

Revenue Implications of Trade Liberalisation¹

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General considerations

Consider first the general implications of trade liberalisation. Research at the IMF came to the following conclusions:

- ◆ Current levels of protection would suggest that a significant number of countries could liberalise further without adverse consequences for trade tax revenues. While obviously depending on individual country circumstances, this reflects cases where the existing tariff levels have been set so high that the implications of trade liberalisation are such as to imply that revenue increases are possible at lower-tariff levels. In addition, for those countries that rely heavily on non-tariff barriers such as quotas, there may be scope to tailor the pattern of trade liberalisation to avoid adverse revenue consequences.
- ◆ Over the longer term, the association between trade liberalisation and more rapid economic growth will further bolster revenues for a given level of tariffs.
- ◆ Nonetheless, revenue concerns may well influence the pace of trade liberalisation. This implies that implementing comprehensive reform of the domestic tax system from the outset of liberalisation should be viewed as a priority. This is even more the case since such reforms have long-gestation periods.
- ◆ In any event, genuine trade liberalisation must eventually result in reduced trade tax revenues and, hence, will raise difficult fiscal issues if appropriate steps have not been taken to strengthen the domestic tax system.
- ◆ It is of course the case that trade liberalisation is greatly facilitated by sound supporting macroeconomic policies and, in particular, appropriate exchange rate policies.

¹This paper was written for the IMF and presented at the Commonwealth Secretariat/World Bank Joint Task Force on Small States conference held in London in February 2000.

Tax reform: best practices

Theoretical and practical considerations have yielded a set of best practices in tax and tariff systems in developing countries. The best tax systems are those that cause a minimum of distortion in the allocation of resources, satisfy equity objectives and are relatively easy to administer. The following are typically the key elements:

- ◆ A broad-based consumption tax, notably a Value Added Tax (VAT) (see Box 1), should be introduced or strengthened, preferably with a single rate, minimal exemptions and a threshold to exclude smaller enterprises from taxation. Experience suggests that excises should be restricted to a limited set of products, principally petroleum products, alcohol and tobacco. VAT and excise duties should be applied equally to imports and domestic products.
- ◆ Taxes on international trade should play a minimal role. Import tariffs should have a low average rate and a limited dispersion of rates to reduce arbitrary and excessive rates of protection. Export duties should generally be avoided.
- ◆ The personal income tax should be characterised by only a few brackets and a moderate top marginal rate, by limited personal exemptions and deductions, by a standard exemption that excludes persons with low incomes and by extensive final withholding. The corporate income tax should be levied at one moderate rate. Depreciation allowances should be uniform across sectors. There should be little use of tax incentives.
- ◆ These regimes may be usefully complemented in some countries by the introduction of a simplified tax regime for small businesses and the informal sector.
- ◆ Reform of tax and customs administrations should include modernisation of systems and procedures. Simplification of the tax and tariff systems is a prerequisite for administrative reforms. Typical reforms stress the reorganisation of tax and customs administrations along functional lines, the adoption of effective procedures for a national system of unique taxpayer identification numbers, strengthening of audits and improvement of taxpayer services. Computerisation is generally a central component of reform, along with upgrading the skills of tax and customs officers and providing them with administrative autonomy and pay incentives.

Box 1. A Primer on the Value Added Tax

The key features of the VAT are that it is a **broad-based** tax levied at **multiple** stages of production, with – crucially – taxes on inputs **credited** against taxes on output. That is, while sellers are required to charge the tax on all their sales, they can also claim a credit for taxes that they have been charged on their inputs. The advantage is that revenue is secured by being collected throughout the process of production (unlike a retail sales tax) but without distorting production decisions (as a turnover tax does).

Suppose, for example, that firm A sells its output (produced using no inputs) for a price of \$100 (excluding tax) to firm B, which in turn sells its output for \$400 (again excluding tax) to final consumers. Assume now that there is a VAT at a 10 per cent rate. Firm A will then charge firm B \$110, remitting \$10 to the government in tax. Firm B will charge final consumers \$440, remitting tax of \$30: output tax of \$40 less a credit for the \$10 of tax charged on its inputs. The government thus collects a total of \$40 in revenue. In its economic effects, the tax is thus equivalent to a 10 per cent tax on final sales (there is no tax incentive, in particular, for B to change its production methods or for the two firms to merge), but the method of its collection secures the revenue more effectively.

Zero rating refers to a situation in which the rate of tax applied to sales is zero, though credit is still given for taxes paid on inputs. In this case, the firm will be due a full refund of taxes paid on inputs. In a VAT designed to tax domestic consumption only, exports are zero rated, meaning that exports leave the country free of any domestic VAT. This is called the **destination principle** and is the international norm; total tax paid on a good is determined by the rate levied in the jurisdiction of its final sale with revenue accruing to that jurisdiction. The alternative to destination-based taxation is **origin-based** taxation in which the tax is paid at the rate of, and to, the country or countries in which the item is produced rather than consumed.

Exemption is quite different to zero rating in that, while tax is also not charged on outputs, tax paid on inputs cannot be reclaimed. Thus, no refunds are payable. In this case, because tax on intermediate transactions remains unrecovered, production decisions may be affected by the VAT.

Small countries have unique features

The conflict between trade liberalisation and revenue concerns can appear to be greatest for small countries that are heavily reliant on international trade; this will particularly be the case if the initial stages of trade liberalisation have already been completed. These economies typically rely heavily on international trade for revenue; apart from revenue concerns, such economies also typically stand to gain the most from free trade. Some observations:

- ◆ There are many equivalencies between taxes with apparently dramatically different notional bases. The stress here is on economic equivalencies. Different legal standards may apply to different taxes that are economically equivalent in certain circumstances. These different standards could arise from constitutional law or international commitments.
- ◆ In the current context, an across-the-board import tariff levied only on final goods imports can approximate the impact of a domestic sales tax in economies where the bulk of final goods is imported. Thus, it is important to note that any tax, be it a value added tax or a tariff, will subject imported goods to taxation in some form.
- ◆ Trade liberalisation means that, whatever the tax regime selected, that regime should ensure that there is no bias against traded goods.

Tax policy and administration considerations for the smallest economies

This section considers some of the tax policy and administration issues that arise when considering the options facing the smallest countries as they liberalise trade. It is important, however, to ensure that any tax reform does not impede progress with trade liberalisation and is consistent with members' obligations under WTO agreements. As an organising theme for the section, the factors that might influence the decision to implement a VAT in these countries is considered, since the VAT is often considered the tax of choice when strengthening and broadening the base for revenues. Against that background:

- ◆ As can be seen from Table 1, many small countries have implemented the VAT.¹ However, are there countries so small that a VAT would be inappropriate? Should we make a distinction between small economies and the smallest economies?

¹The year of introduction is specified for each country.

Table 1. Small Countries with a Value Added Tax

	Population	C-efficiency¹
Albania, 1996	3.5	23.7
Armenia, 1992	3.8	15.8
Barbados, 1997	0.3	23.1
Belize, 1996 ²	0.2	56.2
Congo, 1997	2.5	11.7
Costa Rica, 1975	3.7	87.4
Croatia, 1998	4.8	90.4
Cyprus, 1992	0.6	100.1
Estonia, 1992	1.5	93.6
Fiji, 1992	0.8	84.1
Gabon, 1995	1.4	74.9
Iceland, 1990	0.3	64.8
Ireland, 1972	3.6	66.2
Jamaica, 1991	2.5	83.5
Kyrgyz, 1992	4.8	n.a.
Latvia, 1992	2.6	73.8
Lithuania, 1994	3.8	50.7
Luxembourg, 1970	0.4	82.9
Malta, 1995 and 1999 ³	0.4	67.0
Mauritania, 1995	2.6	46.2
Mauritius, 1998	1.1	n.a.
Moldova, 1992	4.5	71.2
Mongolia, 1993	2.4	94.5
New Zealand, 1986	3.6	103.2
Nicaragua, 1975	4.8	34.6
Norway, 1970	4.4	78.8
Panama, 1977	2.7	67.3
Papua New Guinea, 1999	4.4	n.a.
Samoa, 1994	0.2	n.a.
Singapore, 1994	3.0	107.9
Slovenia, 1999	2.0	n.a.
Togo, 1995	4.1	31.2
Trinidad and Tobago, 1990	1.4	46.8
Turkmenistan, 1992	4.1	n.a.
Uruguay, 1968	3.2	50.9
Vanuatu, 1998	0.2	n.a.

¹Ratio of VAT revenues to private consumption divided by the standard rate.

²VAT abolished in 1999.

³C-efficiency is for 1995.

- ◆ Empirical analysis indicates that the greater the significance of international trade for an economy, the higher VAT revenues will be, if all else is equal. Since smaller economies tend to rely more on international trade, that would appear to indicate that value added taxes actually perform *better* in small countries than in large. (An intuitive rationale for this result is that it is easier to collect VAT on imports than on domestically produced goods.)
- ◆ Whether a VAT is especially appropriate for small economies will also depend on the difference in collection costs between a VAT and the alternative revenue source. The fixed-collection costs associated with a VAT administration may be relatively burdensome for the smallest economies with either small and/or few firms.
- ◆ Focusing on economic efficiency, a VAT will be less advantageous for countries that import most of their consumption and for which the share of intermediates in imports is low, since the economic difference between an import tariff and a consumption tax is then evidently slight. While the smallest economies are likely to import the bulk of their consumption, there is no presumption that the importance of intermediate goods in an economy is related directly to size.
- ◆ As a practical matter, one way to proceed in the smallest economies could be to implement a retail sales tax.