THE COORDINATED REFORM OF TARIFFS AND INDIRECT TAXES

Pradeep Mitra

Tariff reduction designed to encourage outward-oriented development will work only if alternative sources can be found to replenish revenue lost in the cause of reducing protection. Integrated reform of tariffs with taxes would seem to be the answer, but so far analysts have often tended to treat the two instruments separately.

This article looks at the tariff and tax instruments used by developing countries to protect their producers and to increase their revenues, and then lays out the contours of an integrated structure for taxes with tariffs. This structure takes into account not only objectives of efficiency and equity but also constrained administrative capacity. The analysis concludes with an examination of how these ideas may be used to guide the coordinated reform of tax and tariff structures.

Reducing the bias against exports caused by extensive import protection is an early priority in the move toward outward-oriented development. But trade liberalization can be delayed or aborted if complementary macroeconomic policies, especially appropriate fiscal policies, are absent (see Halevi 1988). With public sector deficits averaging 7 percent of gross domestic product in developing countries in 1986 (see Chhibber and Khalilzadeh-Shirazi 1988), revenue losses arising from tariff reductions must be forestalled by tapping other sources of revenue. Such losses—and their macroeconomic repercussions—can be significant: in 1985, for instance, the contribution of import taxes to tax revenue was 14 percent in Latin America, 21 percent in Asia, 22 percent in the Middle East and North Africa, and 26 percent in Sub-Saharan Africa, compared with 2 percent in industrial countries (World Bank 1988).
The tradeoff between moves toward outward orientation and fiscal imperatives is thus frequently central to policy reform.

**Tariff and Tax Policy**

Tariff reform must be seen as part of a broader program of tax reform. Often advice on tariff and tax policy has been insufficiently coordinated, deflecting or even ultimately frustrating the intentions of the reformers.

**Tariff Reform**

Reform of trade policy has figured prominently in strategies for structural adjustment in developing countries. One review (World Bank 1989a) notes that it has accounted for 30 percent of the conditions in the World Bank's adjustment lending.

Typically, recommendations on the reform of import policy consist first of converting quantitative restrictions and other forms of nontariff licensing into tariffs; and second of reducing the level and dispersion of tariffs (Rajaram 1990; World Bank 1989a). The reformed system, to the extent that it includes non-zero tariffs, embodies some discrimination against exports, a feature that is partly offset by various schemes that exempt from tariffs imported inputs into export production.

The implications of tariff reform for revenue, however, are not tackled systematically. A move in 1984 to eliminate the Special Import Tax in Morocco, for instance, miscalculated the impact on revenue; that impact, together with the poor initial performance of the value added tax (VAT), led to a subsequent tariff increase. The same thing happened in Thailand in 1981 because proposals for alternative sources of revenue focused on one-time increases rather than elasticity-enhancing tax reform. In the Philippines, too, the effect of trade liberalization on revenue seems to have been underestimated. The government subsequently introduced an across-the-board import tax and a domestic turnover tax to raise revenue, but these policies are ascribed more to the deterioration of the economy in 1983–86 than to tariff reform. The program of import liberalization was, however, stalled by the above developments (see Rajaram 1990).

**Tax Reform**

Tax reform in developing countries is designed to increase revenue, to improve efficiency, and to promote equity (World Bank 1991). Indirect taxes account for most tax revenue—from 43 percent for the Middle East and North Africa to 61 percent for Sub-Saharan Africa (World Bank 1988). For the reform of indirect taxes, the instrument of choice is a VAT on consumption or a single-
stage sales tax, either of which is applied symmetrically to domestic production and to imports. The VAT replaces a wide range of existing indirect taxes; its coverage is allowed to expand as more and more taxpayers see the advantages of registering in order to benefit from crediting of taxes paid on inputs.

Tariff reform and tax reform are largely studied separately. Studies of tariff reform, as well as neglecting revenue issues, often pay insufficient attention to the domestic tax-subsidy instruments that, along with tariffs, protect local producers. Tax studies, for their part, recommend symmetric treatment of domestically produced and imported goods but leave analysis of the structure and level of protective customs duties to tariff studies. Obviously this separation is practical from the point of view of managing tasks; it also has the apparent virtue of not straining absorptive capacity of policymakers in countries where such resources are often scarce—although the policy reversals noted earlier, which arose from a failure to address budgetary concerns, potentially compromised the credibility of reform. This article (and see also Shalizi and Squire 1989; Linn and Wetzel 1989) argues that a coordinated trade-cum-public finance perspective is preferable. Its particular concern is the interaction of tariffs and indirect taxes with respect to protection and revenue. It leaves aside other important instruments of trade liberalization (for a broad overview of these, see Thomas and Nash 1991) to concentrate on the neglect of revenue issues in tariff reform and on the consequent need to develop in-depth principles that should guide the coordinated reform of tariffs and indirect taxes.¹

Tax and Tariff Instruments

Imports are usually taxed through (a) customs duties applied to the c.i.f. (cost, insurance, and freight) price and (b) sales taxes or value added taxes levied on the price inclusive of customs duty. Table 1 reports the use of those (and other) instruments in Bangladesh, Malawi, Nepal, Tanzania, and Uganda, which, with per capita incomes in 1987 of $160, $160, $160, $180, and $260, respectively, are among the poorest low-income countries (World Bank 1989b). Even in the three Sub-Saharan African countries, where import taxes do not loom as large as in the two South Asian countries, the sales tax on imports is evidently a significant source of revenue.

The table shows, first, that even the poorest countries use at least two different policy instruments to tax imports. A simple example makes the point. Suppose that the c.i.f. price of an imported good in local currency is 100. The customs duty is 20 percent, and the sales tax, which is levied on the customs duty-inclusive price as well as on domestic production of the good, is 10 percent. Assuming that there is no nontariff licensing of imports, the price that domestic producers can charge for the good is the c.i.f. price plus customs duty, or 120. In this example, the customs duty is a measure of the subsidy extended by the incentive system to producers. The customs duty also raises the price of

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¹
<table>
<thead>
<tr>
<th>Tax type</th>
<th>Imported goods</th>
<th>Domestic goods</th>
<th>Total</th>
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<td></td>
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<td>17.7</td>
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<tr>
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<tr>
<td><strong>Total</strong></td>
<td>29.7</td>
<td>38.8</td>
<td>68.5</td>
</tr>
</tbody>
</table>

- \(^a\) Customs and import duties are levied on the c.i.f. value of imports. In Nepal there is a two-tiered structure: only the first slab applies to imports from India, and both the first and second slabs apply to imports from other countries.
- \(^b\) The excise duty is levied on the ex-factory price of domestically produced goods. In Nepal and Tanzania it applies to imported and domestic goods at the same rate.
- \(^c\) For imports, the sales taxes and surtax in all countries are levied on the customs duty–or import duty–inclusive price; in Nepal the excise duty is included in the base for sales taxation as well. In Bangladesh the tax applies only to imports. For domestically produced goods, in Malawi, Nepal, and Uganda the sales tax/surtax is levied on the excise duty–inclusive ex-factory price, and in Tanzania on the ex-factory price (that is, not including excise duty). All three countries treat imports and domestically produced goods in a symmetric way (although until recently in Uganda there were a number of items for which the sales tax rate on imports exceeded that on the corresponding domestic product).
- \(^d\) Sales tax revenue collected from imported inputs is reported as revenue from domestic goods, so that the 11.0 percent share reported is an underestimate of sales tax collected from imports.

Source: World Bank data.
the good to the user above its international price (from 100 to 120), exemplifying the standard observation that a tariff is a subsidy to a domestic producer financed by a tax on the user. Because the tax component of the customs duty raises the price to users of domestic products as well as of imports, whereas its subsidy component applies only to domestic production, the tax revenue from users exceeds the outlay on the subsidy to producers; for this reason, the tariff is revenue-raising. But the customs duty is not the only tax on users of the good. The latter includes the sales tax (10 percent), which, together with the customs duty, raises the price from 100 to 132. The tax on the user of the good is thus, ultimately, 32.

The example suggests that the two instruments could be used in concert both to provide protection and to raise revenue. If the sales tax or VAT applies at an equal rate to imports and domestic production (as it does in Nepal, Tanzania, and, recently, Uganda), the customs duty can (a) play its primarily protective role and (b) combine with the sales tax or VAT to meet revenue objectives. The level and structure of customs duties should be set with reference to objectives of protection, and the sales tax or VAT can then be set at a level that, together with the customs duty, satisfies the government's revenue requirements.

A second important point illustrated by the table is that the excise tax, although it features separately in all the countries, may be thought of as combining the functions of the customs duty and the sales tax. This is because it has both revenue-raising and protective aspects. In Nepal its function is purely to raise revenue; in Malawi and Uganda, however, the excise duty applies to domestic production only and therefore subtracts from the protection afforded by import duties. This effect could be reproduced by adjusting import duties and by offsetting the impact on revenue by adjusting the surtax or sales tax.

Third, faced with an array of taxes and surcharges on imports, it is tempting to recommend that they be consolidated into a single levy to make administration simpler. The foregoing analysis shows that this would be a mistake. Thus customs duties that apply to imports alone fulfill a different function from sales taxes that apply to imports as well as to domestic production. Because the two instruments (which are used not only in the poorest but in a wide range of countries) are aimed at two objectives, protection and raising revenue, consolidation would result in giving up one instrument and reduce the opportunity to treat tariffs and taxes consistently.

**Coordinating the Design of Tariffs and Taxes**

The simple example in the preceding section showed that

- the difference between the producer price and the world price of a good is the subsidy to producers, whereas
- the difference between the consumer price and the world price of a good is the tax on consumers.
This allows us to identify the customs duty with the producer subsidy and the customs duty-plus-sales tax with the consumer tax.

**Producer Prices and World Prices**

The classical justification of wedges between producer prices and world prices is the argument that infant industries need protecting (for a detailed account, see Corden 1974). A variant of that argument runs as follows. It is postulated that the volume of gross output confers benefits of "learning by doing." These eventually lower costs of production and allow the industry to become competitive. In other words, the economy incurs the costs of industrial promotion today in return for the benefits of higher productivity tomorrow. But this proposition does not necessarily translate into an argument for government intervention. If private firms can invest in high-cost production in the early years and appropriate the benefits of higher productivity in later years, no intervention is necessary. Institutional restrictions on appropriability and capital market imperfections may, however, preclude such arrangements. Economic theory would then argue for intervention in labor and capital markets to correct those distortions, without restricting trade in any way (for a careful statement of the appropriate qualifications, see Baldwin 1969). If developing countries lack the administrative capacity to intervene in factor markets in this way, they may resort to an inferior policy of subsidizing production, whether for domestic sale or for export. In practice an even worse policy is generally adopted: tariff protection, which encourages only domestic production and discriminates against exports. Tariff protection is an attractive recourse because it raises revenue and because it extends assistance to favored constituencies in a relatively inconspicuous way.

The infant industry argument has also encountered certain difficulties in practice. One report on trade policy reform (World Bank 1989a, p. 114) observed that "experience with protection policies and their general outcome in the majority of developing countries suggests that infant industry arguments are generally used as a rationale by politically powerful protection-seeking industries, without any serious consideration of whether and under what conditions the economic benefits of the protection will exceed its economic costs. Thus the policies seldom recognize that if the initial economic costs are to be offset, the learning-by-doing benefits (weighted for risks and discounted for the opportunity cost of the capital invested) must appear in a period of, say, five to seven years." Such reasoning weakens the case for protection of infant industries.

**Structure of Protection**

In practice, advisers on tariff design are typically faced with import tariffs that are justified with a combination of learning-by-doing arguments, effective
lobbying by special interest groups with no particular claim to infancy, and political imperatives to keep subsidies hidden (as is effectively done by tariffs) rather than transparent. Because evidence on learning by doing and related externalities across sectors is notoriously elusive, governments find it very hard to identify potentially successful sectors and products for special encouragement. Economists have then recommended that assistance be made uniform, on the grounds either that, in the absence of compelling evidence to the contrary, learning effects might as well be assumed to be roughly the same across sectors or that a uniform structure of assistance is less vulnerable to special pleading. (For a derivation of the relationship between learning by doing and production subsidies, see Mitra 1992. The relationship between structures of incentives and lobbying, however, remains to be demonstrated. For some possible formulations, see Mitra 1989.) Higher time-bound assistance may be provided for a few selected sectors in which there are demonstrable learning externalities.

**Level of Protection**

The arguments about the structure of protection can equally be applied to its level. One argument (Little, Scitovsky, and Scott 1970) holds that manufacturers need special assistance because the market wage exceeds the real cost of labor as a result of distortions in the labor market and constraints on saving. Thus, if wage costs as a proportion of gross value added were on average 15 percent and the real cost of labor were 50 percent of the market wage (a generous allowance), the extent to which value added should be assisted is on the order of 5 to 10 percent. The authors further argue that in the poorest countries, if the wages of unskilled labor were as high as 40 percent of value added, the justifiable level of assistance to value added could be 20 percent. These estimates are no more than illustrative, given the widely ranging circumstances that govern the relationship between market wages and the real cost of labor in different countries. They do, however, provide a rough range within which, in the absence of superior schemes for subsidizing production, the average level of protective tariffs might lie.

The discussion of protective tariffs may be summarized in the observation that a uniform tariff at a level not exceeding 10 to 15 percent could be adopted as an acceptable rule of thumb in countries where administrative and revenue constraints preclude extensive use of factor- or production-based subsidies. Such a structure of incentives discriminates against exports, but the 10 to 15 percent range is thought by development practitioners to be low enough to limit discrimination. The discrimination may be partly offset by granting exporters duty-free access to intermediate inputs. Both common sense and experience suggest that practical schemes that give effect to such proposals—duty drawbacks, exemptions, bonded warehouses, duty-free zones, and the like—are easier to administer when tariffs are set at low levels. This has two significant implications.
The Treatment of Intermediate Inputs

First, access to duty-free imported inputs for exporters implies that domestic producers of such inputs would not be able to compete if they were to charge duty-inclusive prices. If, for example, garment exporters can import fabrics free of customs duties, they have no incentive to purchase locally produced fabrics at duty-inclusive prices. So countries have instead allowed "indirect" exporters, such as the local producer of fabrics, to import input requirements free of customs duty. This helps the fabric producers but does not entirely protect them from the need to compete with imported fabrics in their sales to garment exporters. If successful, however, the policy could help develop both indirect and direct exporting industries and deepen the benefits flowing from outward orientation.

Second, the difficulty of granting duty-free access at high tariff levels implies that attempts to unify tariffs at levels higher than 10 to 15 percent cannot be part of the recommended design. This presents a problem. Consider a situation in which tariffs on final goods are 30 percent, possibly (although this is not necessary to the argument) as a result of previous reform. Tariffs on intermediate goods used in the production of such final goods are low and, for purposes of this argument, may be taken to be zero. Effective protection to import-substituting final goods is therefore much higher than may be justified on learning-by-doing or other grounds. It is assumed, for reasons not usually specified, that the tariff may not be reduced any further. In what indirect ways may protection then be reduced? Two kinds of solution have been offered. The first (Harberger 1988) is an increase in the tariff on intermediate goods (the selective review by Rajaram 1990 suggests that tariff increases on intermediate goods have been recommended in certain countries). In fact, if an intermediate good accounts for x percent of the value of the final good under free trade, a tariff on the intermediate good at a level (100/x) times 30 percent would drive the effective protection on final goods to zero. Because x is less than 100, this level of tariff on the intermediate good would be higher than that on the final good. Harberger does not in fact recommend that tariffs on intermediate goods be set at that level. Instead he suggests, without further argument, that a uniform tariff on intermediate and final good imports is likely to be a satisfactory compromise. The second solution (Shalizi and Squire 1989) is to impose an additional domestic tax on the production of final goods without raising the tariff on intermediate goods.

Both solutions raise revenue and therefore do no budgetary damage. In fact, although neither Harberger nor Shalizi and Squire mention this, the extra revenue could be used to assist producers of final goods hurt by the reduced protection. The first solution offers considerable protection to domestic production of intermediate goods. But, by unifying the tariff structure at the unalterable level of 30 percent, it risks impeding administrators in developing countries from implementing schemes to allow exporters duty-free access to intermediate inputs: the inducements to leakage from bonded warehouses and the likelihood
of fraudulent claims for duty drawback are too great. In contrast, the second solution, by not raising tariffs on intermediate goods, does not complicate procedures to exempt exports from duties. But it offers no protection to intermediate goods and does not unify tariffs at a common level. Under the second scheme, there are two sets of tariffs: a higher uniform rate for final goods and a lower uniform rate (possibly zero) for intermediate goods, complemented by an additional levy on domestic production of final goods (this would be an excise tax intended to reduce protection for final goods).

In neither solution, apparently, is the protection of intermediate goods an issue. Harberger sees the tariff on intermediates principally as an instrument to adjust the effective protection of final goods; implicit in Shalizi and Squire's paper is the perception that the need to protect intermediates is not important in the Sub-Saharan African countries discussed in their paper. If it follows that there is no compelling reason to protect intermediate goods, and the only constraint is the presence of minimum unalterable tariffs on final goods, how is tariff design to be modified? It was mentioned earlier that the case for uniformity is based on the absence of compelling empirical evidence to support arguments for sectorally differentiated learning by doing or externalities. If protection of intermediates is not relevant, low protection for final goods and no protection for intermediates would be the preferred outcome. If this cannot be achieved by lowering tariffs on final goods, and if raising tariffs on intermediate goods would harm exporters (and the policy of outward orientation), an additional domestic tax would be desirable to forestall the high effective protection to final goods that would otherwise result. But if intermediates do deserve protection, their tariff rates should be increased to levels of 10 to 15 percent and an excise tax imposed if necessary on domestic production of final goods as well. The answer to whether intermediate tariffs should be raised from zero to 10 to 15 percent therefore turns on whether intermediates are to be protected in their own right.

Both Harberger and Shalizi and Squire without further discussion rule out the reduction of tariffs on final goods but allow the possibility of increasing tariffs on intermediate goods or levying additional domestic taxes on final goods. What exactly is the basis for this unalterability of the tariff on final goods? If, for example, tariff reduction is blocked by the desire of domestic producers of final goods to maintain a minimum level of protection, those producers may be equally successful in blocking either of the foregoing proposals to adopt indirect methods to reduce that level of protection. In that case, it may be no harder to press directly for the reduction of nominal tariff rates on final goods.

**Consumer Prices and World Prices**

We turn next to the wedge between consumer prices and world prices introduced by the customs duty-plus-sales tax. In the absence of the lump-sum taxes
of classical economic analysis, the purpose of the wedge is to raise revenue. The

government's needs for revenue thus determine the average size of this wedge,
while standard considerations of efficiency and equity guide its structure.

In a one-consumer economy without lump-sum tax instruments it is desirable
to raise revenue by taxing goods that are relatively complementary with
leisure more heavily and goods that are relatively substitutable with leisure less
heavily, where leisure is understood to represent an untaxed time endowment.3
Thus if all goods were equally substitutable for leisure, a uniform tax structure
would be desirable. In the more realistic many-consumer economy, the desired
structure of taxation is determined (a) as before, by substitution possibilities
with leisure, and (b) by variations in consumption patterns among different
consumers and income groups. The second determinant introduces crucial dis-
tributional considerations into the analysis. Thus uniform taxation would be
desirable if all goods were equally substitutable for leisure and if there were no
variation in consumption patterns across different households. These condi-
tions are implausibly stringent. But they can be relaxed if other instruments are
available to the government. If there is a well-functioning income support
scheme and income taxation that can appropriately target the basis of
differences among households, uniform taxation might under certain circum-
stances prove desirable even in a many-consumer economy (see Deaton and
Stern 1986).

Literally interpreted, these prescriptions would call for a complicated
structure of tax rates that could not be administered effectively. Analysis com-
paring optimal and uniform tax structures (see, for example, the calculations
reported in Ebrahimi and Heady 1988; Dahl and Mitra 1991; and Mitra 1992),
together with evidence from developing countries, suggests, however, that
acceptable outcomes may be obtained by implementing the following set of rec-
ommendations.

Structure of Consumption Taxes

First, consumption should be taxed over as large a part of the economy as
administrative constraints permit, and at a uniform rate. This policy does not
discriminate on the basis of the relationship of complementarity and substitut-
ability with leisure endowments, but because information on these is extremely
difficult to obtain, it is not uncommon to assume that all goods are equally sub-
stitutable with leisure. (There are analogies with the earlier situation in which,
in the absence of evidence on differentiated learning effects across infant indus-
tries, it was assumed that they are equally strong.) In practice, given the limited
reach of taxation in developing countries, the uniform tax will not apply to all
sectors at the same rate. Agriculture will be exempt from taxation except for its
purchase of taxed inputs, as will be enterprises in the informal sector and many
services. Once again, the situation varies across developing countries. The
middle-income countries of Latin América generally administer a value added
tax on consumption that extends through the retail level to the point of final consumption. In contrast, the Asian countries (with the exception of the Republic of Korea and the Philippines) and the low-income countries of Sub-Saharan Africa administer a VAT that extends only to the manufacturers' level.

Second, because well-functioning income support mechanisms are lacking and income tax is undeveloped, especially in the lower-income countries, exemptions and some differentiation in the rate structure of indirect taxes are needed to accommodate goals related to the distribution of income. The exemption of nonmarketed food in particular ensures that the tax system has acceptable consequences for income distribution. But a proliferation of rates should be avoided so that the indirect tax system is not required to serve too many objectives or to become too cumbersome to administer.

Consumption can be taxed under the VAT by allowing firms credit for taxes paid not only on raw materials but on capital goods as well. This form of tax also allows exporters refunds on taxes paid on capital goods, a provision that enhances competitiveness and exploits more fully the advantages of outward orientation.

The ensuing discussion makes a distinction between exemption and zero-rating and requires a brief explanation. Exempted sectors, because they are not part of a VAT, do not pay taxes on their output. By the same token, they cannot claim credit for taxes paid on their inputs. Hence exempted sectors are taxed on their inputs rather than on their outputs, whereas sectors under the VAT are taxed on their outputs rather than on their inputs. Zero-rated sectors, by contrast, are exempted from taxation on both their inputs and their outputs. Zero-rating therefore offers a precise way of according relief from taxation.

In most countries the VAT applies either a zero rate or an exemption to necessities, a standard rate to the majority of sectors, and a higher rate to luxury items and goods whose consumption the authorities wish to discourage. Table 2 provides some examples. It shows the main rates of VAT and additional rates applying to a subset of goods in countries of the European Community (EC) (which have used a VAT the longest), other European countries, selected Latin American countries, and Indonesia, Korea, New Zealand, and Taiwan (China). The rates shown are those that apply to domestic sales; virtually all of the countries zero-rate exports. Belgium has the largest number of different rates—six; two or three rates are more common. In Asia, Indonesia has a single rate; Korea and Taiwan, which began with single rates, now have three rates.

All the countries listed in the table have additional taxes on particular commodities. These are separate from the VAT and are therefore not subject to refund. In the EC these additional taxes are excise taxes on tobacco, alcohol, gasoline, and diesel oil. The rates vary widely from one country to another but are often higher than the VAT levied at either 10 percent or 20 percent on goods that are regarded as luxuries. In Korea, there is a special excise tax that is levied at rates between 5 percent and 100 percent on selected goods.

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Table 2. The Rate Structure of VAT in Selected Economies, January 1, 1988

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<thead>
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<th>Economy</th>
<th>Main rate</th>
<th>Other VAT rates</th>
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<td>Norway</td>
<td>20</td>
<td>11.11</td>
</tr>
<tr>
<td>Portugal</td>
<td>16</td>
<td>8, 30</td>
</tr>
<tr>
<td>Spain</td>
<td>12</td>
<td>6, 33</td>
</tr>
<tr>
<td>Sweden</td>
<td>23.46</td>
<td>3.95, 12.87</td>
</tr>
<tr>
<td>Taiwan (China)</td>
<td>5</td>
<td>15, 25</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>15</td>
<td>None</td>
</tr>
</tbody>
</table>

Note: Most countries use a zero rate for a few goods.

Thus distributional objectives may be accommodated through a second or luxury rate within the VAT or by imposing excises on luxuries entering final consumption, together with items such as cigarettes, alcohol, and petroleum products. Once again, the extent of differentiation in the rate structure must be chosen in the light of international experience and the country's administrative capabilities. The standard and luxury rates should, however, be applied symmetrically to domestic production and to imports, leaving the task of protection to customs duties.

In sum, the wedge between consumer prices and world prices should be set (a) at a single rate for all transactions that the tax administration is able to reach, with exemptions for items such as nonmarketed food that are consumed by the poorest, and (b) at higher rates for luxuries and other goods whose consumption the government wishes to discourage, with the extent of differentiation dictated by administrative capacity.

It has already been mentioned that the wedge between consumer prices and world prices is brought about through the operation of the customs duty plus
the sales tax or VAT. Recall the earlier example in which the c.i.f. price of an import in local currency is 100, the customs duty is 20 percent, and the sales tax 10 percent. Because the sales tax is levied on the customs duty-inclusive price (120) rather than the world price, consumer prices could be raised by a uniform proportion over world prices essentially only through a uniform rate of customs duty (which raises producer prices by an equal proportion over world prices) and a uniform rate of sales tax or VAT (which raises consumer prices by an equal proportion over world prices). That proportion would be given in this example by $(1.2 \times 1.1) - 1 = 0.32$. Luxury rates or sumptuary excises would be added to this price of 132 for selected commodities. This consideration accentuates the importance of integrating the design of a structure of customs duty and sales tax or VAT.

**Exports**

The tax and tariff recommendations proposed have so far paid little attention to the tax treatment of exports, except to suggest that inputs entering export production not be liable for customs duty or a VAT. In some circumstances, the taxation of exports is justified, but to the extent that exports are already implicitly taxed via import tariffs, arguments for further taxation should be carefully sifted.

First, a classical argument for export taxation is that world demand for a country's exports is less than perfectly elastic. But the relevant elasticity, as the formulation above makes clear, is not that of world demand as a whole, but of the demand for the country's exports, which, given competition among countries, will usually be much more elastic than world demand. The argument is further weakened by the consideration that long-run demand elasticities substantially exceed short-run demand elasticities. (The data in Imran and Duncan 1988 for cocoa, tea, coffee, and natural rubber confirm these observations.)

A quota on a country's exports, or "voluntary" export restraints, provides a second argument for export taxation. The purpose is to tax quota profits, and the tax should be set at a level that makes exports equal the quota in question. The Multifibre Arrangement and various commodity agreements furnish examples.

A third argument can be made for export taxation when possibilities for domestic taxation are restricted. Thus constraints on the possibilities of taxing agricultural land or income can justify the taxation of agricultural exports (for a review of the comparison between export taxes and land taxes, see Skinner 1991). The taxes can either be explicit or work through agricultural marketing boards that set prices received by farmers below international prices.

*World Development Report 1988* (World Bank 1988) notes that export taxes were used in at least fifty-three of the seventy-four countries singled out for a study of such taxes. The evidence also suggests that they are set at levels much higher than is justified by demand inelasticity or the need to substitute for...
unavailable land or agricultural income taxes. In such cases, export taxes should be replaced by more trade-neutral tax instruments.

**Optimal Policies versus Rules of Thumb**

The prescriptions outlined here do not describe optimal policies. Instead, they are rules of thumb for policymaking that at once are feasible with the administrative resources available to developing countries and acceptably address concerns of efficiency, equity, and protection. Harberger (1988), in contrast, argues for the optimality of uniform tariffs.

Harberger's argument is based on the notion that uniform tariffs guarantee efficiency. His argument is hard to assess because, notwithstanding references to "the protectionist motive," the paper nowhere states in what form one should think about protection either as an objective or as a constraint. Harberger reasons that "the uniform tariff goes on to point out the absurdity (from an economic point of view) of paying a domestic resource cost (DRC) of 22 pesos per dollar in one place, of 16 pesos per dollar in another, and of 10 pesos per dollar in a third place—all being cases of import substitution.... A country gains by moving towards equalization of the domestic resource costs of different import substitute activities" (p. 15). Because the measure of the DRC used here—factor use in each activity evaluated at market prices compared with value added at international prices—is equal, in a standard trade model, to 1 plus the effective rate of protection (ERP), the observation is equivalent to arguing that unequal ERPs are undesirable, from which the optimality of uniform ERPs follows directly.

The difficulty with this argument is that DRCs evaluated at market prices of factors have no significance for welfare in a distorted economy (Srinivasan and Bhagwati 1978). With distortions, the real opportunity cost to the economy of employing or withdrawing a factor from a particular activity is given by its marginal product in that activity evaluated, in the case of tradables, at their world prices and not at their market prices. To make statements on welfare in such an economy, the real opportunity costs of factors must be used in calculating the DRCs. Because only DRCs calculated using the real opportunity costs of factors have any welfare significance, and because this is not the case for DRCs calculated at market prices (which equal 1 plus the ERP), Srinivasan and Bhagwati argue that it is best to drop the terminology and concept of ERPs altogether from cost-benefit analysis. This implies that unequal DRCs at market prices in different import substitution activities cannot be used as evidence of economic inefficiency.

A different line of argument that makes the protection constraint on economic policymaking explicit may be attempted in support of Harberger's claim that uniform ERPs are superior. If the objective is, first, to extend special treatment to a subset of sectors in the economy (for instance, manufacturing), and second, to preserve uniformity of treatment within that targeted subset, a
form of protection constraint formulated by Bertrand (1972), policy interventions clearly would discriminate in favor of the subset compared with those outside but not within it. If there were no economic cost to providing subsidies—that is, if subsidies could be costlessly raised through lump-sum taxation—the objective would be achieved by a uniform subsidy to producers within the targeted sector. Furthermore, this uniformity would lead to uniform effective rates of protection if the aim were to encourage value added (that is, gross output net of intermediate inputs) in the targeted sectors. The argument, however, does not refer to distortionary tariffs at all but to production subsidies financed by lump-sum taxation. In particular, as Mitra (1987) points out, the argument for uniformity is undermined by the need to consider the economic costs of subsidies raised through distortionary taxation. Furthermore, revenue and administrative constraints preclude most developing countries from subsidizing local production, and most tax administrators do not have access to lump-sum instruments to finance those subsidies. This special case of subsidies financed at no economic cost is therefore of virtually no interest for policymakers. But Harberger’s recommendations on uniform tariffs, though they cannot claim optimality on theoretical grounds, may serve as acceptable rules of thumb in a wider class of situations, together with uniform indirect taxes, if they are combined with exemption of nonmarketed food and supplementary taxes on luxuries. This is a conclusion reached also by Balassa (1989) in a paper that synthesizes disparate literatures into a consistent package for policymakers.

Uniformity, then, is not optimal except in very special cases. Analytical study of taxes-cum-tariffs for policymaking would therefore be considerably advanced by identifying circumstances under which the pursuit of uniformity of taxes-cum-tariffs, supplemented by higher taxes on domestically produced and imported luxuries, would be seriously inappropriate, rather than constructing empirically implausible special cases where they hold exactly. Thus, as discussed earlier, weak income support mechanisms and undeveloped income taxation predicate distributionally motivated differentiation in the VAT. Recent research (see Heady and Mitra 1992) suggests that uniform VAT structures may also be quite unsuitable in economies where the public sector, for example, is characterized by extensive price controls. Appropriate rules of thumb have thus been more successfully sought in the design of tax structures than in the design of tariffs simultaneously with taxes. (For an integrated treatment, see Mitra 1992.)

The Simultaneous Reform of Taxes with Tariffs

Policy advisers are rarely called on to design a country’s tax-cum-tariff structure de novo. Usually, they are faced with the need to reduce a considerable anti-export bias in the trade regime brought about by import tariffs and
quantitative restrictions. At the same time, revenue constraints are typically acute, so that accompanying fiscal adjustments are necessary to preserve macroeconomic stability. How might the ideas on desirable structures developed in the foregoing be used to guide the reform?

Nontariff Import Restrictions

Relaxing and ultimately removing quantitative restrictions and import licenses is a standard component of trade liberalization. Schemes range from replacing a positive list of permitted importables with a negative list that allows imports of all items not appearing on it, to auctioning quotas or licenses, to substituting tariffs for nontariff restrictions (see World Bank 1989a). The latter two options increase public revenue. On the replacement of nontariff restrictions by tariffs, two points deserve mention. First, because the object of quantitative restrictions is protection, the customs duty, not the sales tax or VAT on imports, should reflect their replacement by tariffs. Second, this replacement makes public revenue more dependent on tariffs until such time as the country reduces protection and switches from tariffs to more trade-neutral sources of revenue, such as the sales tax or VAT.

Tariff Reduction

An easy stage of "reform" is provided by lowering tariffs that are set so high as to be ineffective, in that collection rates are significantly lower than statutory rates. Reducing those tariffs would increase revenue and raise protection for domestic import-competing producers while reducing protection (in the case of intermediate goods) for domestic users of the product. Removing the numerous exemptions characteristic of tariff codes in many developing countries would have a similar effect.

Matching Sales Tax or VAT

In the subsequent stages of tariff reduction, integrated analysis of taxes and tariffs suggests that the sales tax or VAT on imports should be matched with that on domestic transactions, so that both are taxed at the same rate. This transfers the protective function to customs duties. Customs duties that are purely revenue raising—those levied on commodities for which there is no domestic production—should be brought under the sales tax or VAT. (Because there is no domestic production of these items, the domestic sales tax on them will afford no revenue; the rate applying to them under the sales tax should nonetheless be the same whether the source of supply is imports or possible future domestic production.)
Matching the sales tax or VAT with respect to rates does not necessarily imply that the collection rate, defined as the revenue collection divided by the base, will be the same for imports and domestic production. Domestic taxes generally cost more to collect than trade taxes. World Development Report 1988 (World Bank 1988) reports that the administrative costs of trade and excise taxes range from 1 to 3 percent of revenue collected, whereas the corresponding figure for VATs can be as high as 5 percent (for personal income taxes, it is 10 percent). It is not, however, the average administrative cost but the marginal administrative cost of collection that is relevant in switching from protective customs duties to a VAT; unfortunately, no evidence is available on the extent to which these differ across taxes. Nevertheless, in practice, satisfactory matching of the sales tax or VAT for imports and domestic production requires a concomitant strengthening in domestic tax administration.

**Adjusting Trade-Neutral Taxes and the Exchange Rate**

The numerical example used earlier conveniently illustrates the kinds of adjustments necessitated by tariff reform. Recall that the c.i.f. price of the imported good was 100, the customs duty 20 percent, and the sales tax 10 percent, so that the producer price was 120 and the consumer price was 132. Lowering the customs duty by, say, 50 percent reduces the producer price to 110. However, because sales taxes are levied on the customs duty-inclusive price, this also reduces the consumer price to 121 \[= 110(1 + 0.1)\], so that reducing the customs duty lowers not only the relative producer prices of importable goods but their relative consumer prices as well. The result will usually be excess demand for those goods and a worsening of the current account deficit in the balance of payments unless it is offset by a policy of cutting absorption—that is, the sum of consumption and investment.⁶

A disabsorption policy typically combines measures to restrain expenditure and to increase revenue. Our concern in this article is with the revenue-increasing portion of the policy. This should take the form of raising the sales tax or VAT symmetrically for domestic production and imports, a move in the direction of restoring the tax wedge between consumer prices and world prices. But although the disabsorption policy will help to redress a potential imbalance in supply and demand for tradable goods, it will also reduce demand for nontradables. If the prices of the latter are (realistically) assumed to be downwardly rigid, a situation of excess supply will replace the equilibrium in the market for nontradables that prevailed before the tariff reform. This can be corrected by a depreciation of the exchange rate, which, by raising the domestic prices of tradables relative to nontradables, reduces excess supply of nontradables. The new equilibrium will be characterized by the prereform current account deficit (external balance) and equilibrium in the market for nontradables (internal balance) brought about by two instruments: a trade-neutral sales tax or VAT and the exchange rate. (For a particularly lucid exposition of the basic
balance of payments model, see Corden 1980, who does not, however, use that model to discuss tariff reform.) The trade-neutral tax is intended primarily to restore external balance, and the depreciation of the exchange rate to restore internal balance, but each of the two instruments contributes to both objectives of policy. The new sales tax or VAT rate and the exchange rate must therefore be set at levels that recognize their effects on those objectives (for a detailed application of this approach to one country, see Mitra and Go forthcoming). The resulting reformed equilibrium will generally be characterized by a higher dependence on a nondiscriminatory sales tax or VAT, a more depreciated exchange rate, and a lower relative price of traded to nontraded goods.

The estimate of revenue expected from increasing the sales tax or VAT rate structure must be adjusted downward by the increased cost that is incurred in collecting the extra revenue from the tax, net of the cost saving arising on the customs side. The marginal collection costs cannot be quantified, but it is worth bearing in mind that resources will have to be reallocated across the units entrusted with administration of the different taxes if the reform is to succeed.

Revenue and Protection Constraints on Reform

The extent to which revenue considerations limit the reduction of protective tariffs depends ultimately on administrative constraints on expansion of the domestic tax base. These will vary from country to country, but the following general point may be made. The evidence cited earlier shows that the importance of trade taxes in public revenue declines with per capita income, so that administrative impediments to finding revenue sources other than trade taxes can be expected to be most acute in the low-income countries. Would a reduction of protective tariffs therefore rapidly encounter revenue constraints in such countries? Not necessarily, for the low-income countries do not have a diversified manufacturing sector and therefore many of their import taxes are mainly revenue-raising rather than protective. Because liberalizing trade should aim to reduce protective rather than purely revenue-raising tariffs (the latter being absorbed within the sales tax or VAT), the extent of revenue lost from tariff reduction will in fact be much smaller than if tariffs had been predominantly protective, and the adjustment in domestic tax structures required to offset the loss will be correspondingly modest.

How much considerations of protection themselves limit the reduction of protective tariffs will be strongly influenced by the ability of import-competing producers to preserve the implicit subsidy that the tariffs provide. With existing tariff levels in many countries well in excess of the recommended range of 10 to 15 percent, a policy of outward orientation will clearly require a significant reduction in protection of import-substituting sectors. Producers will need time to adjust. Other time-bound forms of assistance could assist the transition (some possibilities are explored in the next section).
The literature on international trade discusses two paths to tariff reform (for an extended discussion, see Corden 1974). One is the concertina method, which collapses the structure by reducing the top rate at each step of the transition to the next-highest level, while leaving other rates the same. A second is the radial method, whereby at each stage all tariffs are reduced to a fraction of their previous levels. The conditions under which these methods improve matters are stringent. The concertina method, to improve welfare, essentially requires substitutability among commodities—a property almost certainly absent when intermediate and capital goods, as well as final goods, are imported. The radial method improves welfare only if there are no domestic taxes or, more generally, if those taxes are also reduced radially—conditions that would significantly erode the country's revenue base. Furthermore, both methods require the government to offset the revenue gains and losses at each stage through lump-sum taxes and subsidies, a feature that greatly limits their relevance for policy. As a practical alternative, it would be preferable at the outset to preannounce the desired tariff structure and to evolve a realistic timetable that takes into account the problems of adjustment in sectors most heavily affected by the reform.

**Toward Explicit Assistance**

The government can help producers adversely affected by tariff reduction as they adjust to the new regime. For instance, a tariff on a key intermediate good such as steel may have been imposed to protect one or two large and visible high-cost local producers, possibly but not necessarily in the public sector. Reduction of the tariff on steel is recommended in order to make downstream producers, say producers of light engineering goods, more competitive in export markets. The government agrees with that objective but is concerned that the reform would make local producers of steel uneconomic, threatening jobs and leading to other negative consequences. In such a situation, where the affected producers are few and visible and almost certainly registered with the domestic tax authorities, it would be administratively feasible to assist them with subsidies, with the required revenue coming from a further upward adjustment in the sales tax or VAT. Such a policy, unlike tariff protection, would have the advantage of being explicit, more open to periodic budgetary scrutiny, and hence more time-bound than assistance through tariffs.

**Conclusions**

Because lack of supportive macroeconomic policies can delay or reverse trade liberalization programs, it is important to prevent potential losses in public revenue arising from tariff reductions from exacerbating macroeconomic difficulties. The risk of pursuing tariff and tax studies independently is that the
implications of tariff reform for revenue and the implications of tax reform for protection may not be properly integrated, with negative consequences for the credibility of policy change.

The adoption of a more comprehensive public finance perspective on policy reform is made easier by the fact that even the poorest countries have essentially two sets of instruments for the taxation of imports—customs duties and sales taxes or VATs—that are usually levied on the customs duty—inclusive value of imports and that apply to domestic transactions as well. Because the customs duty raises the price facing producers of an import above the world price, it is a subsidy to domestic producers. Because the sales tax or VAT, together with the customs duty, raises the price facing users of the import above the world price, they constitute a tax on domestic users. The customs duty can then serve protection objectives, while the two together can be designed to meet revenue requirements.

**An Integrated Structure of Taxes with Tariffs**

The following prescriptions provide a point of reference toward which reforms may be directed:

- a basic customs duty at a uniform rate of no more than 10 to 15 percent
- a basic value added tax on consumption, applied at a uniform rate, depending on revenue requirements, to domestic production and imports and exempting agriculture, in particular nonmarketed food consumed by the poorest
- a luxury rate of excises applied at a common rate to domestic production and imports of selected items
- zero-rating of exports under the value added tax
- exemption of imported inputs entering export production from customs duty
- taxes on selected exports when world demand for the country's exports is expected to remain less than perfectly elastic, or when the country is subject to export quotas, or when there are significant constraints on land or income taxes.

The article argues that these elements must be looked at as part of an interrelated package so that, for example, attempts to unify customs duties at levels higher than the recommended range would create administrative problems in implementing duty exemptions on inputs entering export production.

The prescriptions are rules of thumb that can generate broadly acceptable outcomes in terms of efficiency, equity, and protection and that should be flexibly applied in the light of country circumstances and administrative capability. They are not properties of optimal tariff and tax structures. Thus analytically oriented studies of taxes and tariffs would be more valuable to policy advisers.
if they were to identify circumstances in which pursuing such rules is likely to be inappropriate, rather than to construct empirically implausible special cases in which they hold exactly.

**Coordinated Reform of Tariffs and Indirect Taxes**

Coordinated reform of a distorted structure of tariffs and indirect taxes in accordance with the principles just enumerated will include the following components:

- Tariffs too high to be effective, for which collection rates are significantly lower than statutory rates, should be lowered. The numerous exemptions characteristic of tariff codes should be eliminated.
- The sales tax or VAT rates on domestic production and imports should be matched, so as to transfer the function of protection to customs duties. Customs duties on items for which there is no domestic production and which are therefore purely revenue-raising should be made part of the sales tax or VAT—that is, they should apply at the same rate to imports and possible future domestic production.
- The desired tariff structure should be preannounced and a realistic timetable developed that takes into account the problems of adjustment in sectors most heavily affected by the reform.
- To lower customs duties to reduce the excess of producer prices over world prices (the element of protection) would require an upward adjustment to the sales tax or VAT structure and—if nontradable goods prices are downwardly inflexible—a depreciation of the exchange rate, to maintain external and internal balance in the economy.
- Export taxes in excess of levels justified by less than perfect elasticity of world demand for the country's exports, or quotas on the country's exports, or voluntary export restraints, or restrictions on more targeted instruments such as taxation of land or income in the sector from which exports originate should be replaced by trade-neutral taxes.
- Demands for adjustment assistance arising from sectors adversely affected by tariff reductions may be met by an additional upward adjustment in the sales tax or VAT rate. Such assistance, if extended through the budgetary process, would have the advantage of being explicit and thus subject to periodic scrutiny.

**Notes**

Pradeep Mitra is a lead economist in the South Asia Region in the World Bank. An earlier version of this article—a product of the Public Economics Division in the Country Economics Department—was presented at the World Bank Conference on Tax Policy in Developing Countries, March 28–30, 1990.

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1. An agenda for the simultaneous reform of tariffs, quantitative restrictions, exchange rates, indirect taxes, and government expenditure is developed for a particular country in Mitra and Go (forthcoming).

2. We ignore here the departures from free trade that may be justified by the "new" trade theory. Their relevance for developing countries remains to be established. See, for example, Srinivasan (1989).

3. The result follows from a desire to tax the consumer's endowment. It is common to choose leisure as the endowment good. It could equally be interpreted as nonmarket time. For a careful statement of these conditions, see Stern 1987.

4. VAT systems that do not allow credit for taxes paid on capital goods—"income-type" VATs—are generally not used. Exceptions among developing countries are Argentina, Peru, and, to some extent, Turkey. Income-type VATs by definition credit taxes paid on purchases of capital goods only when the goods depreciate: depreciation accounts must therefore be maintained if such VATs are to be implemented. In practice, however, the depreciation provisions used in Argentina and Peru are very generous. In contrast, VATs of the gross product type, as practiced in Finland and Morocco, do not allow tax credit on depreciation.

5. International opinion is divided as to what framework is appropriate for the tax treatment of luxuries and other goods whose consumption the government wishes to discourage. One option is to incorporate luxury rates on income-elastic goods within the VAT, with additional sumptuary excises on selected items. A second option is to use a single-rate VAT with sumptuary excises outside the VAT.

6. This statement would need qualification if the government, which loses tariff revenue, has a pattern of consumption which, compared to that of the private sector, is more heavily oriented toward traded goods. That qualification does not, however, affect the conclusion of the next paragraph, namely, that two instruments are needed to achieve internal and external balance.

7. In a review of the World Bank’s approach to subsidies, Myers and Brondolo (1986) take the view that explicit subsidies are preferable to implicit subsidies and that it is undesirable to finance subsidies through nonbudgetary instruments.

References

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