ceiling. Once a sufficiently high amount over and above which the normal system is applicable has been established, a minimum limit is also to be established so that those below this limit may be subject to a "a forfait" system. Those between the two ranges are to maintain a regular accounting system although they will be subject to the "a forfait" system but may choose to be taxed on the basis of the normal system.

The "a forfait"system consists of a simplification of the system for the substitution of returns on monthly payments made throughout the year and it may, in certain cases, consist of a jeopardy assessment of the taxable base. Enterprises subject to the "a forfait" system are to be exempt from the obligation of issuing invoices on sales and taxation may be imposed on the full amount of the sale (instead of on the added value) at a usually reduced rate (e.g., one third of the normal rate), naturally without deduction of the tax on purchases. Also, a fixed annual exemption may be granted to which is added, whenever rate deductions are not granted, a reduction in the percentage of sales value. If there is an organization within tax administration with an electronic center in which sales and purchases between taxpayers may be followed-up for the entire year, it is not difficult to identify and add all of the sales of normal taxpayers and those of taxpayers under the "a forfait" system; these could be separated by means of a special series of numbers in the fiscal code. If we know the volume of purchases of these taxpayers, we have a first element for controls over sales volume. It is also possible to directly establish the added value instead of obtaining it through the difference between purchases and sales. The above consists of an addition of the total paid by the taxpayer for the different production factors: salaries, rental, interest and profits, for income tax purposes. The total represents the value added of the enterprise and its determination may be made easier by calculating the difference between the tax on purchases and the tax on sales. If investments are not important, as is generally the case with these enterprises, this method may be considered satisfactory for the assessment of the tax.

The problem becomes more complex in the agricultural sector which is, in general, a depressed sector that is less

able to withstand tax burdens; cash payments in this sector require a lower rate of tax mainly because agricultural products are staple commodities for the lower income sectors that have a small taxpaying ability. On the other hand, value added in the agricultural sector is very different to that on sales. Since there is no possibility for controls based on accounting, a special "a forfait" system for this sector -which seems to be the preference of the European Economic Community- consists of the following:

The purchases made by farmers from other sectors (fertilizers, fuel, agricultural machinery, etc.) are subject to the normal tax rate. Sales to industrial enterprises or commercial firms subject to value added tax are taxed at reduced rates (for instance, at half of the normal rate) and these are calculated in such a way that the reduced rates may, on the average, compensate for the tax added to purchases. The sales tax at the reduced rate is not paid by the former by crediting it to the buyer but is paid by the buyer directly to the Treasury by means of what is called "self-invoicing". For instance, assuming that the farmer's purchases are 100 and his sales 200 and that the normal tax rate is 10%, the tax on purchases is 10 (10% of 100). According to the normal system, the tax on farmers' sales should be 20 (10% of 200) and the tax paid by the farmer is 10 (20-10).

In the proposed "a forfait" system, the tax rate on sales is reduced to 5% (i.e., to 10 when the balance of 10 compensates "a forfait" the tax added to purchases) and the buyer pays this 5% (i.e. 10) directly to Treasury, by registering it on an invoice issued by himself. Thus, agricultural producers pay 10% on purchases made from other sectors and 5% on their own sales.

12. Problems encountered in the transition from a cascade tax to value added tax

These problems may be divided into two groups, depending on whether we approach them from the point of view of 1) relations between the taxpayer and the Treasury, or 2) the economic problems resulting from the impact of the transition on the market.

The problems encountered in relations between the taxpayer and the Treasury are derived from the fact that cascade taxes imply advance payment of the tax on the part of enterprises for the amount of taxes incorporated at previous

stages on raw materials, stored finished products, products being manufactured and installations and fixed assets existing at the end of the fiscal year and not yet amortized, while value added tax requires no advance payment of the tax since the tax paid on purchases is immediately credited to sales for the month.

This implies that products purchased before a change in the system and transferred after the reform, having been subject to cascade tax cannot be deducted from value added tax. Therefore, in the transition period, the overlapping of both systems would imply double taxation.

The obvious requirement is that of reimbursing the cascade tax collected on stock in existence at the beginning of the fiscal year as well as that on the value of non-amortized installations.

The problem presents two aspects: one has to do with the calculation of the tax rate imposed on the goods and the other with the valuation of installations.

In what concerns the tax rate collected on stock and installations, it is to be remembered that this amount as it is eventually to appear on the invoice is not sufficient since it will also be necessary to include the tax added at previous stages which does not appear on invoices. The problem may be solved by applying to products in existence at the beginning of the fiscal year, the same rate applicable to drawbacks on exports.

In what concerns the valuation of fixed assets, it does not pose many problems. The value to be used as a basis for calculations is the net value of installations. However, the amount to be reimbursed, in view of stock volume in existence and the investments made by corporations is very important from the point of view of the entire national economy and, therefore, implies an important loss in revenue for the Treasury that it may not be able to withstand.

If this loss in revenue is to be limited, it will also be necessary to progressively reimburse these amounts in time. The limitation may consist of allowing for reimbursement but reducing the amount of tax that is reimbursable. This can be done by limiting the reimbursement to the rate applied on purchases or machinery, and by cutting out the portion corresponding to preceding stages. Within certain limits, since it is not always possible to be sure of the entire forward shift of the tax, this could be justified.

Also, reimbursements could be made on installations made in a given period of time (for example, two years) before the enactment of the law, or for all installations, not immediately, but on the basis of future amortization installments. In other words, reimbursements could be made on the basis of the annual sales resulting from the use of the installations and of the annual amortization installments taking the annual amount of installments as purchases. If this solution is adopted, as of the enforcement of the new tax system, amortization installments are calculated on the basis of the value of purchases after deduction of the cascade tax included in them. Thus, annual amortizations are reduced.

Each year the company can claim an amount equal to that of the tax to be reimbursed as credit on value added tax, and this amount is to be calculated on the original value of the installation and is to be proportional to the amortization installments shown on the balance sheet, which proportionately reduces the tax credit until a break-even point has been reached.

As an example we may assume that a company has a capital of 1000 entirely invested in an installation which, including 10% sales tax, represents 1000 (of which 100 for tax is included in the price).

If the annual amortization rate is of 10% (10 years useful life of the installation) and if the company utilizes all of its installments year after year, after five years (at the time of tax reform) its balance will be the following: Under Assets: installations 1,000; cash 500; total 1,500. Under Liabilities: capital 1,000; amortization fund 500 (100 x 50); total 1,500. At the time of tax reform an account for "Tax Credit" 50 is posted under Assets (1,000 - 500 = 500; 10% = 50) and under Liabilities the amortization fund increases from 500 to 550. In each subsequent year for the next five years, an amortization installment of 90 (1,000 - 100 = 900; 10% = 90) is charged to cost with a total for the five years of 450, and is deducted from value added tax (10% of 100 = 10) with a total for the five-year period of 50. Thus, at the end of the five years the installation value will be of 1,000 (to be written off) and cash value 1,000 (500 from past amortizations, 450 from the new, and 50 for tax reimbursements), a total of 2,000. Under Liabilities the capital will be of 1,000, and the amortization fund of 1,000 will be made up as follows: 500 past amortizations on the balance of the tax.

With this procedure, the state fully reimburses the cumulative tax included in the value of the installations, respecting the VAT principle of not incurring in double taxation, but maintains the cascade tax by forcing the company to advance the tax up to the time when the asset is totally paid for.

The new installation may be renewed with an expenditure of 900, and the remaining 100 are free (amount of the tax) for other investments.

Naturally, if it is believed that the loss for the Treasury will be excessive, the amount to be reimbursed may be reduced by reducing the applicable rate.

It should be remembered that part of the loss in revenue derived from the implementation of the VAT system is offset with the increase in income tax for these corporations, since amortization quotas deductible from gross income will be reduced. Therefore, if income tax is, for example, 50%, each 100 lire of tax reimbursed will represent an increase in taxable income as well as in the direct tax. Thus, the loss for the Treasury is reduced by half. This also suggests other types of compensations which could consist either of a temporary increase (e.g. 5) in value added tax to offset the reduction in income, or of a reduction in the amount of the reimbursement not calculating this reimbursement for income tax purposes. In other words, if a reimbursement of 50% is granted on the suppressed tax, it is also possible to establish that amortization installments on the non-taxable amounts not be deductible for income tax purposes. Thus, if the tax rate is of 50%, there is a benefit in favor of the taxpayer equal to his overall reimbursement (half of which is made in taxes and half of which is made on the portion that affects his income).

The problem of goods in stock and in the process of manufacture is to be viewed from a different angle because, with the exception of those cases in which production takes up more than a year, goods are destined to be re-sold within the same year. Therefore, the tax incorporated to them is to be offset in the same fiscal year. The most difficult problem is that of quantity and value of goods in stock. For companies having adequate accounting systems this is easily solved, -at least if the rate of the suppressed tax is not a differential rate for some goods-, by charging the rate of reimbursement to the value of the goods appearing on the balance sheet (discriminating the rate on the basis of whether the goods were purchased or are final products).

If, on the other hand, the companies do not have adequate accounting systems, it will be necessary to allow them to adopt this type of accounting system at the time that the new tax is enforced and the books are to then reflect the value of stock appearing on an inventory drawn up against the latest purchase invoices right up to the value given on the balance sheet. In these cases, it will be necessary to allow for the recovery of the reimbursed tax within a sufficiently long period on the assumption that tax administration may prove that stock has been over-valuated or on the assumption that the company abandon proper accounting in a given number of years. Whenever proper accounting systems are used, fraud is unlikely since an over-valuation of stock aimed at obtaining cascade tax reimbursements would imply that subsequent reductions in stock represent a greater volume of sales at a much higher tax rate.

When evaluating the consequences of these provisions on fiscal revenue it is necessary to remember that a transition from cascade tax to value added tax implies, in the course of the first year of enforcement, a loss of one twelfth of the total revenue. In fact, in January no receipts will be forthcoming on the cascade tax that is to be suppressed but value added tax revenues will start as of the following month, after having calculated all purchases or all sales for the month of January, with a subsequent delay of 10 to 15 days in which companies may make their calculations and file their monthly return. This inconvenience is not encountered if the cascade tax is collected on the basis of accounting systems since in January all payments on the suppressed tax for December will be made. Therefore, in the course of the first year of transition from cascade tax to value added tax there is an important loss in revenue for the Treasury, either due to a one month delay in tax payments, or due to the need to reimburse the suppressed tax on stock and installations.

13. Economic problems involved in the transition

The second group of problems is that of the effects of the transition on national economy.

In the first place, whenever the entrepreneur foresees that the cascade tax incorporated to his purchases will not be fully reimbursed with the implementation of the new system, he will try to delay purchases up to the time of enforcement of the new law. This reduction in purchases will

cause a decrease in production and could bring about a recession, though temporary, that could also lead to later excessive demand.

The above procedure is naturally dependent on the extent of actual reduction that could be reached without acting in detriment of the operations of the corporation, e.g., if stock is divided into two portions, the permanent portion formed by the volume of merchandise that cannot be reduced without affecting production levels and the speculative portion destined to be increased or decreased in accordance with economic conditions, imply that only this second portion could be affected by tax predictions. It would look as if the problem might not be too serious in view of the above and particularly since the phenomenon would be concentrated in the last months of enforcement of the previous tax system.

On the other hand, in what concerns installations, a reduction in expenditure can be anticipated for a much longer period of time but, here too, in view of the time required to plan an installation the fact that many installations in the process of construction would be partially detained and would thereby become subject to higher taxes, would adjust the negative effect.

However, whenever this happens the only solution is that of guaranteeing total reimbursement of the cascade tax or that of penalizing investments made immediately after the enforcement of the new tax.

From a logical point of view, assuming stability in global income and normal market conditions, it may be said that when one type of sales tax is to be substituted by another, the overall price level will not vary inasmuch as the public budget, public expenditure and demand for currency do not vary.

Relative prices are to change. As is well known, cascade tax on the assumption of a complete shift forward is very uneven as regards final prices due to its cumulative effects. Thus, the overall tax included in the price is dependent, -all other conditions being equal-, on the amount of transactions required by the product to complete its production cycle. The total burden varies in accordance with whether the added value is concentrated at the first or last stages of the production cycle. In the first case, for obvious reasons, the tax is higher than in the second case.

To the contrary, the other two taxes, single-stage tax on retail sales and value added tax, are the same and it may be said that their incidence on the final price coincides with the nominal tax rate.

Recently, an opposite thesis has been sustained to the effect that value added tax would have cumulative effects since it is contended that, as a tax on purchased goods it is an element of cost when the price is established through mark-up procedures and this fixed percentage is applied on a price that includes the tax. This determines a spiralling effect that leads value added tax to an increase in prices that is above the nominal rate.

This reasoning requires certain precisions.

If the tax is assessed by addition (such as an income tax assessment tax) it is evident that, as mark-ups cover fixed costs and profits as well as the tax, the margin of profit is decreased. For this reason, whenever profits are again returned to the original rate, the mark-up is increased and, with it, the sale price which includes the tax and thus determines the cumulative effects mentioned.

The same may happen when the tax is assessed through the method of deductions base by base. Here again, if the tax in not charged separately on the invoice, it can have the same effects since the price appearing on the invoice also includes the tax.

However, these argumentations lose all of their value when cost accounting is correctly kept, with the tax by tax deductions system (French method and that of the E.E.C.). Assuming that this cumulative effect should be due to an erroneous indication of costs, this reasoning would only be valid for brief periods, or until the mark-up is again reduced to take profits to their original rates. The observation has no logical basis unless it is attributed to irrational behavior on the part of the businessman, but in that case it would be possible to make many other assumptions in what concerns the method of deduction tax by tax. With this method, the tax appears separately on the invoice and to the buyer it is only a reimbursement of an advance made by the supplier on account of the tax he will have to pay for his sales and he recovers from his client.

Businessmen who keep adequate accounts show on their books the taxes paid on purchases and the tax collected on sales and offset these accounts. In general, the law requires that corporations show the tax separately on invoices.

Under their stock account, businessmen invoice the net price of the goods because in actual fact goods in stock or in the process of production are not taxed under this system.

Neither is it technically possible to base the mark-up on total cost with the addition of VAT since the cost arising from industrial cost accounting does not include the VAT. And more so since often the tax collected by the buyer is higher than that paid by the seller; in other words, it is a means of self-financing for the corporation for the time elapsing before payment of the tax (an average of 23 to 25 days). Therefore, it should perhaps be calculated as a cost reduction at least for interest purposes, but it should not be considered as a tax under any circumstances.

On the other hand, the same problem arises with all taxes collected at the source on account of the Treasury. Can it be said that these taxes form part of the base-cost on which the mark-up is applied? Certainly not. Here also the tax is administered by means of cash-on-hand accounts so as to avoid making erroneous entries to the cost for the period.

Therefore, it can be said that value added tax calculated by the method of credit tax by tax is not in any way cumulative. Other hypotheses may be made, but they are based on an irrational behavior on the part of the businessman.

It has also been said that in the case of a substitution of the cascade tax for value added tax, -on the assumption of rational market mechanisms without any type of friction-, after a given lapse of time the prices for every product are subject to two opposing forces: they tend to a decrease due to the elimination of the previous tax and tend to an increase when the new tax is levied. The price for each product will increase or decrease in accordance with the element that prevails and even if relative prices are modified since the exact tax incidence cannot be verified on all goods and on each stage of their production. The overall price level will probably not vary since the global impact of the increase will run parallel to the global impact of the decrease. Naturally, relative prices will vary in accordance with the different taxes incorporated to production costs after the transition.

However, due to the imperfection of the markets, corporations may adopt another type of behavior. If they do not reduce their prices in an amount similar to the tax incidence of the suppressed cascade tax on their purchases (and the

percentage varies haphazardly from product to product) the transition may lead to an increase in prices since the latter usually rise more or less in accordance with the new tax rate which is equivalent to the nominal rate of the suppressed tax. If we take longer periods of time into consideration, it is very difficult for prices, once increased, to ever be reduced again. Quite to the contrary, they will continue to rise to provide larger profits and to offset other production factors. Whether this happens or not depends on persuasion and on the publicity made by government authorities on the new system but, in actual fact, it will be very difficult to avoid an increase in prices.