SOUTH CENTRE

South Centre Analytical Note
December 2004

SC/TADP/AN/MA/1
Original: English

REVENUE IMPLICATIONS OF WTO NAMA TARIFF REDUCTION

TABLE OF CONTENTS

Introduction 1
I. Definition of tariff revenue dependency 2
Table 1: Import Duties as a share of Total Tax Revenue in some Developing Countries 3
II. The challenges faced: fiscal adjustment 5
III. Formulating demands in the Negotiating Group on Market Access 6
A. Capacity to absorb the fiscal consequences of tariff cuts 6
B. Appropriate Studies 7
C. Compensation through increased export earnings 7
D. Targeted technical assistance 8
E. Financial assistance 8

INTRODUCTION

1. It is generally accepted that trade liberalisation could have a detrimental impact on developing countries' government revenue. Indeed, since tariffs collected at the border represent a large share of total government revenues in many WTO developing country members, an overall reduction or elimination of tariffs as a result of NAMA negotiations would force governments to find alternative sources of revenue.

2. The extent of the impact of tariff reduction on government revenue is difficult to quantify and depends on several variables. However, two of the most significant variables concern:

   i. The ambition of the reductions (the deeper the cuts, the greater loss of revenue for the same amount of imports), and;

   ii. The relative weight of tariffs within a country's fiscal policy (the larger the proportion of revenue dependent on tariffs, the greater the loss of revenue after reductions).

3. The fact that many WTO members will indeed need to restructure their fiscal policies in order to implement tariff reductions resulting from NAMA negotiations is widely acknowledged by WTO members in the Negotiating Group on Market Access (NGMA). There is in fact a wide consensus that such countries deserve to have their specific needs fully taken into account. Hence, Annex B of the July Decision by the General Council states in its paragraph 16:

4. We recognize the challenges that may be faced by [...] those Members that are at present highly dependent on tariff revenue as a result of these negotiations on non-agricultural products. We instruct the Negotiating Group to take into consideration, in the course of its work, the particular needs that may arise for the Members concerned.

5. A breakdown of this short paragraph allows for the identification of three important elements concerning dependence on customs revenues:

    i. "*challenges that may be faced*": What is the nature of the challenges that will be faced? Will all countries face similar challenges and will they face them to the same extent?

    ii. "*at present*": Is there a base year in which dependency on tariffs will be assessed? Does this phrasing have any bearings for the negotiations?

    iii. "*highly dependent*": How can "high" dependence be defined? What is the dividing line between countries that will be able to benefit from possible negotiated flexibilities under this heading and those that will not?

6. This short note is a contribution by the South Centre aimed at providing information to countries dependent on customs revenues so that they can articulate their demands and needs within the Negotiating Group on Market Access (NGMA). The need for such coordination is made particularly timely in view of the Chairman's organisational fax which invites members to discuss "tariff revenue dependency" during the next session of the NGMA.1 In point 7 of the fax, members concerned are particularly asked to "further elaborate on the issue".

7. This note is structured around three main questions related to customs revenue dependency. Firstly it explores the concept of "high dependency" and identifies the countries concerned under each possible scenario. Secondly, it succinctly discusses some of the challenges faced and links customs revenue dependency to NAMA negotiations. Finally, it suggests some ways in which the problem of fiscal imbalance could be mitigated or compensated for in the WTO NGMA.

I. DEFINITION OF TARIFF REVENUE DEPENDENCY

8. There is no established definition of the level required for a country to be considered "*highly dependent on tariff revenue*", simply because there is no consensus, from a merely fiscal point of view, around the need to move taxation away from tariffs. While the cost of raising $1 of tax through tariffs is higher than the cost of raising $1 though other types of taxation (for instance, output taxation) in a number of WTO members, the opposite is true in other

[1] The next negotiating session of the Group on Market Access is to be held from 06 to 08 December 2004.

countries. [2] Structural differences among countries (patterns of employment, production, administrative capacity to raise taxes, etc.), do not allow making one clear-cut single recommendation in that regard.

9. The evidence remains, however, that because of the comparative ease to collect import duties when a product crosses national borders, many developing countries have based their tax systems largely on tariffs. Where tariff revenues account for more than 50% of government revenues, there is little doubt that dependency would be considered "*high*". However, what is high? What are the parameters to define a significant level of reliance?

10. While tariff dependence is undisputedly very pronounced in some developing countries, particularly in Sub-Saharan Africa, the Caribbean and the Pacific, it is lower, but still significant in many other countries. The United States has suggested in a Communication to the NGMA[3] that a 10% dependency level is not substantial and would thus not need any particular treatment in the negotiations apart from extended periods for the implementation of tariff reductions (2015). The communication suggests that only a dependency level of 20% or above would be considered as "high".

11. The table hereunder presents tariff revenues as a percentage of *total taxes collected* in WTO developing country members where that ratio is above 10%.

Table 1: Import Duties as a share of Total Tax Revenue in some Developing Countries[4]

Country	Share (%)
Algeria	12.1%
Bangladesh	30%
Burundi	16.4%
Cameroon	31.6%
Congo D.R.	33.7%
Congo R.	23.2%
Cote d'Ivoire	27.6%
Dominican R.	44.1%
Ethiopia	26.3%
Guinea	42.9%
India	24.1%
Iran	14.4%
Jordan	20.4%
Lebanon	39%
Madagascar	53.5%
Mauritius	29.3%

Country	Share (%)
Morocco	18.8%
Nepal	30.9%
Oman	10.3%
Pakistan	15.4%
Papua New Guinea	24.2%
Paraguay	17.5%
Peru	10.5%
Philippines	19.6%
Sierra Leone	49.8%
Sri Lanka	27.4%
Swaziland	54.7%
Syrian A.R.	11.7%
Thailand	12.3%
Tunisia	12.5%
Uganda	50.3%
Venezuela	12.1%

[2] Table 2 on the marginal costs of tariff and output tax collection in "Development opportunities and challenges in the WTO negotiations on industrial tariffs", by Santiago Fernandez de Córdoba, Sam Laird and David Vanzetti of the Trade Analysis Branch of UNCTAD.
[3] TN/MA/W/18/Add.2
[4] Import duties comprise all levies collected on imported goods at the point of entry into the country. Data is not available for all WTO developing country members. The data presented concerns 2001 and was taken from Table 5.6 at page 281 of the *World Development Report*, 2003, World Bank.

12. The disadvantage of using a percentage level to approach "high" dependency is that countries below the chosen level (which would most likely be negotiated) would be unable to benefit from flexibilities under this heading. Such an approach might reveal to be unfair and arbitrary, excluding countries that will face great challenges despite a relatively small dependency in percentage points. For instance, in 2001, taxes on international trade transactions accounted for "only" 4.45% of total government revenue in Bolivia. That amount of resources corresponds however to more than the central government spent on housing or agriculture, forestry, fishing and hunting in the same year.[5] In other words, a small dependency on international comparative terms could hide resources which are domestically very important.

13. To avoid choosing a percentage level to define "high" dependency (in the table above, a 10% level of dependency on tariffs had been chosen), one could instead adopt a comparative approach. One possibility would be to assume that the tax structure of OECD countries represents the long term trend in fiscal matters, that is, little reliance on foreign trade and more emphasis on direct taxes (e.g. income tax) and payroll taxes (e.g. social security contributions). In that case, any level of customs revenue dependence above OECD average levels would qualify as "high". The level of tariff revenues as a percentage of total tax revenue in OECD countries is around 1%.[6]

14. Under this approach, given the low average level of reliance on foreign trade tax prevailing in OECD countries, the majority of developing countries would be "*highly dependent on tariff revenue*" and would therefore be able to benefit from possible flexibilities under this heading. The average level of import duties as a share of government revenue in developing countries is 15%.[7]

15. Finally, it is worthwhile commenting on the methodology for calculating dependency. Reliance on tariff revenue can be calculated as a proportion of:

    i. Total government revenue, comprising both tax and non-tax revenues (which comprises taxes and other compulsory transfers imposed by government units, property income derived from ownership of assets, sales of goods and services and grants from other governments and international organisations),

    ii. Total tax revenue, which comprises only direct and indirect taxes (excluding certain fines and penalties)[8].

---

[5] Supplement to the 2002 Government Finance Statistics Yearbook, prepared by the Government Finance Division, IMF Statistics Department, using the classification of the functions of government (COFOG).
[6] IMF Government Finance Statistics, October 2003 taken from table "*Central Government Tax Revenue by Type of Tax* (percentage of total tax revenue)" in United Nations Online Network in Public Administration and Finance.
[7] TN/MA/W/18/Add.2, Communication from the United States
[8] This categorisation is generally accepted and contained in the IMF "Government Finance Statistics Manual, 2001",

16. Using the ratio to total tax revenue provides higher levels of dependency and might be a more accurate approach than using total government revenue, since the latter contains items such as grants items may account for a large share of government revenue, they remain extremely unpredictable and can thus not be relied upon for purposes of fiscal planning. Moreover, governments cannot always act upon them domestically. Tax policies, on the contrary, fall wholly within the governmental sphere of action.

II. THE CHALLENGES FACED: FISCAL ADJUSTMENT

17. The main fiscal consequence that tariff reductions resulting from NAMA negotiations will have for governments that rely on tariff revenue is that national tax collectors will collect less taxes because of reduced tariff rates. That translates into a loss of revenue, which in turn unfolds into the following consequences:

    i. Governments will have to establish effective alternative systems of revenue collection to compensate for the fiscal losses. That could be done through shifting the tax base from foreign trade taxes (tariffs) to sales and consumption taxes for instance (e.g. value-added tax), and / or;

    ii. Governments will be pressed to increase the efficiency of the collection of other existing taxes (i.e. reducing the marginal costs of raising a tax unit), and / or;

    iii. Countries will have to improve the efficiency of the services currently delivered. That comprises making current expenses more efficient, reducing them or cutting them altogether. Pressure in this sense will add to the many efforts that developing countries are already making to restructure their tax systems under IMF and World Bank programmes. Moreover, added pressure for the reduction of government expenses will further jeopardise the capacity of governments to provide essential social services and to finance developmental strategies.

18. Having a more efficient and effective tax collecting apparatus and cutting down inefficient government expenditures are certainly a desirable move. However, developing countries are of the fact that such changes involve lengthy processes, and hence that there is a need to match the time of adjusting to the timeframe for trade liberalisation. If tariff liberalisation is not accompanied pari passu by the implementation of alternative revenue sourcing strategies, countries are likely to face serious shortages of revenue.[9]

19. Moreover, it is worth recalling that recommendations for cutting expenditures and optimising tax raising have been formulated and imposed as part of structural adjustment programmes by the IMF and World Bank in many developing countries. Making further fiscal adjustments (i.e. finding new

[9] The possibility of temporary shortages of revenue and the difficulty to finance national Balance of Payments (BoP) is officially recognised by the establishment of the Trade Integration Mechanism (TIM) by the IMF. The TIM is further discussed below.

sources of taxation) might therefore prove very difficult. Countries that have reduced their reliance on tariff revenues over the past ten years from high to lower levels are still likely to experience difficulties in coping with further losses of tariff revenue. For instance, Pakistan has already reduced its dependency on tariffs from 29% (1992) to around 15% (2001)[10], but that does not mean that adjustment will be smooth, because finding yet alternative sources of taxation may prove extremely difficult.

20. Responding to fiscal imbalance will indeed require efforts of a varied nature by the countries concerned. First of all, reforming fiscal policies implies a political decision - and not a simple one - aimed at securing domestic support for what sometimes will turn out to be a substantial reform of taxation (e.g. introducing a new consumption tax where there was none before). Securing political support may also prove difficult since trade liberalisation and fiscal adjustment are more often than not perceived with suspicion in many developing countries.

21. Secondly, such changes will most likely have substantial financial implications because of the need to train officials and acquire new IT equipment.

22. Thirdly, such changes require administrative choices (e.g. opt for one or another type of taxation) that bear several future consequences which are not wholly understood in several countries. This is particularly problematic where human and technical resources for designing and implementing alternative sources of revenue collection lack.

III. FORMULATING DEMANDS IN THE NEGOTIATING GROUP ON MARKET ACCESS

23. From the challenges that many developing countries will face in implementing the concessions currently required in NAMA. Five sets of conclusions can be drawn:

A. Capacity to absorb the fiscal consequences of tariff cuts

24. Limiting tariff cuts to levels that can be fiscally absorbed by developing countries is an important way to ensure that tariff liberalisation matches individual countries' development needs. Taking tariff dependency into consideration when undertaking tariff cuts is a way of operationalising the principle of "common but differentiated responsibility", according to which developing countries would contribute to NAMA negotiations to an extent commensurate with their level of development. This would translate into:

    iv. Developed countries should accept an increase in tariff binding levels as a concession, and thus a full contribution, to the negotiations, without requiring cuts for newly bound tariffs. Binding could be undertaken at a level above current applied rates;

[10] TN/MA/W/18/Add.2

v. The coefficient used for the formula could be different for developing countries dependent on tariffs, so as to create a built-in special and differential provision for those countries;

vi. Developing countries could insist on matching the periods of implementation of concessions with the timeframe needed to restructure fiscal policies (implementation periods).

B. Appropriate Studies

25. Paragraph 16 of the Doha Ministerial Declaration and Paragraph 15 of the July Framework affirm that NAMA negotiations will be accompanied by appropriate studies which ensure that developing countries participate fully in the negotiations. That mandate has remained vague until now.

26. Developing countries can require that the pace of NAMA negotiations respect the full understanding (and measurement) of fiscal implications of tariff liberalisation within NAMA. Developing countries can also ask the WTO Secretariat to undertake more specific studies on the consequences of NAMA tariff liberalisation in specific countries whose imports are particularly concentrated on NAMA products.

27. Data on tariff revenue dependency lack for many developing countries (see IMF data) and that informational gap put those countries at a disadvantage in negotiations. As a prerequisite to further negotiations, a complete assessment of the phenomenon for all WTO developing country members could be asked as an initial contribution by the IMF to the negotiations.

28. The availability of that data before a final deal is stroke is crucial. In fact, tariff dependence will determine the extent to which developing countries can absorb the effects of tariff reductions. Hence, the availability of accurate data during the negotiating process will provide negotiators with a reference point of the extent of the commitments they can undertake. Data should cover all members so as to ensure a negotiating level playing field.

C. Compensation through increased export earnings

29. It is true that reduced tariff rates may stimulate official imports and therefore compensate partially or wholly for the loss of fiscal revenue. With reduced tariff rates (1) importers would be less inclined to smuggle goods into the country, and (2) the volume of imports may increase as a result of the fall in the price of the imported product. Nevertheless, compensation through increased volume of imports is not necessarily an adequate compensation since many developing countries fear that increased imports will translate in a disincentive for local production and therefore lead to a loss of output and jobs.

30. Moreover, the occurrence of increased tariff income because of an increase in imports would only be possible in a tariff reduction scenario, but not in a tariff elimination one. Tariff elimination - including in only some sectors - is the

scenario which would have most extreme consequences on government revenue. It is worth recalling that, at the disaggregate level (tariff revenue by sectors), individual sectors may provide very significant proportions of tariff revenue in some countries (e.g. motor vehicles, metal manufactures, chemicals). This constitutes a powerful argument against sectoral tariff elimination initiatives.

31. Only an increase in output (exports), employment and therefore welfare would be likely to generate growth and constitute a safe base for alternative taxation. Tariff revenue dependency compounds the need for enhanced market access in NAMA for developing countries.

D. Targeted technical assistance

32. Developing countries, particularly those that are most dependent on tariff revenue and those who lack human and technical resources, will need technical assistance and capacity building programmes in order to devise and implement alternative fiscal policies. Technical assistance should not only concentrate on laying out the tax choices available for specific countries but also on how to match specific situations with development-enhancing policies. Assistance aimed at training officials and implement fiscal policies should also be prioritised.

33. No other organisation has accumulated so much experience on fiscal matters as the IMF. Therefore, resources can be pulled together from the WTO, IMF, World Bank and regional Banks, building on their past experience and in-depth expertise in advice and assistance on fiscal issues.

34. The availability of technical assistance before the end of NAMA negotiations and the Single Undertaking is also very important because it also determines the extent of commitments that developing countries can make. Striking a deal in NAMA without a meaningful promise for technical assistance would leave many developing countries unprotected. Reversing that situation would then be more difficult since developing countries would not have the leverage they now have to require effective assistance as part of the negotiations.

E. Financial assistance

35. The benefits of technical assistance can only be optimised through the provision of adequate direct financial assistance, particularly where tariff dependency is more severe and hits particularly the poorest developing countries. Such assistance could aiming at assisting developing countries in training officials, acquiring new IT equipment, setting up institutional, administrative and technical mechanisms and procedures, etc.

36. While the Trade Integration Mechanism (TIM) made available by the International Monetary Fund (IMF) is a positive step towards providing finance to cope with adjustments needed to cope with trade liberalisation, it falls short from being sufficient. The TIM considers fiscal imbalance as a general structural problem of developing countries, and not as a challenge

posed by trade liberalisation. It does not target specifically the problem of loss of revenue because of tariff reductions.

37. Moreover, TIM is particularly inadequate as it provides additional lines of credit that is debt, and as such will increase the burden carried by already heavily indebted countries. Credit in the form of target development aid, aimed for instance at resolving supply side constraint issues, at the promotion of exports or at building producers capacity to export would be a more adequate solution.

38. Finally, the existence of an assistance programme in the IMF should not constitute an argument to take the issue outside the WTO. Since tariff reductions are being discussed in the WTO, possible solutions should also be explored there.

Chemin du Champ d'Anier 17
Case postale 228, 1211 Geneva 19
Switzerland

Telephone : (41 22) 791 8050
Fax : (41 22) 798 8531
Email : south@southcentre.org

Website:
http://www.southcentre.org