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Revenue Implications of Trade Liberalization

Communication from the United States

Addendum

The following communication, dated 10 April 2003, has been received from the Permanent Mission of the United States.

Introduction

1. The United States is pleased to transmit this paper on the revenue implications of trade liberalization in order to help clarify the nature and scope of this issue. The International Monetary Fund (IMF) has done extensive work in this area that the Negotiating Group may also find helpful as it considers modalities for addressing tariffs on non-agricultural goods. Several countries have made far-reaching modalities proposals for non-agricultural market access that would substantially reduce tariffs and in some cases eliminate all tariffs over time. Substantial action on tariffs would have significant economic benefits. The World Bank estimates that the elimination of tariffs would result in developing country income gains of $500 billion and lift more than 300 million people out of poverty by 2015. Three-quarters of this gain would come as a result of developing countries eliminating their own trade barriers.[1]

2. A number of developing countries have raised concerns about the revenue implications of trade liberalization during the discussion of modalities in the Negotiating Group on Non-Agricultural Market Access (NAMA). For many developing countries, tariffs have been an important source of government revenue, and they argue that the elimination of tariffs could have serious consequences for their fiscal stability. While the reduction of high tariffs may initially increase revenue as imports grow, aggressive trade liberalization must eventually result in reduced tariff revenue. Many of the modalities proposals recognize this and allow developing countries sufficient time to reform their domestic tax regimes in order to take best advantage of the benefits of free trade by proposing long implementation periods, in some instances through 2015.

3. The purpose of this paper is to share information on the scope of the tariff revenue issue, highlight tariff revenue trends in the context of ongoing programs of fiscal and tax reform, and note some of the programs available to advise and assist developing countries in adjusting to the revenue implications of tariff reduction.

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[1] World Bank, Global Economic Prospects (2002).

Overview

4. 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. The IMF has emphasized the importance of implementing and sequencing comprehensive reform of the domestic tax system from the outset of the trade liberalization process. Tariff regimes are neither an equitable nor economically efficient means for developing countries to raise revenues, since tariffs tend to distort resource allocation and shift the tax burden to the poorest segments of the economy. For example, the highest tariffs in both developing countries and developed countries are often concentrated on consumer goods (such as apparel) and agricultural goods. In tandem with the direct benefits of tariff reduction and elimination, replacement of tariffs by efficient tax systems would reap significant additional developmental benefits.

5. Import duties are gradually becoming less important as a source of government revenue for most developing countries. On average, import duties accounted for about 15% of total government revenue in 2000/01 for those developing countries listed in the IMF's Government Financial Statistics Yearbook (GFSY), down from 18% in 1991/92.[2] This trend reflects the efforts of developing countries to reduce tariffs and to reform their systems for collecting revenue. The major exception is the group of African least-developed countries, where dependence on import duties remains significant and has actually grown over the past decade.

6. The capacity to adjust to the revenue implications of substantial reduction (and eventual elimination) of tariffs is likely to vary from country to country, and from region to region:

- Many developing countries are much less dependent on tariff revenue as a source of government revenue and should have less difficulty adjusting to the revenue implications of significant tariff reduction and elimination. 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.

- Those countries that may need the most advice and assistance in adjusting to the revenue impact of tariff reduction and elimination over the medium-term appear to be limited to very specific groups – many least-developed countries (LDC), some additional Sub-Saharan African countries, and some island countries in the Caribbean and Pacifica. Even among these groups, there are a number of countries that have already substantially reduced their dependence on import duties.

- Many developing countries are already in the process of implementing ambitious fiscal reform programs to address their fiscal problems. 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. A survey of economic literature on public finance reveals that fiscal policy can play a fundamental role in affecting the long-run growth performance of countries.

- For those countries that need assistance, the international financial institutions, particularly the IMF and World Bank, can provide advice and assistance for countries willing to undertake tax and trade reform efforts in the context of sound economic programs. Of key importance, the IMF has opened or will open regional centers where assistance may be most critical – Pacifica, the

[2] IMF, Government Finance Statistics Yearbook, 2001 and 2002 editions.

Caribbean, East Africa, and (in the near-term) West Africa. The World Bank offers programs to provide substantial financial support for tax reform in those countries that ask for such help.

- In many instances, tariff reduction may not necessarily have adverse revenue consequences. A number of studies have found that reducing high tariffs may actually increase government revenues by stimulating substantial growth in trade and GDP. Furthermore, the IMF has found that revenue is more likely to be positively affected by trade reform when the initial trade regime is highly restrictive, i.e., with protectionist tariffs, quantitative restrictions, and other protectionist non-tariff barriers.

- 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.

- Well-designed and properly administered tax systems represent more efficient and equitable mechanisms for raising revenues than import duties. The IMF has outlined a number “best practices” for implementing comprehensive tax and tariff reforms. 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. The shift from import duties to other sources of revenue will not only help developing countries generate sufficient revenue more equitably, but will improve resource allocation and reinforce their growth prospects.

Role of Import Duties in Government Revenue

7. The capacity to adjust to the revenue implications of the reduction and elimination of tariffs is likely to vary from country to country and from region to region. Each developing country needs to have an accurate picture of the extent to which it is (or is not) dependent on tariff revenue for government revenue. In making this assessment, it is important to distinguish between “import duties” – which would be reduced and then eliminated – and “other taxes collected at the border,” such as excise taxes and the value-added tax (VAT) on imports – which will not be reduced by tariff proposals.

8. The table below summarizes the importance of import duties as a source of government revenue (excluding grants).

Import Duties as a Share of Government Revenue (by region)[3]

Region	Sub-Group	Import Duties as % of Revenue	
		1992-93	**1999-2001**
Africa	Least-Developed	29%	34%
	Other	26%	22%
Asia	Least-Developed	27%	20%
	Other	18%	11%
Western Hemisphere	Caribbean	27%	23%
	Central America	20%	10%
	Other	8%	6%
Middle East		12%	8%
Europe		7%	4%
Developing Countries		**18%**	**15%**

9. Many developing countries may not have much difficulty adjusting to the revenue implications of tariff reduction and eventual elimination. Most developing countries in Latin America, the Middle East, and Europe already rely primarily on other revenue sources. For these countries, import duties now account for 10% or less of government revenue. Several of these countries are currently in the accession process. In many instances, countries in these regions have already undertaken substantial reforms of their domestic tax regimes. Central America in particular has undergone a substantial adjustment in the past decade, with the share of import duties to total revenue dropping from 20% to 10%. Countries in this group could adjust to the loss of import duties from tariff elimination, particularly given a long transition period through 2015.

10. While tariffs play a more important role in many Asian countries (accounting for about 10% to 20% of government revenue), these countries have already demonstrated a capacity to expand revenue through non-trade taxes such as income taxes, value-added taxes, and other taxes on goods and services. Many of these developing countries are already in the process of implementing fiscal reform programs (including tax reform) to address fiscal problems. In addition, for many of these countries, the real growth in non-trade tax revenue during the past decade significantly exceeded their current level of duty collections, thus demonstrating a capacity to adjust revenue collections in the future. These countries have an opportunity to design their fiscal programs to reduce dependence on import duties and expand other more efficient and equitable sources of revenue.

11. A transition period through 2015 should allow these countries sufficient time to adjust to the revenue implications of tariff elimination. A number of countries in the region are already becoming less dependent on import duties.

- Pakistan has already undergone a significant adjustment in its tax system and is now less reliant on import duties for government revenue. Import duties only accounted for 8% of total government revenue in 2002, down from 29% in 1992.

- Similarly in Malaysia, import duties only accounted for 6% of total government revenue in 2001, down from 11% as recently as 1997.

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[3] This summary is based on statistics on 107 developing countries in the IMF's Government Finance Statistics Yearbook (GFSY), supplemented by information from recent Article IV consultations. The GFSY does not cover all developing countries, including several Sub-Saharan African least developed countries.

- India's reliance on import duties has fallen from 25% of government revenue in 1991 to 19% in 2000. Furthermore. the Kelkar Report, which was commissioned by India's Ministry of Finance and released at the end of December 2002, has called for a major overhaul of India's tax system.[4] The net effect of the Kelkar recommendations would be to further reduce India's dependence on import duties as a source of revenue.

12. The revenue implications of trade liberalization are most significant for those countries where import duties account for more than 20% of government revenue. Most of these countries fall into very specific groups – the least-developed countries (LDC), some Sub-Saharan African countries, and some island countries in the Caribbean and Pacifica. For many of these countries, current import duties exceed (sometimes significantly) even the nominal growth in non-trade tax collections over the last 5-10 years.

13. Even among these groups, however, there are a number of countries that have already substantially reduced their dependence on import duties. Among Sub-Saharan LDCs, Burundi, Zambia, and Tanzania rely on import duties for about 10-16% of their government revenue. Furthermore, their collections of non-trade tax revenue have grown significantly in recent years, and they appear to have the capacity to absorb the revenue impact of tariff elimination over a reasonable transition period. Although not members of the WTO, Asian LDCs such as Bhutan, Myanmar, and Nepal also seem to have the capacity to replace import revenues because of manageable import duty to revenue ratios. A number of non-LDC African countries also have relatively low or moderate import duty to revenue ratios, including Botswana, Republic of Congo, Kenya, Nigeria, South Africa, and Zimbabwe. Among the Caribbean countries, Barbados, Jamaica, Trinidad and Tobago, and Grenada are not heavily reliant on import duties.

14. Underscoring the change that is already taking place, 49 of the 108 developing countries surveyed have already reduced their dependence on import duties by more than 30 percent over the past 5-10 years. Well over half have reduced their dependence on import duties by more than 20 percent.

Tax Reform

15. Well-designed and properly administered tax systems represent more efficient and equitable mechanisms for raising revenues than import duties and can complement growth strategies. An IMF staff paper entitled Fiscal Policy and Long-run Growth systematically reviewed the existing economic literature on the relationship between the growth of countries' economies and various public finance instruments (including tax policy) and concluded that fiscal policy could play a fundamental role in affecting the long-run growth performance of countries.[5] Instruments of public finance that can enhance economic growth include the adoption of policies to improve the neutrality of taxation, promote human capital accumulation, and lessen income inequality. The IMF has found, for example, that a properly designed and administered value-added tax retains production efficiency. "Since it is levied on consumption and not on intermediate transactions between firms…, a VAT does not distort the prices that producers face in buying and selling from one another. Accordingly the tax has the desirable feature of not violating production efficiency…"[6] The two features necessary to ensure that a VAT is only a tax on consumption are (1) at each stage, net tax must be payable only on the difference between sales and purchases, and (2) there must be no breaks in the VAT chain.[7] By

[4] "Consultation Paper by Task Force on Direct Taxes under Chairmanship of Dr. Vijay Kelkar," presented to India's Ministry of Finance, November 2002.
[5] Tanzi and Zee, Fiscal Policy and Long-run Growth, IMF Staff Papers, 1997.
[6] Ebrill, Keen, Bodin, and Summers, The Modern VAT, IMF 2001, p 15.
[7] Ebrill, Keen, Bodin, and Summers, The Modern VAT, IMF 2001, p 16.

contrast, import duties are highly distortive because they are not uniform, discriminate between imported and domestic goods, shift the tax burden to the poorest, and undermine efficient resource allocation in an economy.

16. The IMF has outlined a number "best practices" for implementing comprehensive tax and tariff reforms.[8] 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.

- The income tax system should be simplified. The corporate income tax should be levied at on moderate rate, tax incentives should be avoided, and depreciation allowances should be uniform across sectors. The personal income tax should be characterized by only a few brackets and a moderate top marginal rate, limited personal exemptions and deductions, and extensive use of final withholding.

- Taxes on international trade should play a minimal role. Import tariffs should have a low average rate and a limited dispersion of rates.

- These reforms could be complemented by the introduction of a simplified tax regime for small business and the informal sector.

- Non-tax revenue, such as surpluses from state enterprises and profits from central bank operations, should decline.

- Reforms of tax and customs administrations should include modernization of systems and procedures. Simplification of tariff and tax systems is a prerequisite for administrative reforms.

17. Virtually all developing countries already have income tax systems in place, and many developing countries have VATs, including almost half of the least developed countries. An IMF publication entitled The Modern VAT provides detailed information on the VAT.[9] For developing countries as a group, there generally appears to be an inverse relationship between a country's dependence on a 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.

Advice and Assistance

18. The international financial institutions, particularly the IMF and World Bank, can provide advice and assistance for countries willing to undertake tax and trade reform efforts in the context of sound economic programs. Such reforms will not only help developing countries generate sufficient revenue more equitably, but will improve resource allocation and reinforce their growth prospects.

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[8] Ebrill, Stotsky, and Gropp, Revenue Implications of Trade Liberalization, IMF Occasional Paper 180, 1999.
[9] Ebrill, Keen, Bodin, and Summers, The Modern VAT, IMF 2001.

19. The IMF is already providing substantial advice and assistance to many developing countries undertaking fiscal and tax reforms. IMF mechanisms for providing advice and/or assistance include its regular programs, Article IV consultations, technical assistance, staff missions, and its regional centers. Many developing countries are already in the process of implementing ambitious fiscal reform programs (including tax reform) to address fiscal issues. The IMF's Fiscal Affairs Department provides about 30% of the total technical assistance delivered by the IMF. The IMF estimates that its fiscal technical assistance amounts to more than 100 effective person years per year.[10]

20. In addition, the IMF established regional centers in East Africa (AFRITAC) in October 2002, the Caribbean (CARTAC) in October 2001, and Pacifica (1993) that can assist countries with these revenue issues. The IMF plans to open a similar regional center in West Africa. These centers are strategically placed to help those countries that must undergo the most substantial fiscal reforms, which in most cases coincides with the countries that are most dependent on tariff revenues. The centers will give priority to improving the capacity of governments to raise revenue, strengthen their institutional framework for tax policy and revenue administration, and manage public resources more efficiently. A key focus is adjustment to the revenue implications of trade liberalization. CARTAC (just opened in 2001) has already undertaken substantial tax reform work for Barbados, Guyana, and the Bahamas and is advising on the preparation of a road map for tax reform in each member country within an agreed sub-regional framework.

21. Other international financial institutions such as the World Bank and the Inter-American Development Bank are actively involved in fiscal/tax reform efforts. For example, the World Bank has provided extensive advice and lending operations focusing on both tax policy and tax administration reform. Of about 120 lending operations in the 1990s with components seeking to strengthen some aspect of the tax system, 43 projects with an outlay of $3.8 billion had major tax or customs administration reform components and 40 others had important components addressing other aspects of tax systems.[11] The availability of assistance from these institutions is demand-driven, i.e., they are willing to provide advice and assistance on fiscal/tax reform issues, but the developing country must ask for it so that it can be mainstreamed in the country assistance strategy. Structural lending by the Bank in this area can provide a bridge while the borrower reforms its tax policies and improves its tax administration, and the Bank has consistently found that the economic/financial return on these operations easily offsets the costs of the loans. In addition, several Members have bilateral programs that can assist developing countries in implementing tax and fiscal reforms. We would invite members that are providing bilateral assistance on revenue issues to share their activities and experiences with the Negotiating Group.

Revenue Impact of Tariff Reduction

22. The revenue implications of tariff reduction may differ from the revenue implications of tariff elimination. A number of studies have found that reducing high tariffs may actually increase government revenues in the short-term by stimulating substantial growth in trade and GDP. The IMF has found that revenue is more likely to be positively affected by trade reform when the initial trade regime is highly restrictive, i.e., with protectionist tariffs, quantitative restrictions, and other protectionist non-tariff barriers. Those countries with the most restrictive trade regimes tend to be the same countries that are most dependent on import duties for government revenue.

23. The IMF's Occasional Paper entitled Revenue Implications of Trade Liberalization, published in 1999, provides the most detailed analysis of the nexus between trade and revenue.[12] While this

[10] IMf, Annual Report 2002
[11] Barone, Das-Gupta, De Wulf, and Hansson, "Reforming Tax Systems: The World Bank Record in the 1990's," 1999.
[12] Ebrill, Stotsky, and Gropp, Revenue Implications of Trade Liberalization, IMF Occasional Paper 180, 1999.

analysis did not envision a duty-free world, many of its key conclusions are enlightening with respect to the revenue concerns associated with significant trade liberalization. Its major conclusions were:

- Current levels of protection suggest that many countries could liberalize further without adverse consequences for trade tax revenue even in the near term. Evidence from comparative analysis indicates that it is possible to tailor the pattern of trade liberalization to avoid adverse revenue consequences. Over the longer term, the link between trade liberalization and more rapid economic growth will further bolster revenue for a given level of tariffs.

- Implementing comprehensive reform of the domestic tax system from the outset of the liberalization process is a priority, given the long gestation for such reforms.

- Trade liberalization, at least initially, can result in revenue increases, particularly when the initial trade regime is highly restrictive, i.e., with protectionist tariffs, quantitative restrictions, and other protectionist non-tariff barriers.

24. Genuine trade liberalization must nevertheless eventually result in reduced trade tax revenue and hence will raise difficult fiscal issues if appropriate steps have not been taken to strengthen the domestic tax system. A reformed tax system will not only help generate revenue, but also will work to improve resource allocation, potentially contributing to higher rates of sustainable growth. The U.S. delegation can provide further information and contacts for those countries that wish to explore the benefits of a reformed tax system.

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