ActionAid International Briefing

Trade taxes

Progressive Taxation Briefing

What are trade taxes?

Trade taxes, as the name suggests, are charged on the value of products that flow into and out of a country, notably in the form of import and export duties. Imports can also generate significant amounts of value-added tax (VAT), though import VAT is usually considered to be a domestic rather than a trade tax.

Trade taxes, also known as tariffs, stretch back into ancient history although in modern times, as countries have become more prosperous, revenues from other kinds of taxes have come to play a larger role in the total tax take. Developing countries, and particularly low-income countries, have until recent decades relied heavily on trade taxes because they are relatively straightforward to assess and collect.

There are two major concerns about trade taxes. One is the effect of trade agreements in eliminating or reducing the taxes that can be charged, which can also be driven in practice by tax competition between countries when duty exemptions are offered as tax breaks. Lower trade tax income means that less revenue is available to be spent on public services, obliging governments to increase their income from other sources. The other concern is the extent to which the incidence of trade taxes falls on the poorest in society. Export taxes can undoubtedly be burdensome for producers, especially small manufacturers and farmers which governments should be supporting. The cost of import duties may also be passed on to people living in poverty in the form of higher prices on imported goods, or on imported inputs and raw materials which go into products consumed by the poor.

On the other hand, import duties do perform some potentially valuable functions, such as offering a measure of protection to domestic producers who find themselves competing with foreign corporations able to produce at a lower cost. Such protections have been a key part of developing formerly poor economies, such as those of

Southeast Asia from the 1960s through the 1980s. That does not make the tax progressive, of course, since it can raise the price of goods bought by the poor, but such taxes can be part of creating a healthier domestic economy in the medium and long term. For this reason, the elimination of most trade taxes by trade liberalization has been blamed for damaging efforts to build self-reliant domestic economies.[1]

Financial transaction taxes (FTT) are another form of trade tax. This is a tax on financial transactions such as trade in shares or currencies. Such a tax already exists in some form in around 40 countries and in 2011 raised around US$38 billion.[2] A proposed new FTT in the EU would raise an estimated US$23.5 billion annually.[3] Both developed and developing countries that do not yet use FTTs could benefit from exploring their use at both the national and regional levels.

Trade tax rates have been falling since the 1970s, in line with the spread of neoliberal economic orthodoxy favouring open markets and the reduction of trade 'barriers', as manifested in structural adjustment policies mandated by the International Monetary Fund (IMF) and World Bank in the 1980s and 1990s.[4] Several expert analyses in recent years have found that after lowering trade taxes, developing countries have often found it difficult to make up the lost revenues from other taxes, despite efforts made to do so, notably through increasing VAT (which tends to fall more heavily on poor people).

A 2005 study, published by the IMF itself, found that high-income countries were easily able to make up revenue lost from reducing trade taxes out of other sources. The study suggested that middle-income countries only made up between 45% and 65% of the loss, and low-income countries only made up about 30% of the lost revenue, reflecting the reality that these countries tend to have much narrower domestic tax bases on which to draw.[5] A more recent study, published in 2016, suggested that more than half of developing countries experienced losses equivalent of up to 3% of Gross Domestic Product (GDP) after lowering trade taxes. Some 40% of low-income countries and 34% of middle-income countries did not replace any of the lost revenue during the study period (1970 to 2006). The study concluded that "the typical trade liberalisation reform in developing countries since 1970 was not revenue-neutral but [led] to a decrease in total revenues."[6] Despite such concerns, the IMF has been an enthusiastic advocate of replacing trade taxes with VAT.

High-income countries did not experience these problems because they reduced trade revenues at a much later stage in their development, when their economies were large enough to make up the losses from other taxes. These findings echo what critics of the IMF-led approach to trade liberalisation have long argued: that policies derived from the experience of high-income countries have been inappropriately pressed on developing countries.

How can trade taxes be made more progressive?

If the cost of import duties is passed on to consumers in the form of higher prices on goods which are imported (or which use imported inputs), then people will bear the cost of the tax. If poor consumers spend more of their incomes on these particular imported goods than rich consumers, then the tax will fall disproportionately on them. But because import duties cover a wide variety of items, understanding their effects on the poor will depend on analysis of what people actually consume (as with VAT).

Governments may also grant exemptions for social purposes, such as for key food products relied on by consumers, or as a tax incentive for investors. An example of the latter is Zambia's reduction to zero of import duties on some machinery used in the textile industry and in the production of vehicles.[7]

Examples of good and bad uses of trade taxes

Despite the significant losses in tariff revenue in recent decades, trade taxes still form an important source of revenue for developing countries. The extent of this reliance – and, therefore, the potential impact of trade liberalisation on tax revenues – varies from country to country. **Ghana**, for example, raised an average of 15% of its total tax revenues from import duties between 2012 and 2016, compared to only 8.5% of total revenues in **Uganda**. Ghana's duty on cocoa exports, which raised another 5% of total tax revenues, has no equivalent in Uganda.[8]

Such variations, as well as differing patterns of international trade from one country to another, mean that the effect of lowering or abolishing trade taxes will be felt differently in different developing countries. A 2012 study, which drew on the findings of several previous studies, suggested that the impact of an Economic Partnership Agreement (EPA) with the European Union, which requires developing countries to lower their tariffs on most goods over a period of years, would be "very high" for Ghana and "high" for Uganda, but "moderate" for Mozambique and "low" for Zambia. Based on data from the mid-2000s, this study suggested revenue losses over time of anything from 8% to 22% of total tax revenues in Ghana, while for Zambia, by comparison, the losses might be between 0.7% and 3%.[9]

A 2013 ActionAid Ghana study estimated that under its Economic Partnership Agreement (EPA) with the European Union, which was in force on an interim basis at the time, Ghana would lose US$88.6 million a year in revenues from import duties between 2008 and 2022. The study assumed that if Ghana did not proceed with the EPA, taxes on trade with the EU would fall anyway, in line with a trend of declining imports from the EU, but could be made up by taxes on trade from other sources.[10]

Recommendations

Governments should:

- *Be wary about entering into trade agreements that strip away their rights to tax trade.*
- *Carry out impact assessments of the likely revenue costs and the prospects for recouping that revenue from other sources, before undertaking trade negotiations.*
- *Collect more and better data on income and consumption patterns among the poorest citizens, particularly women living in poverty, and then use this data to assess whether to help them by exempting goods and services on which they depend from import duties.*
- *Be transparent about exemptions or reductions in import or export duties and discontinue those exemptions whose benefits to the public are outweighed by their costs in foregone revenue.*
- *Be willing to remove export duties on products produced by the poor, for instance cash crops grown by small farmers or items made by small manufacturers.*
- *Explore greater use of financial transaction taxes at national and regional levels.*

This is one of a series of briefings on Progressive Taxation published by ActionAid International in October 2018. You can find them at www.actionaid.org/taxpower

Endnotes

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