Trade Liberalization and Trade Taxes *

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* A note prepared for the meeting of Trade and Integration Network, August 14-15,2003

Traditionally, trade taxes have been an important source of revenue in developing countries (D.C.)

- ?? For all D.C. they have accounted for almost one third of tax revenue.
- ?? For Latin American countries, the share of total revenue has been lower and that share has been falling in recent years. But these taxes remain important especially for small countries and for island countries

The Doha Round and programs of regional integration now under way, by asking for the removal of these taxes, could lead to revenue reduction and create macroeconomic difficulties for some countries.

Fear of this reduction, on the part of the policy makers of some countries could reduce the support for further trade liberalization unless that reduction could be compensated by other revenue.

Thus, the main issue should not be the reduction of trade taxes but of total tax revenue. If the fall in trade taxes could be easily compensated by increases in other taxes, then there would not be a problem.

Especially in the decades of the 1960's and 1970's fiscal economist interested in developing countries studied the way in which tax systems had developed over long periods and formulated what came to be called the theory of tax structure developments.

Inter alia, the theory of tax structure development argued that, as countries develop they progressively the change their tax structure to adopt it to the changes in economic structure. More specifically they tend to replace trade taxes with domestically based taxes. This

development has characterized many countries including the United States. In the 18th century the United Sates collected as much as 50% of its total revenue from trade taxes. Today it collects almost nothing.

While the replacement of trade taxes with domestic taxes would occur as a natural process accompanying growth, trade liberalization, which results from specific policy decisions, would accelerate this process by forcing some countries to reform their tax systems more quickly in order to protect the level of their tax revenue.

Not all countries would find easy the reform of their tax system to replace revenue from trade taxes with other revenue.

The structure of the economies; the sophistication of the tax administrations; or political obstacles, could make the needed reforms particularly difficult, or requiring more time, in some countries.

In any case it is of fundamental importance for the policy makers of countries that face a process of trade liberalization to address systematically and in an informed way the question of the potential impact of that process on their tax systems.

It is important to anticipate that impact and to take the necessary actions in a timely fashion if it is concluded that the impact could be significant. Countries should avoid being faced by unpleasant surprises.

By potentially changing the structure of the economy, trade liberalization will affect not just tax revenue but also the role of the state in the economy and, thus, also public spending. In this discussion we focus on taxation and ignore the potential impact of trade liberalization on public spending.

A more detailed analysis would need to look at this issue

The two key issues that policy makers need to address are:

1. The impact that the opening of their economies could have on tax revenue; and, if this impact is significant,
2. What they should do about it.

These two issues need to be related to the specific circumstances of each country. General answers are not likely to be very helpful for specific countries. Nonetheless it may be worthwhile to discuss some of the relevant aspects. This discussion helps identify the questions that policy makers need to ask.

At a general level (as predicted by the theory of tax structure development) the share of total tax revenue accounted by foreign trade taxes has been falling in most countries, including the Latin America countries. Thus the fiscal cost of trade liberalization is lower now than it would have been in the past.

Especially significant is the almost <u>disappearance of export taxes</u>. These taxes were important in past decades and especially in some Latin American countries. Good economics calls for the elimination of these taxes. It is thus a good development that they have almost disappeared. This outcome is the result of policy decisions.

Import duties, however, remain important in several countries even though they are less important now than in the past.
Thus the potential impact of trade liberalization in general and of regional economic integration in particular merits the attention of the policy makers of the relevant countries.

The policies connected with trade liberalization should, over time, tend to reduce or eliminate all the policy-induced impediments on foreign trade and not just the trade taxes.

These impediments may be of a quantitative nature, such as quotas. Or they may come in the form of tariffs on imports. In most countries there are both. Therefore trade liberalization should reduce or eliminate both quantitative trade restrictions (QTR) and import duties.

QTR may be simply eliminated, by government decision, as obstacles to trade. Or, they may be replaced by tariffs with the same or lower restraining effects on imports. In other words if a country was allowing the importation of only a given quantity X of a given product, it could allow the same quantity to enter the country through the replacement of the quantitative restriction by a well calibrated imports duty.
This process of converting QTR into tariffs is referred to as the tarification of quotas.

If QTR are simply eliminated, there cannot be any direct loss of revenue to the importing country because the QTR had not been producing any tax revenue to the government. On the other hand they had been producing rents to some groups in the importing countries who, because of the import restrictions, could sell the imported products, (or could produce them domestically), at higher prices.

However, if QTR are replaced by tariffs that allow the same volume of imports, then the government of the importing country will experience an increase in tax revenue. The tarification of the QTR will transform part or all of the rents that the beneficiaries of these quotes were receiving into tax revenue. The government will gain but some domestic groups, who could be politically powerful, will lose.

In connection with this process of tarification two aspects may be mentioned.

First, to the extent that those who were receiving the rents from the existence of the QTR were paying some taxes on these rents, there could be some revenue losses to the government connected with the disappearance of these rents. Therefore, the net revenue gain to the government from the tarification of quotas would be reduced.

Second, the disappearance of these rents might set in motion pressures on the government to replace them either with some form of public spending; or alternatively with tax expenditures or tax incentives on domestic activities. Whether these pressures lead to significant effects either on public spending or on the tax expenditure budget will depend on the government's ability to resist them. These pressures, coming especially from those who will argue that globalization of economic activities is bad and is hurting some social groups, can be anticipated.

Another aspect to consider is that trade liberalizations may be accompanied by the elimination of special incentives connected with the importation of inputs (raw material, parts etc) used in the fabrication of the domestically produced consumer goods. Import substitution policy has often been characterized by the free importation of inputs based in domestically produced consumer goods. Thus, in the new regime unless inputs continue to be imported without duties, revenue from some taxes on imports of these inputs will rise.

Let us now consider the relation between revenue from import duties and average tax rates.

The relationship between revenue from import duties and imports, that is the effective tariff rate, may not be a good indicator of the degree to which trade is prevented or liberalize.

A country that forbade imports would have zero trade taxes just like a country that let all imports come in duty free. In both cases the effective tariff rate would be zero. A country that did not forbid trade, but limited it only through quantitative restrictions such as quotas, would have imports but not revenue from trade taxes. Again, the effective tariff rate would be zero

A country that taxed imported consumer goods with very high tariffs, (that discouraged most imports of consumer goods) and allowed the duty free importation of inputs needed to produce similar consumer goods, domestically could also have a low ratio of revenue from trade taxes to imports—i.e. a low effective tariff rate.

Because they discourage imports, tariffs may be above the level that would maximize revenue from trade taxes. In this case some reduction of import duties, by encouraging more imports, would increase and not reduce trade taxes. For some range of the rate of import duty, a lowering of the rate will increase imports by so much as to more than compensate for the reduction in the tax rate. In this range imports are elastic will respect to the import duty. There is a point at which the level of import duties is such as to maximize revenue from trade taxes. Below this point, the reduction in import duties would reduce the revenue from import taxes.

In this discussion the impact of a charge in imports on the exchange rate and the availability of foreign exchange would also need to be taken into account. This aspect is ignored in our discussion here. But in general it can be assumed that trade liberalization will not just increase imports but also exports.

The level of tariffs at which trade taxes are maximized is an important empirical question. We may not know much about this level. It is likely to depend on the products traded as well as on the level of development and economic structure of countries. The demand for some products is likely to be more price elastic than that for others. But, the higher is the initial level of tariffs, the more likely it is that trade liberalization pursued through tariff reduction will, at least for a while, increase rather than decrease tax revenue.
At some point, of course, a further reduction in tariffs will reduce trade taxes. This is the point at which the price elasticity of demand for the product is equal to one. Countries entering a process of trade liberalization should make an effort to identify this point for the major products.

It is not likely that the revenue maximizing level of tariffs can be determined by the average ratio of trade taxes collected to imports i.e. by the level of effective tariff rate. This is particularly true if there is a wide dispersion in the tariffs applied to different products.

Empirical studies that have tried to determine the revenue maximizing level of tariff from the average or effective tariff level may not be very useful for specific countries.
See for example Ebrill, et al (2000) and Khattry and Rao (2002). These studies have found that the revenue maximizing level of tariffs is between 20 and 40 per cent. In any case a survey of these studies may prove useful.

In all it s aspects, trade liberalization, is likely to make a country's economy more open and to change its structure. Some economists such as Dani Rodrik, have argued that the role of the state and the level of public spending tend to be higher in more open economies because openness brings more risks. Thus if he is right more open economies may need higher levels of taxation. Trade liberalization could facilitate the replacement of trade taxes and the increase in the tax level.

For example, imports are often a major base for value added taxes. In some countries imports account for as much as 50 per cent of the base of the VAT. And in many cases excise taxes may be largely collected from imports. Therefore trade liberalization is likely to raise revenue from value added taxes and to facilitate the collection of excise taxes. This is especially true in the medium run.

Other potential benefits for tax revenue, may come through indirect channels such as the impact of trade liberalization on efficiency of the economy and on economic growth. In fact this is the major rationale for trade liberalization. Over benefits come from the reduction of smuggling activities that often accompanies trade liberalization.

In the process of liberalizing trade, it would be prudent and worthwhile for countries to take the opportunity to modernize their tax systems (a) as an end in itself, (b) to compensate for any loss in revenue; and (c) to make the system more progressive in order to compensate for undesirable effects on income distribution that might come from, or might be attributed to, the opening of the economy.

Therefore some discussion of tax reform possibilities may be necessary drawing from the vast literature on tax structure change during economic development and from recent experiences with tax reforms. What are the lessons from that literature? Are they still useful today?

Obviously general lessons, while useful, may not contain the full answer to the needs of specific countries. In some way, when it comes to taxation each country is, or feels that it is, unique. It may be useful in future work to classify the countries in different categories (small versus large; poor versus less poor; island versus continental, etc) to see if lessons more appropriate to each of these categories can be drawn.

In some cases the revenue compensation for lost revenue may be possible by simply increasing the rates or even better the taxable bases of existing taxes. In others it may be necessary to introduce new taxes. For example, countries that do not yet have a value added tax could introduce one. Countries that have a VAT that restrict excessively the base on which it is applied, as the case of Mexico, could widen it. Countries that make little use of income or property taxes may increase their use. In some countries the adjustment in the fiscal accounts could also come from the expenditure side of budget especially if unproductive spending could be identified.
And of course in most cases the adjustment should look at all of these possibilities.

Small island countries may be particularly vulnerable to the loss of trade taxes and more in need of major adjustments. These countries have relied the most on trade taxes.

Ministers of finance must address the relation between revenue from trade taxes and trade liberalization. They must identify the most likely effects for their countries and the technically and politically most feasible ways of compensating for any potential revenue loss. They should use this exercise as a stimulus for making adjustments in their public accounts that could improve the performance of the economy.

Modernization in the trade area should be accompanied by modernization in the public finances. This modernization requires a broad discussion of what the role of the state should be in the market economy of not fully developed countries.