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Director of the Institute for the Economy in Transition  
**CITY AND COUNTRY:** Moscow  
**FAX NUMBER:** 202-39-93  
**FROM:** Harry G. Brodman  
**SUBJECT:** Draft WTO Accession Policy Note on Uniform Tariffs

**MESSAGE**

Please, find attached

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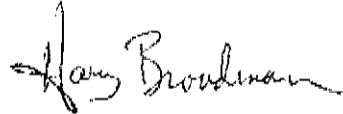
Mr. E. Gaidar  
Director of the Institute for  
the Economy in Transition

*Draft WTO Accession Policy Note on Uniform Tariffs*

Dear Mr. Gaidar,

Enclosed please find a draft version (in English) of the first of the four WTO Accession Policy Notes: "*Uniform Tariffs: Principles and International Experience*". As promised, because we wanted to get to you an early version of this Policy Note, we intend, following your reactions to it, to revise the paper and put it into final form. (At the same time, we will begin to translate the paper into Russian.) I will be at the Bank's Resident Mission in Moscow until December 11, 1997 if you would find it convenient to meet to discuss the paper. I can be reached on 253-4810 or through my colleague Vladimir Drebcntsov. Alternatively, you may write to me at the above address in Washington or through Mr. Drebcntsov.

Sincerely,



Harry G. Broadman  
Program Team Leader for Russia  
and  
Senior Economist

# **UNIFORM TARIFFS: PRINCIPLES AND INTERNATIONAL EXPERIENCE**

*FIRST DRAFT  
PREPARED FOR THE WORLD BANK*

Centre for International Economics  
Canberra & Sydney  
December 1997

## Scene 1

### The idea of a uniform tariff

*A minister has called in one of his key advisers to help solve a policy issue. Three visiting international agency missions have met with the minister over the past few months to advise on a restructuring of the tariff. As to whether this advice has been expert, detailed, extensive and conflicting, the answer is 'all of the above'. One group of experts contended that the existing escalating or cascading tariff had many advantages over a uniform tariff and was certainly better than no tariffs. A second group of advisers presented a formula which took into account various elasticities and weights to derive a tariff structure which would both maximise revenue collections and minimise resource allocation distortion. The third group's claims were more modest. They doubted that the knowledge to fine tune tariff settings existed. They suggested that a uniform tariff would be simple to apply, would not hurt the revenue pending the establishment of a proper tax base and would be a practical step on the way through to completely open trade. Moreover, they contended that a simple uniform tariff would be less vulnerable to capture by interest groups than complex tariff manipulation. Faced with all this advice the minister decided the only course was to work it through with his trusted adviser. This is the story of their deliberations.*

Minister: Our recent expert visitors seem to have strong opinions about uniform tariffs. I only wish their opinions were similar. It looks like you and I will have to work this one out ourselves.

Adviser: As I understand it the basic idea would be to apply a relatively low duty, say, no more than 10 per cent, to all imports.

Minister: We tend to have high duties on consumption goods — especially those which can be produced here. But for material inputs and capital goods not produced in this country, our policy is to have low, and even zero, duties. I gather you would call this a cascading or escalating tariff. Wouldn't a uniform tariff involve raising protection on goods which currently enter free of duty? I thought these advisers were going to help us reduce protection!

Adviser: That's a fair question. It reveals one of the contradictions of protection. A low tariff for some goods can actually raise the protection for other people — mainly producers using those goods in production. Perhaps when you get time you should read through the note on effective protection in box 1.

**Box 1 A note on effective protection or assistance**

The effective rate of protection (or assistance) for the output of an individual industry is defined as the percentage by which the entire set of a nation's trade barriers raises the industry's value added per unit of output. The formula for calculating an ERP or ERA is:

$$ERA = \frac{\text{assisted value added} - \text{unassisted value added}}{\text{unassisted value added}}$$

Originally the effective rate concept covered only tariffs and was called the 'effective rate of protection'. Now effective rates are used to measure a wide range of interventions and are called 'effective rates of assistance'.

The three pieces of information needed to calculate an effective rate of protection are:

- value added with assistance (or protection);
- nominal protection on output;
- nominal protection on inputs; and

Nominal protection on outputs and inputs are used to adjust observed (or with assistance) value added to a free-trade, or unassisted, basis.

Assume the local producer is able to charge a price that is 50 per cent above the world price (that is, the cif price of imports). Put another way, the nominal rate of protection (NRP) for shoes is 50 per cent. Assume also that a pair of shoes can be imported for \$100 before the tariff is imposed. These can be produced locally using one pair of soles and uppers that are also imported and costing \$85 before tariffs. The tariff on soles and uppers is 35 per cent in each case. At these assumed tariff rates the local price of the shoes would be \$150 and the soles and uppers used as inputs cost the producer \$114.75 (These costs are summarised in the table below). Value added measured in world prices is \$15. When the effects on domestic prices of protection is taken into account, value added is \$35.25. It follows then that the ERP is 135 per cent (that is, the proportion by which value added measured at domestic prices exceeds value added at world prices). It costs \$35 of local resources to earn \$15 foreign exchange.

This example demonstrates that a cascading rate structure will lead to an effective rate of protection that is higher than the tariff rate on the output (that is the nominal rate of protection). This is an example of one hypothetical firm and it is worth considering how this analysis would change under different conditions. There are two factors that can be varied: the value added generated by the productive activity and the relationship between the output and input tariffs.

**Table Effects of cascading tariff on effective rate of protection**

	World prices	Tariff rate	Domestic prices
	\$	%	\$
Shoes	100	50	150.00
Soles and uppers	85	35	114.75
Value added	15		35.25
Effective rate of protection			135%



Minister: But even when some activities are highly protected, if at least we can take some step towards no protection then surely that would be a step towards the free trade people advocate so strongly?

Adviser: Well minister, with that question you have exposed one of the fundamental truths about protection. Tariffs which protect one activity in an economy invariably tax some other activity in that economy. The effective protection concept applies the commonsense notion that tariffs on inputs matter as much as tariffs on output in settling whether something is highly protected or not. The problem is that activities with high effective protection are better able to attract resources and therefore to grow. Thus, it is our unprotected industries that suffer. And only in very rare circumstances can we get other countries to pay for our protection. These days we want activities to grow because they are efficient, not because they are protected.

Minister: Does this mean that equal protection for all would be the same as protection for no one?

Adviser: Well almost - 'protection for all is protection for none' is a nice way of putting it. Of course, it is not quite that simple, for example, to achieve a protection for none (or free trade) equivalent, you would need to assist exporters as well as producers for the domestic market. But the basic notion is a useful one. That's one reason why people have been suggesting the idea of a uniform tariff to you. But, its also important to note that they have been talking about a *low* and uniform tariff. High tariffs, even if they were uniform, would disadvantage exporters so much that it would be impractical to assist exporters to the same extent.

Minister: So, in theory or in principle, high uniform is much the same as low uniform but in practice low uniform is preferable?

Adviser: Yes that's right. Besides the practical problem of compensating exporters, an economy in which the government tries to protect everybody (and does not) is unlikely to be as efficient as an economy in which the government tries to protect nobody. Obviously, when the government endeavours to protect everybody there will be waste as people devote resources to lobbying government. When they try to protect at a high level, there will be a lot of waste and when they try to protect at a low level, there will also be waste, but less of

it. You might read the note in box 2 on rent seeking which explains why that is so.

**Minister:** But surely it cannot be as simple as that. Just about every country I know has an escalating tariff — how is it that everybody gets it wrong? How would you handle export promotion policy with a uniform tariff? And what about revenue — duties on imports still generate about 20 per cent of this country's revenue — we cannot throw that away for some theory? Finally, I am not at all sure about the political implications of a uniform tariff. I worry that it would please nobody. At least high tariffs please somebody — you had better be able to explain that.

**Adviser:** All good questions. I am not sure that you are right about all those countries with escalating tariffs but why don't we do this properly and you set aside the time to talk about each of the issues you have just raised? Let us first discuss why an escalating tariff is so bad. Second, we will talk exports, third, revenue and finally the political implications of the idea.

**Minister:** I'll read your note on effective protection — is there anything else I should read?

**Adviser:** The notion of a uniform tariff has been the subject of both theoretical and practical policy discussion. Box 3 contains a description of a sample of this work, perhaps you could have a look at that.

**Box 2 Boxmaking, rent seeking and all that**

Perhaps one way of thinking about the matter is to think of a crowd at a football match. Imagine some people buy boxes to stand on in order to get a better view. So long as only a few people do this they would indeed get a better view. But consider what would happen if everybody bought a box to stand on. As with protection, a box for all is a box for none. And as with protection, there has been a waste of effort in making all these boxes. Boxmaking in this 'football economy' is a waste of resources. Economists have coined an equivalent term to describe the resources wasted in an economy when people devote effort to getting high tariffs or some other special treatment from government (boxes to stand on). This term is 'rent seeking' and it was first used by Krueger in 1974 to describe the process of the resources wasted in people lobbying government for special treatment.

**Box 3 Quick literature review**

**Thomas, V., Nash, J. and Associates 1991, *Best Practices in Trade Policy Reform*, published for the World Bank, Oxford University Press.**

This book contains a two page section entitled 'Designing a Tariff Structure'. If the objective is to maintain the domestic value of production of some importables at a level above that which would be maintained at free trade, the best policy would be a uniform output subsidy – provided revenue can be raised costlessly. If revenue cannot be raised costlessly then tariffs might be the most effective way of achieving the objective. The main difference between an output subsidy and a tariff (assuming costless revenue raising) is that a subsidy only distorts production, whereas a tariff distorts both production and consumption. If revenue is the objective, then consumption taxes – on imports and domestically produced goods would usually be the best approach as there would be no production distortions. If information on elasticities of demand were available then the most efficient tax system would be non uniform, that is, goods in inelastic demand would be taxed at a higher rate. In the case of the treatment of final goods and intermediate goods, uniform treatment is welfare improving for importables but not in the case of exportables, so an efficient duty drawback system would be needed. Finally, the authors say, uniform tariffs are simple and make it easier for governments to withstand demands from lobby groups.

**Magoe, S.P. 1994, 'The Political Economy of Trade Policy', in *Surveys in International Trade*, Greenaway, D. and Winters, L.A. (eds), Blackwell, Oxford, United Kingdom and Cambridge, USA.**

This survey article canvasses the various theories of the political economy of protection. While there is no specific mention of uniform tariffs, the article is relevant because it raises the proposition that the existing arrangement of tariffs in a particular country is endogenous. That is, it is an outcome of all the different forces at work on that country. Thus, whether it be a move to free trade, to uniform tariffs or, for that matter, to an increase in tariffs, the change is unlikely to be durable unless the underlying forces shaping protection have also changed.

**Panagariya, A. and Roderick, D. 1991, *Political-Economy Arguments for Uniform Tariff, Policy, Research and External Affairs Working Papers*, May, Country Economics Department, The World Bank.**

This paper describes various proposals and arguments in favour of a uniform tariff going back to proposals by W.M. Corden in 1958, that Australia should adopt a uniform tariff. Other writers around that time supported this view largely on the theoretical grounds that uniform tariffs would lead to equalised effective protection. Subsequent articles by H. Johnson and B. Bolassa show that there is no theoretical basis for concluding that a uniform tariff is superior and that given sufficient information on elasticities the optimal tariff would be non-uniform. Thus, the basis for a uniform tariff rests on a practical issue of the small information needed to apply such a tariff, its simplicity, the low administrative costs and the political economy benefit of treating import substituting industries equally.

**Subramanian, A. 1994, *The Case for Low uniform Tariffs*, the International Monetary Fund and the World Bank, Finance and Development, June.**

Policy makers in many developing countries are taking the path of low uniform tariffs to policy reform. This partly reflects recognition of the misallocations that occur when effective protection diverges as a result of high tariffs on consumer goods and low tariffs on raw materials and intermediates. The paper reports on the experience of Bolivia, Chile, Colombia, Mexico, Uruguay, Bangladesh, India, Pakistan, Sri Lanka, Egypt, Ghana, Kenya and Uganda. Most countries reduced special surcharges, removed exemptions and imposed maximum rates. Only two countries raised minimum rates but others set minimum rates as targets.



## Scene 2

### The effects of a cascading tariff

*In their first meeting the minister and the technical adviser discussed the notion of a uniform (and low) tariff. While some of the reasons why so-called escalating or cascading tariffs are undesirable were canvassed, the minister remained unconvinced that having some zero tariffs would not be closer to free trade than having no zero tariffs at all. Why, the minister wanted to know, is a cascading tariff so bad?*

Minister: You have explained what people mean by a uniform tariff. And you have referred to a cascading tariff in terms which indicate it is a fate worse than death. But just what do people mean by a cascading or escalating tariff?

Adviser: A cascading tariff or escalating system usually means that the highest rates are levied on final goods, somewhat lower rates are applied to intermediate goods and the lowest rates of all are applied to raw materials and capital goods. Chart 1 describes a 'typical' cascading structure.

Minister: Is that all there is to it?

Adviser: Frequently this classification is reinforced by end use distinctions in the tariff. With these distinctions, say, a refrigerator for industrial use might be dutied at 10 per cent while a refrigerator for domestic use might be dutied at 40 per cent or more. Such distinctions inevitably cause headaches at customs clearance (and give rise to scope for corruption) and lead to wasteful use of industrial size goods in domestic applications.

Minister: That's all very well in theory but do these undesirable things really happen in practice?

Adviser: I understand that when Sri Lanka moved away from a system of licensed import controls in the early 1980s, the first step was to a six band escalating system with widespread end use distinctions. A low rate of duty on industrial air conditioners, for example, combined with a high rate on a domestic air conditioners, brought their prices after duty

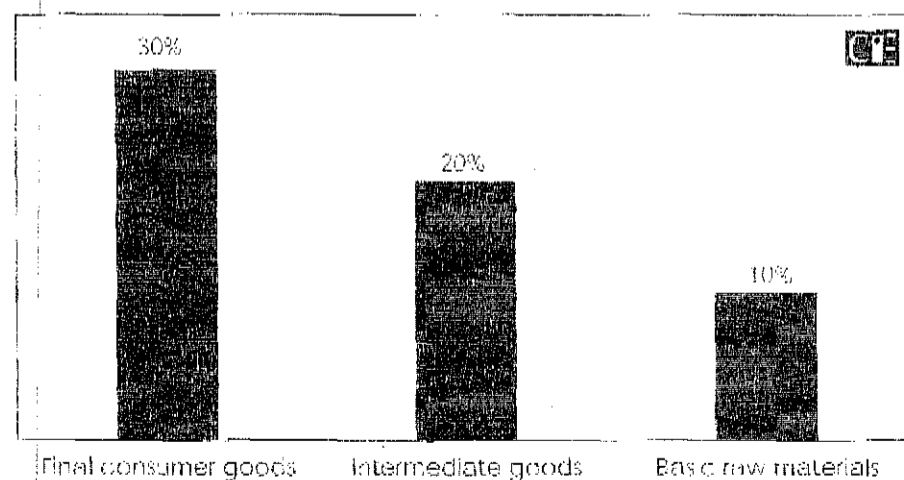
much closer. This meant that householders were induced into installing unnecessarily powerful, (energy demanding) and expensive appliances. Sri Lanka, by the way, has gradually compressed the number of tariff bands and the rates and policies are now being proposed for a two band tariff system with a top rate of around 20 per cent.

**Minister:** There is widespread concern here about the focus on low value adding processing industries. We need a deeper and more integrated production structure. Wouldn't a uniform tariff discourage that?

**Adviser:** Why should we be concerned about a 'processing' economy? If processing is what we are good at, by virtue of location or peoples' skills, then what's the problem? Perhaps the important point is that with a cascading tariff structure the government is in effect saying to producers 'we don't want you to make capital and intermediate goods, all we want you to do is put final goods together'. A uniform tariff would reduce that problem, not worsen it. It's a common enough problem. For example, in Bangladesh in the 1980s the government set the duties on electric pumps at zero. One effect of this was to render unprofitable a moderately protected diesel pump manufacturing capacity.

**Minister:** Are you saying a cascading tariff system provides undue incentives for processing activities?

Chart: Cascading tariff rate structure



Advisor Yes, very much so. Recall our earlier effective rate of assistance discussion where we said that the effective rate depended on tariffs on output, tariffs on inputs and the share of value added in output. Simple assembly activities tend to have low value added shares (often as low as 1 or 2 per cent); most manufacturing consumer goods typically have value added shares between 5 and 30 per cent; manufacturers of intermediate goods and processing of raw materials usually have somewhat higher value added shares; commonly between 20 and 60 per cent; and agricultural production is characterised by quite high value added ratios, in excess of 80 per cent. If you have a look at the material in box 4 you will see that processing activities with a low value added share can end up with very high effective rates, even when output tariffs are modest.

**Box 4 The interaction of low value added processing activities and cascading tariffs.**

In the table below estimates of effective rates of protection have been made for value added ratios (measured at world prices) between 1 per cent and 99 per cent. Consider first the effects of different levels of value added on ERPs for the tariff rates used in the previous example (that is, 50 per cent for outputs and 35 per cent for inputs). With an extremely low value added ratio, say 1 per cent, the resulting LRP is enormous — 1535 per cent. As the value added ratio increases the ERP falls, sharply at first. (For example, a 15 per cent value added ratio yields the ERP of 135 per cent obtained in the above example.) As the value added ratio gets larger the impact on the LRP declines because this reflects the decreasing amount of raw materials used. (If no inputs are used — that is, the entire output represents value added — the nominal and effective rates of protection are equal — in this case 50 per cent.) To summarise, the same cascading tariff rates can lead to very different incentives depending on the share of value added of the activity.

**Table Simulated ERPs — variable input tariffs**

Value added Ratio	Tariff rates: outputs-inputs			
	50.15%	50.25%	50.35%	50.45%
1	3515.0	2525.0	1535.0	545.0
5	715.0	525.0	355.0	145.0
15	248.0	191.7	135.0	78.3
20	190.0	150.0	110.0	70.0
40	102.5	87.5	72.5	57.5
50	73.3	66.7	50.0	50.0
90	58.8	56.3	53.8	51.3
99	50.4	50.3	50.2	50.1

Minister: If cascading tariffs are so bad, how did they become so common?

Adviser: As I understand it, back in the 1960s governments in developing countries began to adopt policies which they hoped would encourage industrial development. At that time, tariffs were primarily used to raise revenue. But with import substitution seen as the vehicle for industrialisation, simple consumer goods processing activities were regarded as the easiest things to get going. So their tariffs were raised and material inputs, intermediate goods and capital goods had lower, or zero rates. The hope was that as these activities became established other kinds of manufacturing could be drawn in.

Minister: So what was the problem?

Adviser: Well one of the lessons of the 1970s and 1980s was that this hope did not eventuate. In the first stage, high protection was established for many final goods. As you will see from box 4, when value added is low it does not take a very high output tariff to yield very high effective protection so long as input duties are lower. Box 5 contains some examples which illustrate this point. These first stage firms couldn't operate without the high protection. As a result it was impossible for governments to move to a second stage where tariffs for intermediate goods could be increased and their production encouraged. In retrospect it is clear that the highly protected first stage firms would have been ill advised to become competitive as the consequence of that would have been to have their protection removed.

Minister: Is that what you reckon is happening here?

Adviser: It is not easy to say. If you look at the composition of our imports by tariff band you see that over 40 per cent come in at 5 per cent or less rates of duty. This compares with less than 15 per cent of total imports which enter after paying duty of 25 per cent a month.

In a sense, this is not surprising as high tariffs discourage imports so we would not expect to see big import volumes in higher tariff bands. That's one reason why our average tariff of around 16 per cent doesn't mean much in effective protection terms.

This apparently low average rate is quite consistent with high duties on some goods and low duties on others. And as we know from the earlier boxes effective protection is shaped as much by the goods that come in at zero to 5 per cent as those which don't come in at 100 per cent.

Minister: If I look at figure 1 it suggests that our tariffs are uniform within a band of zero to 30 per cent. How bad is that?

Adviser: As the effective rates examples illustrate, a range of 30 per cent can yield very large rates of effective protection. In any event as I understand it, when we take into account specific duties some tariff chapters have very high rates — in the order of 100 per cent in a couple of cases.

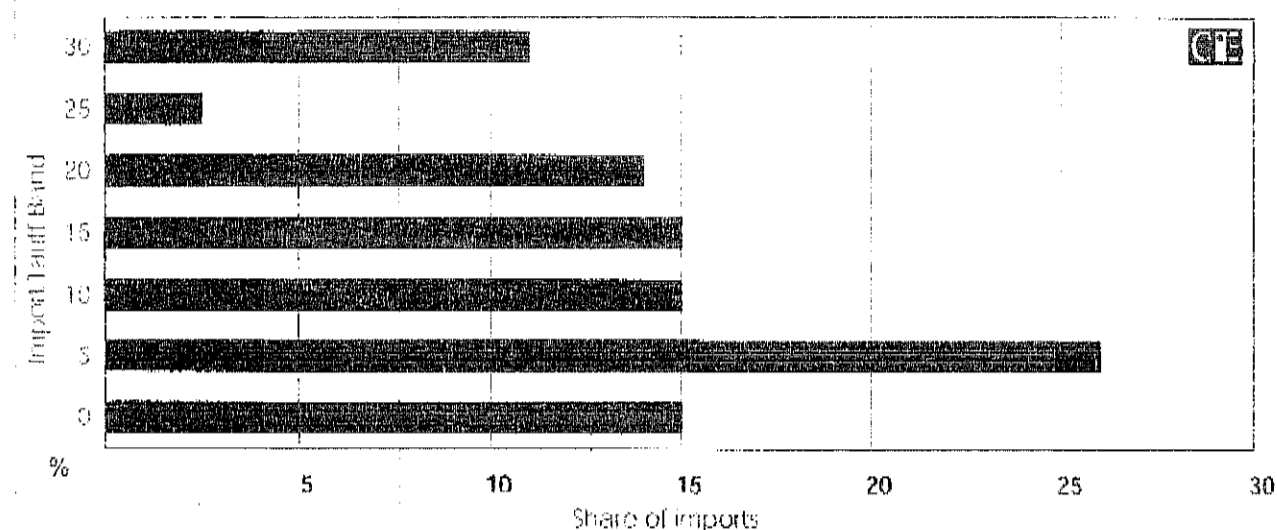
Minister: I can now see that high (effective) protection can result as much from low duties on inputs as from high duty on output. That has been a key insight for me. It explains the paradox where I seemed to be the one arguing for low tariffs while you seemed to be assuming the role of a tariff advocate.

Adviser: Yes, there is no paradox. My position can be summarised as follows:

- our country's economy will perform best with lower or zero barriers to trade;
- but for a whole lot of reasons there are barriers and these barriers are not going to disappear overnight;
- in a hierarchy of tariff structures:
  - wide divergences in treatment such as an escalating tariff is bad,
  - a narrow band of tariffs is not quite so bad,
  - a uniform and low tariff is better, and
  - zero tariffs for everything is best.

So in advocating non zero tariffs on some things I am really making the case for equal or neutral treatment. And bearing in mind the box maker, in order to not waste too much effort making boxes which do nobody any good, low and uniform is better than high and uniform. Now some of our visitors consider we can be more clever and by taking into account

Figure 1



**Box 5 Cascading tariffs and low value added: a recipe for very high protection**

The impact of changing the degree of cascading (that is, relative tariff rates between inputs and outputs) can be examined by adjusting the tariff for inputs keeping the rate for outputs constant at 50 per cent. The estimates presented in the chart show that the greater the degree of cascading or the difference between the tariff rates for outputs and inputs, the higher will be the ERP for a given value added ratio. For example, increasing the duty on inputs from 15 per cent to 45 per cent leads to a corresponding fall in the ERP from 715 per cent to 145 per cent (with a 5 per cent value added ratio). Whereas, for an activity with a high value added ratio, say 80 per cent, raising the duty for inputs from 15 per cent to 45 per cent only reduces the ERP from 58.8 per cent to 51.3 per cent.

It is worth examining briefly how the same degree of cascading will affect incentives with different levels of tariff rates (that is, varying the level of output tariffs). To do this consider the estimates based on a wide range of output tariffs but with a constant 15 per cent differential between the tariffs for outputs and inputs. The same degree of cascading (that is, a constant differential between input and output tariffs) yields ERPs that are broadly similar for activities with low value added, even with quite large differences in output tariffs, however, as intermediate goods inputs play less and less of a role and value added increases, relative differences in ERPs correspond more closely to the differences in output tariff rates. Also quite low tariff rates can yield very high effective rates of protection. For example, a 15 per cent output tariff, no duty on inputs, with a value added ratio less than 15 per cent results in ERPs that are greater than 100 per cent.

**Table Simulated ERPs — constant differential (15 per cent)**

Value added Ratio	Tariff rates: outputs: inputs				
	15:15	50:35	75:60	100:85	200:185
	%	%	%	%	%
0	1500.0	1335.0	1580.0	1585.0	1685.0
5	300.0	335.0	330.0	385.0	485.0
10	100.0	135.0	180.0	185.0	285.0
20	75.0	110.0	135.0	180.0	260.0
40	37.0	72.5	97.5	122.5	222.5
60	25.0	60.0	85.0	110.0	210.0
80	15.8	53.8	78.8	105.8	203.8
99	15.2	50.2	75.2	100.2	200.2



various elasticities of demand and supply we could fine tune tariffs in a non-uniform way. Maybe so, but I don't see us having the information to do that. Moreover, we shouldn't see a uniform (and low), tariff as a final objective. Rather, it should be seen as a useful, practical step on the way to free trade and certainly an improvement over a crude cascading system.

Minister: I can appreciate that raising duties on low rated inputs is likely to reduce protection in effective rate terms to highly protected industries and to raise, a little bit, protection for activities which are disadvantaged by protection. But some of these disadvantaged activities simply don't exist here and are not likely to, why should we raise their protection even if only by a little bit?

Adviser: There are about a hundred answers to that question. I'll give you just a few. First, economic growth is about what we might do, not about what we do do. A cascading tariff designed to protect the things we do do — or things the government thinks we should do — is at the same time a tax on the things we might do.

Second, you say that the government intends to let market forces be the guiding forces for settling industry expansion, and contraction. While a uniform tariff will get in the way of these market forces a bit, a cascading tariff will get seriously jam market signals.

Third, and remember the effective rate discussion, a zero tariff on an input confers protection to processes using that input so in a sense it adds to the protection of things we do produce. This is a kind of subtle point and that is one reason why some groups might like a cascading tariff. It raises a fourth, political economy issue, which we will come back to. For now, consider the proposition that the things we do now have a constituency, while there is not much of a constituency for protecting the things we don't (but one day could) do.

Minister: Are you saying that when we try to please everybody we encourage our citizens to spend time lobbying the government and that this time would be better used doing something productive?

Adviser: Yes that is the boxmaker point and it is probably worth having a special session about it.

Minister: As I am understanding you, its not so much that you are advocating raising low tariffs, its more that you are advocating neutral treatment — oh yes, neutral and low treatment — so that market forces and not the way we have designed the tariff, will sort out what we do. Is that why you think neutral treatment is such a good thing?

Adviser: Yes, we never really know what might be produced in a particular country. When governments set differential tariffs they are implicitly saying they know best.

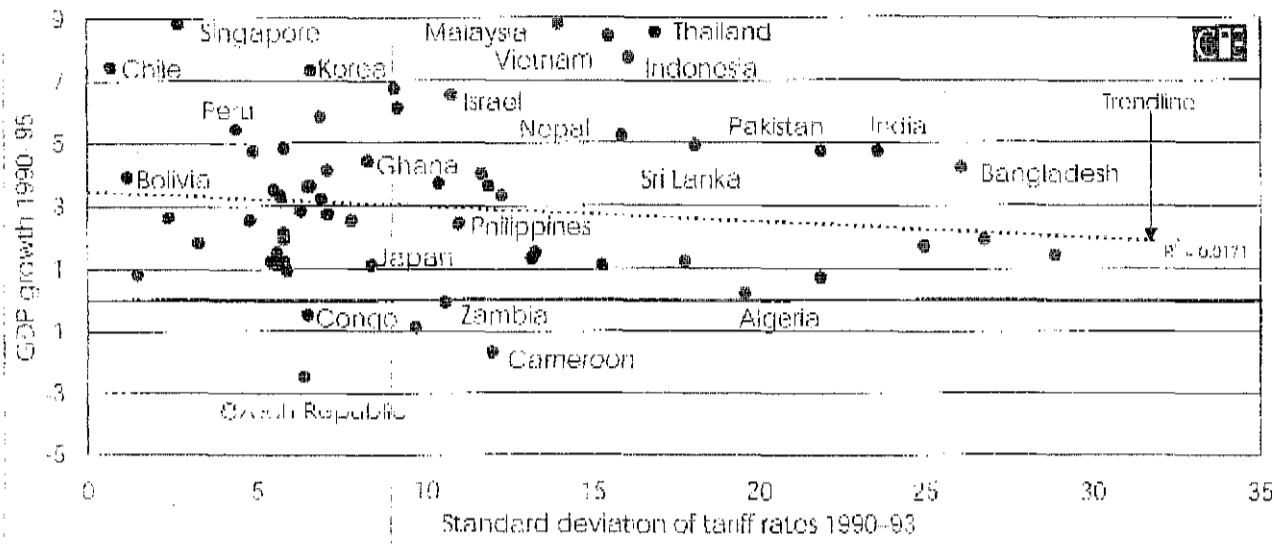
Minister: Our tariff is a long way from being uniform and as I understand it the proposition is that a uniform (and low) tariff would help us grow. Is there any evidence that countries with uniform tariffs (and low) have performed particularly well economically?

Adviser: That's a difficult question to answer because so many factors determine growth rates besides the structure of the tariff. For example, industrialised countries which frequently have low and uniform tariffs tend to have relatively slow rates of growth mainly because they have already exploited available technology. On the other hand, there are a lot of developing countries which may have some way to go in terms of reforming their tariff, yet which in recent years have been growing quite rapidly for a whole range of reasons including the fact that they are taking advantage of technological catch up.

Nonetheless, the World Bank's World Development Indicators provides a basis for the test you have proposed. This information is summarised in chart 2. As you can see these countries with high growth tend to have low dispersions but for the reasons spelled out above the relationship is not strong.



Chart 2 Correlation between standard deviation of tariffs and GDP growth



Data source: World Bank 22777



## Scene 3

### What to do about exports?

*The meetings so far have been mainly about tariffs and their impact on import substituting industries and there has been little discussion about impacts on exports.*

Minister: Over the past few years we have actively encouraged exports through export subsidies and promotion. What do we do about that with your uniform tariff idea?

Adviser: Well, you will recall that when we first started discussing this matter, I made what was probably an obscure qualification that protection for all was equivalent to protection for none, so long as exporters were being compensated. In some ways existing export assistance schemes have the same neutralising or equal treatment objective that I am getting at with the uniform tariff idea.

Minister: Please explain — I thought we were encouraging exports because exporting was a sign of an economy's good health?

Adviser: It's true that some of the so called 'new growth' theories argue that exporting creates benefits in terms of exposure to new ideas but the main reason why encouraging exports might be a good idea was so that we could import more. Because import barriers make it difficult to import, in effect they also make it difficult to export.

Minister: So a tax on imports is a tax on exports?

Adviser: Precisely. A tariff is a tax on imports and a tax on imports is a tax on trade and a tax on trade is a tax on exports. That makes sense if you think that in the long run the way we pay for our imports is by exporting. We could borrow, or someone might give us some money, but that won't happen for long. So in a sense the right or opportunity to import is the reward earned by exporting. Indeed, there is not much point in exporting unless it improves opportunities to import. Because a tax on imports reduces the returns from exporting it is in the end a tax on exports.



We help exports with export promotion policies because we were hurt them with import protection policies. Box 6 kind of illustrates what happens to exports when we cut off imports with a tariff.

Minister: But when you put it that way, it seems like boxmaking gone mad. The obvious thing to do would be to stop taxing exports.

Adviser: I think so. That's why we say *low* and uniform tariffs as a first step along with some kind of export compensation as a first step. Then as a second step, we would move to free trade and no export compensation.

Minister: Some of our export industries rely on getting their inputs free of duty. We do have some kind of scheme to enable them to get a rebate when they do pay duties but this is apparently slow and inefficient and most exporters count on getting inputs free of duty. If we go the uniform tariff, even with low tariffs, would that not put a cost burden on exporters who would be unable to pass it on and who are already operating in tight markets?

Adviser: That's a good point. Unless your uniform tariff was very low indeed, moving to a uniform tariff might make the treatment of importing industries more neutral but the tax on exports could be aggravated. The way around that would be to make sure the systems for giving exporters access to their inputs free of duty really work.

Minister: How do you do that.

Adviser: There are two main ways. These are:

- temporary admission or duty deferral schemes
- duty rebate or duty drawback schemes

I would not want to underestimate the practical difficulty of operating such schemes and it does no harm to point out that the lower the uniform rate the less you need to worry about compensating exporters and you don't need to worry at all with free trade.



## Scene 4

### What about revenue?

*Discussion between the minister and the adviser has so far been about the allocative effects of taxes on trade. But as it happens, revenue considerations are also a major concern to the minister.*

Minister: Let's say I am convinced that a cascading tariff had all these undesirable effects. But you know as well as I do that we still count on import duties to raise about a quarter of total government revenue. You are not the only person I talk with and all my other advisers are going on about stabilisation, fiscal balance and things like that. Given that we have yet to develop other sources of revenue, they are bound to argue against tariff adjustments which put revenue collection at risk.

Adviser: You shouldn't be so pessimistic. My guess is that a low uniform tariff, with no exemptions, would probably be revenue neutral.

Minister: Your 'guess' and probably is not going to be good enough for these people. You are asking for an experiment at a time when we cannot afford it.

Adviser: We can do a lot better than guess and in any event it's not as if you know what our revenues are going to be under the cascading system.

Minister: Well, a uniform tariff would involve some significant reductions in tariff and therefore in revenue.

Adviser: You seem to be assuming that with the change in tariff there will be no change in quantities imported. But surely with these big reductions in tariff there will be some increase in imports and that alone should have a positive effect on revenue.

Minister: Okay then but when we increase duties on other goods their imports will fall.

Adviser: Yes but now we will be collecting some tariff revenue instead of none at all. Moreover, the duty envisaged is still quite low and as we saw from figure 1, some 15 per cent of imports currently comes in free of duty. In some cases this is because the duty is zero. In other cases, it is because an exemption of some kind has been arranged. Even a very low duty on all of these goods would earn substantial revenue.

Minister: It certainly would make the job of the customs department much simpler.

Adviser: Yes, there would be no need for argument about classification and exemption. Perhaps most importers would be happy to pay a low duty and clear their goods quickly and easily. It is even possible that an efficient customs operating with less need for administrative discretion would attract trade into official channels.

Minister: You mean there might be less smuggling?

Adviser: That's likely. After all a low tariff on intermediate and raw materials is unlikely to drive these goods into informal channels. But a reduced tariff on final goods may well attract those goods into the formal system.

## Scene 5

### The 'political economy' of a uniform tariff?

*On technical grounds there seems to be little argument about the deficiencies of a cascading tariff. But the choice between a uniform tariff over a system calibrated to reflect elasticities, import shares and the like seems to rest mainly on information needs and political considerations.*

Minister: Your arguments for a uniform tariff seem to be based on a mix of technical, administrative and political matters. On the last mentioned I am concerned that it does not seem to tackle the reasons why we have ended up with the system we have.

Adviser: It is difficult to argue with the view that whatever the system is, it didn't just happen but is the result of a mass of domestic forces. I suppose that means that durable change requires a change in these basic underlying forces.

Minister: Yes, that is one of the things that is worrying me. As I understand it from you fellows, it is widely recognised that tariffs are inferior to production subsidies if the objective is to encourage a particular sector, yet for some very powerful reason we have ended up with tariffs.

Adviser: You are in good company with these concerns. As you will have seen from the quick literature review in box 3, a number of people interested in political economy have addressed the same issues.

Minister: So what is your answer?

Adviser: I suppose I was assuming that the fundamentals have changed or are changing. After all our entire economy is now being run on market lines. That is because the old centrally planned system with managed trade simply did not work. So as I see it, the move to a uniform tariff would be a way of moving towards a position that the government had foreshadowed and been supported on.



Minister: Why aren't you advising us to go to free trade tomorrow then?

Adviser: Well, we can talk about that if you like. I have assumed that for a number of reasons, including the revenue reasons discussed earlier, that it would not be possible to go to free trade immediately.

Minister: What are the other reasons?

Adviser: One is the argument for predictable and gradual change. Another is that so long as the direction of change and the end point is credible then it does not matter so much if change is gradual.

Minister: I would like to be persuaded, is there more?

Adviser: Fair enough. Let's just say that if it is not politically feasible to move to free trade straight away, the question is how do we get there? And in particular, how do we get there from an escalating tariff?

Minister: What are the options?

Adviser: There is an infinite number of options. Tariffs could be reduced from the top ones first. Or you could go sector by sector, or you could go to a narrowing of bands then to a uniform tariff and finally to a zero tariff. There is no single right answer on any of this.

Minister: Anything else?

Adviser: Besides its escalating basic structure, our tariff system has a host of other problems. For example, there are many administratively determined exemptions, the number of tariff rates is too large and the tariff has too many end-use distinctions.

A tariff reform program which:

- reduces the top rate;
- reduces the number of different tariff rates;
- removes exemptions; and
- removes end use distinctions; and



- raises the minimum rate;

will invariably be an improvement. Its a process that still leaves you with some revenue pending the introduction of some other tax system. It is simple to apply and requires no fancy information to design or administer. Other people might say to you that, theoretically, a tariff which causes the least distortions for a given revenue would probably be non uniform. That may well be right but in my view, such an approach would be clever but not wise. The information to run such a system does not exist and pressure groups would have a field day in manipulating arguments for different tariffs to suit themselves. Finally, a rule based system has the advantage of treating a large number of people roughly equally. But it's not a soft option, it does involve dismantling preferences to some groups.

Minister: I was afraid of that.

Adviser: Well, I guess that's why you are a minister and I am an adviser.

