

# Reforming indirect taxation

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**Objective: draw lessons from the reforms initiated in the late 1980s.**

## **Initial objectives of the reforms**

- Reform the customs tariffs, the only protection measure, to gradually liberalize the economy.
- Adopt the most neutral domestic taxes possible, to mobilize revenue to offset the effect of lower tariffs.



# Key aims of reforms

- Replace non-tariff protection measures with tariffs.
- Make the protection system more neutral by (1) reducing differences between the effective rates of protection offered; and (2) lowering the average level of protection.
- Offset loss of revenue by taxing domestic consumption, a more efficient mechanism than tariffs.



# Aspects of systems recommended for the reforms

- A customs duty with three or four positive rates between 5% and 25 – 35 %to reduce dispersion.
- Subject to administrative capacities, replace turnover tax with a flat-rate VAT, a limited list of exemptions, and a fairly high threshold for liability.
- Excise taxes on targeted products such as alcohol, tobacco, petroleum.



# The role of regional integration agreements (RIAs)

- In the late 1990s, they facilitated the adoption of tariff reforms that faced some resistance at the country level (dilution effect).
- The number of agreements and their overlapping signatories made the implementation of trade and tariff policies more complex.
- They promoted the harmonization of domestic indirect taxation (VAT, excise tax).



# Results of revenue mobilization

- Countries that chose to implement VAT mobilize more revenue.
- Most middle-income countries have succeeded in offsetting lower tariff revenue. What matters is not whether they impose VAT, but the quality of the system (flat rate, high threshold) and its implementation.
- Less obvious for low-income countries, given marked differences between them.



# Challenges in implementing tariff policies

- Determining customs values is always problematic.
- The customs tariff is the “common law,” but many imports are exempt (investment codes, sector codes, NGOs, externally funded projects).
- Key reasons for the proliferation of exemptions: tax competition, high rates (20-35%).



# The constraints of belonging to a customs union

The adoption of a Common External Tariff (CET) is a compromise entailing delegation of tariff policy to regional authorities, hence:

- Incentive for members to divert CET to preserve national interests.
- Member states' reluctance to request modifications tends to freeze the CET structure.





# Problems in the VAT implementation mechanism

- VAT neutrality, its main advantage, is compromised by any break in the process of allocating amounts paid upstream: it is no longer a tax on consumption but on inputs.
- In a worst-case scenario, an improperly implemented VAT is equivalent to a turnover tax at a higher rate than previous turnover taxes. While the yield is high, the tax hurts companies' competitiveness.
- In addition to weak administrations, certain provisions help create problems: exemptions, constraints on credit refunds (deadlines, delays in allocating refunds), high thresholds, multiple rates, and estimated payments.



# .Estimated payments used to tax the informal sector: merits and limitations

- While informal operators bear their full share of VAT on imports, the informal sector's share of unimported inputs remains untaxed.
- To compensate, a WTO-compatible estimated tax may be collected on imports or taxes may be withheld at the source.
- However... if estimated payments are not properly allocated and any associated credits are not promptly refunded, they become the equivalent of a tariff and at-source withholdings become “residual” VAT.



## .To summarize...

- Mobilization of domestic tax revenue should be consolidated to ensure tax transition, especially in low-income countries.
- Customs tariffs have been simplified and streamlined, but their structure remains largely intact.
- VAT has failed to live up to expectations of neutrality.
- The persistence of various levies (recording fees, stamp duty) that produce little yield compromises the anticipated effects of reforms of the principal taxes.



## **.Defining objectives for today's context**

- The challenge remains the same: how to increase revenue to offset lower tariffs, reduce distortions, and avoid increasing inequalities?**
- Yet loss of tariff revenue in developing countries is unavoidable given international commitments (WTO) and regional agreements (EPAs, in particular).**



# .Preserve the initial bases of reforms

- The pillars of early reforms still apply:
- A flat-rate, broad-based VAT with a relatively high threshold for liability remains central to a sound domestic indirect tax system.
- An appropriate tariff structure combined with reduced customs exemptions must accompany gradual trade liberalization.



## .Target measures to streamline VAT

Pursue two concurrent objectives:

- Ensure neutrality so it is truly a tax on end consumption; and
- Increase its fiscal yield to ensure that revenue losses are offset.

Which means, practically speaking, to: (1) broaden its base and (2) ensure that it functions properly.



## .Broaden the VAT base

- In most developing countries, the share of end consumption subject to VAT is generally very limited (about 50%).
- However, for VAT to be effective, its base must be broad, in particular to prevent breaks in the process. Exemptions on goods and services must be reduced.
- But this is hampered by: (1) high rates (about 20%, compared to 10% for "new" VAT) and (2) its regressive nature.



# .Respond to the recurring question on the regressive impact of VAT

- VAT, like the turnover tax it replaced, is regressive by nature, but most studies show that it is less regressive than tariffs.
- Redistributive impact of exemptions and reduced rates?  
Morocco: (1) In 2007, 32% of the goods taxed at 7% were consumed by the wealthiest quintile and only 11.8% by the poorest; (2) the imposition of VAT on five commodities (milk, semolina...) appears to have no perceptible impact on poverty (2010).
- In contrast, the redistributive impact of social spending made possible by the additional revenue is significant (Ethiopia, 2004; Central America, 2010).





## **.Identify the problems preventing proper VAT functioning**

- While VAT is applied across the board, the systems established and especially the procedures for administering the tax differ greatly from one country to the next.**
- The economic consequences of potential problems, which must be identified and analyzed, vary depending on the specific circumstances of each country (production, consumption).**



## .Regain control of tariff policy

- Don't stop at assessing the tariff losses expected to result from international and regional commitments, but....
- Be sure to maintain a consistent system of incentives during the liberalization process, possibly by changing the structure of the tariff and the rate levels (lowering the highest rates to curtail trade diversion in the case of RIAs; tariff = 0 for capital goods).



## .Ensure consistency of reforms

- Consistency between tax policy reform and reforms of the relevant administrations (and strengthening of links between tax and customs reforms);
- Consistency among the various tax policy components (direct/indirect, revenue/expenditure);
- Consistency between national bodies and regional bodies given fragmented decision-making processes (RIAs);
- Consistency in the reform schedules (tariff dismantling/ modification of the domestic tax rates...).



## In conclusion...

- The pursuit of the indirect tax reforms today requires resolution of the technical problems involving implementation and adjustment. It is no longer a question of one model being appropriate for all countries. Each case is specific.
- This policy focus will emphasize enhanced monitoring and management of reforms at the national and regional levels (development of capacities for analysis, forecasting, and quick response within appropriate, enduring institutional structures).

