Journal of International Economics 56 (2002) 489–507
www.elsevier.com/locate/econbase

Journal of INTERNATIONAL ECONOMICS

Coordinating tariff reduction and domestic tax reform

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Received 3 May 1999; accepted 28 February 2001

Abstract

A key obstacle to fundamental tariff reform in many countries is the revenue loss that it ultimately implies. This paper establishes and explores a simple and practicable strategy for realizing the efficiency gains from tariff reform without reducing public revenue, showing that for a small economy a cut in import duties (respectively, export taxes) combined with a point-for-point increase in domestic consumption taxes (production taxes) increases both welfare and public revenue. Increasingly stringent conditions are required, however, to ensure unambiguously beneficial outcomes from this reform strategy when allowance is made for such important features of reality as non-tradeable final goods and tradeable intermediate inputs. © 2002 Elsevier Science B.V. All rights reserved.

Keywords: Tariff reform; Tax reform; Intermediate inputs; Imperfect competition

JEL classification: F12; F13; H20

1. Introduction

Tariff reform continues to be a pressing policy issue in many developing countries. Reducing trade barriers is frequently a core and problematic element in programs of structural adjustment, while the prospective scale of liberalization for some countries remains substantial. Pakistan, for example, cut its maximum tariff from 45 to 35% in 1999, having reduced the ratio of import duties to import value

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PII: S0022-1996(01)00123-4

over the previous decade from 42 to 22%; substantial reductions, but clearly far from full liberalization. The slow progress seen in many countries doubtless reflects in part the power of vested interests. Perhaps the most important obstacle, however, is even simpler: trade taxes continue to be a major source of revenue for fiscally stretched governments. In Africa, most spectacularly, the share of trade taxes to GDP, which stood at 6.7% in 1975, was still 5.5% 20 years later.[1] Thus, a key concern for any such country contemplating the liberalization of its tariff structure must be with how it is to recover, from other sources, the revenue loss that must ultimately be entailed.[2]

The literature offers surprisingly little guidance on this. There exists a substantial and mature theoretical literature on the welfare effects of piecemeal tariff reform – central contributions including those of Hatta (1977) and Fukushima (1979), with thorough reviews provided by Dixit (1985) and Woodland (1982) – but this pays scant attention to the revenue consequences of tariff reform,[3] typically precluding any revenue motive for the deployment of tariffs by supposing the revenue they yield to be returned to consumers in lump-sum form. Thus, most of this literature simply assumes there to be no tax distortions other than tariffs: and if that restriction is relaxed, then many standard results of the literature fail (see Beghin and Karp, 1992). Reflecting this narrow focus of the literature on tariff reform, remarkably little has been written on coordinated tax-tariff reforms.

As a matter of general principle, it is of course well-known that it is optimal for a small open economy to raise any revenue it needs by setting all tariffs to zero and relying entirely on destination-based taxes on consumption (Dixit, 1985): this indeed is a straightforward application of the Diamond and Mirrlees (1971) theorem on the desirability of production efficiency. While this implies that there exists some way of replacing tariffs with domestic consumption taxes so as to raise welfare while maintaining revenue, it would be helpful to go beyond this existential observation to provide policy makers with some specific guidance as to precisely what such a reform might look like.

The literature offers few such insights. Informal discussions of coordinated

[1] Ebrill et al. (1999), Table 2.

[2] See for example the discussion of tax reform strategies for developing countries in Burgess and Stern (1993). It should though also be noted that partial measures of trade liberalization need not lead to lower revenue from trade taxes, and indeed Ebrill et al. (1999) show that in many instances trade tax revenue has remained buoyant (perhaps because of protectionist motives leading to tariffs at above revenue-maximizing levels, partly too because some measures of liberalization – such as the tariffication of quotas – directly increase trade tax revenue). However, since revenue from a fully liberalized trade structure is zero, there must come a point at which liberalization reduces revenue from trade taxes.

[3] A notable exception being Falvey (1994) who studies conditions under which a reduction in tariffs raises both welfare and public revenue. See also Dahl et al. (1994).