The fiscal impacts of trade liberalization

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The fiscal impacts of trade liberalization represent an important aspect that relatively recently has begun to gain relevance. The Monterrey Consensus (2002) with its call to achieve "Coherence and consistency of the international monetary, financial and trading system" establishes, undoubtedly a guideline to follow in the elaboration of policies in both areas of this relationship: trade and fiscal.

Center of Concern has actively promoted efforts of civil society groups working both in the area of trade, as in the area of finances, in order to examine the concrete consequences that trade and financial policies may have and make an integral analysis of both of them. Looking at it closely, important consequences for the design of policies in the trade and the financial areas can be drawn from this integral vision. The idea of this analysis, however, is beyond what is merely academic. The purpose is to evaluate whether what is being developed in terms of trade policy will have a positive impact in the area of finances, and viceversa. This presentation focuses specifically on fiscal policy, e.g. what type of fiscal policies should be defined to better support trade for development?, what type of unilateral and bilateral trade policies should be supported in order to improve fiscal revenue?, etc. This is an exercise of wide consequences.

The aspect of long term income

In the context of the neoliberal model, which predicates the long terms gains of trade and investment liberalization through a growth of GDP, there is no question that, even if there are some negative fiscal impacts in the short term, the liberalization will lead to compensate them and, eventually, larger fiscal revenue derived from growth of economic activity that serves as base for taxation.

A number of free trade agreement negotiations tend to be driven by the assumption that the financial consequences of liberalization of trade and investment will be a greater income through larger exports and attraction of FDI.

This type of analysis leads, for instance, to recommend borrowing in order to finance public fiannces adjustment that may become necessary when trade is liberalized. In order to implement this adjustment, which is deemed temporary, the International Monetary Fund (IMF) has launched three years ago an instrument, the Trade Integration Mechanism (TIM). Originally, this mechanism did not contemplate the loss of fiscal income, at least not explicitly, as one of the situations where it would be applicable. In a recent reformulation of the mechanism, made in the framework of the discussion on "Aid for Trade", this situation was explicitly added. The Trade Integration Mechanism would, thus, be a policy for

[1] Paper prepared for the Seminar/Workshop: Fiscal Policy in the New Political and Economic Scenario of Latin America. Organized by CEDLA, La Paz, Bolivia, March 14, 2007

countries to be able to borrow from an existing facility, or augment an already outstanding loan, with the purpose of financing fiscal revenue lost due to trade liberalization.

However, except for some facilities such as the PRGF (or ENDA which is not relevant to the case of fiscal reforms), the Fund facilities are not concessional. This means that a rate similar, or very close, to the market rate must be paid on the borrowed funds. Therefore the proposal is, basically, to increase debt in order to repair what is considered to be a temporary adjustment of the balance of payments. This only makes sense if it is true that liberalization leads to increased growth, hence enabling repayment. But the support to this assertion in reality is, until today, still uncertain. Several studies have shown that there is no systematic relationship between the average tariff and non-tariff barriers of a country and its economic growth. (Malhotra, K. 2004) Similarly, the evidence does not support the assertion that increased FDI leads to increased growth. (Milberg 1999; UNCTAD 2003, 76) And the very link between investment liberalization and increased FDI – or increased investment altogether—is not exempt from challenges.

So, this data are important in evaluating the possible long term impacts on fiscal revenue.

The aspect of short term income

With regards to the most immediate, short term impacts, they are relatively well established, and are admitted even by those who defend the benefits of trade liberalization.

The negative fiscal impacts have received renewed attention in the last years and the developing countries have complained that the pressure to liberalize puts them in the dilemma of either breach trade commitments or fuel unsustainable fiscal deficits (eventually fueling larger public debt). Paradigmatic of this is the case that Argentina brought before the WTO in the late 1990s, to be allowed to impose a tax that it considered necessary under the conditions of its agreement with the IMF.

It is important to bear in mind that, for low income countries, trade-related taxes are an important source of income that normally diminishes when they liberalize (WTO 2003; Wise and Gallagher 2006)

While those defending the benefits of trade liberalization argue the losses are rather small, a research team has found that “tariff losses for developing countries could outweigh the benefits by a factor of four.” Moreover, these losses are not reported in the discussions of trade gains because the modeling exercises assume that fiscal balances of governments are fixed, that is, that tariff income losses will be compensated by other taxes. (Wise and Gallagher 2006:3) These same researchers quote UNCTAD which has shown that just tariff losses related to NAAM –the industrial goods agreement being negotiated in the WTO Doha Round—could reach the amount of 63.4 billion dollars.

Against this backdrop, trade liberalizers also argue that government revenue losses should not be an obstacle to liberalize as they can be recovered by resorting to other taxes. For instance, this has been the IMF position. (WTO 2003) In particular, the IMF recommends

the replacement of the income establishing value added and sales taxes. But, is this a feasible solution?

The capacity of low-income countries to recover income losses is limited. Implementing other taxes, such as value added taxes, demand more administrative capacity that many countries do not have, and has negative consequences for income distribution. (Economic Commission for Africa 2004) A report published in 2002, looking at a panel of 84 countries between 1970 and 1998, concluded that low- and middle-income countries had experienced lower fiscal income as a result of a fall in trade related tariffs and income, with structural characteristics justifying this reduction. (Khattry and Rao)

More recently, IMF researchers have accepted the reality of the practical problems of recovering the income lost from trade-related taxes. This study, reviewing a panel of information of 125 countries concludes that middle-income countries had been able to recover between 35 and 55 cents per dollar of income from lost trade income, whereas lowest income countries had recovered basically none. (Baunsgaard and Keen, 2004) Nonetheless, instead of leading the IMF to rethink its advice on liberalization, the general reaction to these findings has been to recommend more caution in the design of tax reforms that should accompany trade reforms.

Looking further into the distributional impacts, a study conducted by Stiglitz and Emran (2005) stated that the general consensus on the virtues of replacing trade taxes income with taxes on internal consumption does not take into account the structure of developing countries. The larger the sector of the informal economy, the larger the welfare costs of such a policy as this will increase inter-sector distortions between the formal and informal sectors. (Stilglitz and Emran 2005, 600)

Investment liberalization also brings negative fiscal consequences. A commonly understood manner this happens is through the phenomenon of tax competition. The cost of strategies based on less taxation as a way to attract FDI may well outweight the benefits expected from such investment flows. The costs are associated to 1) the loss of income for the recipient government (Morisset et al 2001, 94) and 2) the difficulties of administering in an effective manner such schemes, especially in developing countries (Ibid., 95)

Nor should the impact of practices such as transfer pricing be underestimated. Transfer pricing is associated with the growing internationalization of cross-border transfers of goods, services, know-how, technology and intellectual property between "parent" and affiliated companies. While the purpose of Framework Agreements on Transfer Pricing is to promote reasonable fiscal income for all countries involved, this is far from being the most common case. Thus, the transfer pricing has direct effects on the fiscal income of recipient and source countries. (UNCTAD 1999, 3) Paramount among the measures that could reduce the revenue damage caused by transfer pricing are some performance requirements, typically banned by in investment liberalization processes and rules (see, for example, Tang 2003) Certainly, two key measures to reduce the possibility of this practice are local sourcing and foreign exchange balancing requirements, both banned by the TRIMS agreement of the WTO.

It may be in the area of services, however, where the greatest problems to prevent transfer pricing are observed. The complexity of services transactions, the relative novelty and innovation they present and the difficulty to value and price the different components, may be an insurmountable difficulty for the controlling public agencies. This is even the case in the most advanced countries. (Financial Times, 2005) Therefore, it is even more of a problem in developing countries, given their difficulties to regulate such activities. In a survey UNCTAD revealed that 41 percent of developing countries did not, at all, address services in their regulations, administrative guidelines and requirements on transfer pricing.

More in general, a number of studies have pointed out the inevitable result of free movement of capital tends to be a greater difficulty in taxing capital and a consequent increase in the weight of wages and consumption taxes in the total fiscal revenue. (IDB 2004, 7) These trends are not unique to developing countries and the same trends have been found in OECD countries (Ibid.) but in the former is where they show themselves with the more intensity because the difficulties and flaws of the control infrastructure on mobile capital are, obviously, greater.

It is worth noting that the World Bank and the IMF also encourage lower tax levels with their packages of recommendations to improve the investment climate and, that way, attract FDI and promote exports. The hypothesis seems to be that a lower tax level on export gains is a precondition to increase exports, without which the necessary investment for production and exports might not take place. At the same time, export-oriented FDI would go up. From a perspective of growth and capital accumulation it is worth asking, of course, to what extent is it beneficial to increase exports whose revenue cannot be appropriated domestically.

An example of the evaluation of investment climate by the World Bank is its Annual "Doing Business" report, published since 2004, which includes a ranking of economies based on "the ease of doing business." Governments get desperate to climb up those rankings because they guess the higher up they are in the ranking, the more foreign investment is going to seek the country It has been observed that the rankings do have an impact in making countries introduce reforms. Regarding the fiscal theme, taxation is one of the criteria taken into account in preparing the "Doing Business" report, and one of the three elements that are considered within this item is that the lower taxation on companies is, the higher in the ranking the country will be. Like the other indicators, this applies to all countries in a one-size-fits-all fashion, no matter what is the revenue profile (or efficiency of public revenue use) in each case, which makes the indicator completely indefensible.

It is important to explain the role of agencies such as the Bank and IMF because it shows that the liberalization of investment does not only come from treaties, but also from conditions imposed and the pressure that emerges from rankings created by external actors that generate a perception that more investment can be lured by applying certain policies (not a result that is endorsed by the available evidence, either).

The aspect of expenses

In assessing the fiscal impacts of liberalization it is not enough with looking at the income aspect, but it is also necessary to look at expenditures, and the increased public expenses generated by trade liberalization.

The demands of a growing regulatory and institutional burden as a result of trade agreements has been mentioned as a source of expenses that adds to the shattered budgets of low-income countries engaged in liberalization. A widely cited review of the impact of new rules on developing countries puts the costs of compliance in only three areas: customs valuation, TRIPS and sanitary and phytosanitary measures, around the 150 million dollars per country. (Finger and Schuler 2000)

This estimate not only does not include all rules. It also does not include all costs a government needs to incur in order to modernize systems of production and infrastructure so they can respond to the demands of a more intense competition. The taking of huge "competitiveness loans" that accompanies the signing of trade agreements in countries such as Costa Rica, Colombia and Perú, shows the impact of these infrastructure on the public coffers.

The cost of provision of basic services by the State in the face of the dislocation of employment conditions created by trade liberalization, the inequalities of coverage brought by services liberalization or the adoption of patent protection, is relatively less studied, but can be considerable, as researchers from UNDP have brought to attention. (Heuty 2004) For instance, the state must absorb the burden of dislocation of employment conditions created by trade liberalization. It also must absorb the gap services liberalization opens in the access to essential services for a sector of the population, inequalities of coverage, as well as the provision to entire sectors that are priced out of coverage due to rate increases. At the same time, because of the same liberalization process, the state does no longer have the taxing and cross-subsidizing capacity that it had when it was in charge of the general provision.

Finally, within this chapter of expenses, it is important to mention government procurement. Government procurement is one of the proposed chapters of the FTAA. Likewise, it is a segment of the model FTA pursued by the US in its bilateral negotiations. And it is, as far as services procurement is concerned, covered by provisions of the GATS. Disciplines to liberalize government procurement were also one of the "new issues" that the Doha Round was promoting until they were left aside after the collapse of the 2003 Cancun Ministerial. At a unilateral level, reform of government procurement is frequently recommended by the Bank and the IMF as a condition for financial assistance packages. Under the heading of transparency of government procurement, it is not unusual to have these institutions recommend also liberalization disciplines (e.g. National Treatment).

The implementation of National Treatment rules in the field of government procurement seeks to discipline government purchases and prevent the government from assigning quotas to direct part or all of its expense to local companies. It is true that some positive fiscal consequences may emerge, as greater competition may bring down prices of goods and services supplied to the government. But it is also important to take into account that contracting foreign providers represents a drain on public resources of funds that could be

transferred inside the national economy being, in this case, also subject to further taxation, as part of the profit of other actors of the national economy.

Conclusions

This presentation finishes, then, recommending that governments review the rules of trade –within or outside agreements—that it is in their interest to apply, having very especially in mind the impacts they will generate on the fiscal system. This is not a frequent exercise, particularly as it requires a high level of coordination among ministries with different portfolios, but it is surely one whose results will more than justify the efforts.

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