

# Rationalization of Tariffs: Some Lessons From International Experience<sup>1</sup>

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A remarkable feature of international experience of trade policy reform is the similarities of lessons across countries that differ in many other important respects. This attests to the robustness of some basic economic forces related to the gains from trade and to the incentives facing different vested interests in the process of reform. The SADC countries are certainly not alone or unique in the problems and opportunities they face in integrating with the global economy through rationalization of tariffs and other trade policy reforms.

The lessons discussed here are based on the author's experience in trade policy reform and in the design and implementation of tariff-setting mechanisms in a large number of countries in various parts of the world. The particular lessons discussed here are selected on the basis of their likely relevance to SADC Member States. They relate primarily to the benefits of tariff rationalization and to the process of achieving it successfully. Some of the lessons concern the costs of *not* doing so (i.e. the costs of protection), and others deal more with the process of achieving successful reform.

The second part of the presentation discusses a few principal implications for tariff-setting bodies.

## 1. Lessons About Tariff Rationalization

*The principal beneficiaries of tariff rationalization are in the domestic economy*

- The main beneficiaries of tariff rationalization in any SADC country are the consumers and producers of that country itself.
- Thus, the main focus of any tariff rationalization strategy should be on unilateral, self-interested measures.
- There is seldom any benefit from trying to use access to any SADC member's own markets as a bargaining chip for others to liberalize. To delay unilateral integration measures as a threat to other countries hurts only the domestic economy.

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*Vested interests play a major role in the process of tariff-setting*

- This provides the answer to the puzzling question “If protection is so bad, why do all countries engage in it?”
- Interests opposed to integration include producers of protected goods and officials who enforce protective laws and collect taxes and other income from them. Producers and workers in industries and activities that have not developed as a result of poor tariff structures, and workers and users of such goods seldom have a direct voice in decisions about protection.

*Protection hurts labor-intensive downstream industries*

- Protection on inputs and raw materials provides negative protection to users of these protected goods.
- Protection of upstream petrochemicals, plastic raw materials and steel in Thailand and Indonesia has imposed high costs on labor-intensive downstream industries; the same thing is now beginning to happen in Vietnam.
- In the highly protected Indonesian economy of the early 1980s, it was found that the cost of each job created by protection of capital intensive import substitution industries was two to four jobs which were lost in efficient labor-intensive industries.

*Protection hurts exporters*

- Protection makes it more difficult for exporters to compete because of its direct effects on the cost of raw materials and intermediate inputs, and because of its indirect effects on the cost of labor and the exchange rate.
- Earning foreign exchange from competitive exports is far more effective than earning it through protection of non-competitive import substituting industries. In Indonesia it was found that investment in competitive export industries earned four times as much foreign exchange as the same investment in high cost import substitution.
- Insulating exporters from the costs of protection through EPZs, duty drawbacks and special exemptions is a useful, but only partial and temporary solution, with unfortunate negative long-term effects on the development of SMEs and supporting industries. Malaysia has been among the most successful users of special schemes for exporters and yet has failed to develop integrated manufacturing sectors built on successful export activities.

*NTBs are costly and have many unintended side effects*

- In the early stages of a country’s international economic integration, non-tariff barriers to imports and exports (NTBs) are often the most common and pernicious form of protection.
- NTBs breed arbitrariness and non-transparency. Their administration and compliance

costs are high, especially after taking account of the processes of negotiation over the setting and allocation of importing rights. They do not generate government revenues (although they might create substantial hidden incomes for some officials). For all of these reasons they are one of the primary sources of corruption in trade policy regimes.

- The varieties and types of NTBs are almost endless. Rules of origin are an especially pernicious and often unrecognized form of NTB that is part of all preferential regional trade arrangements, including SADC. The incentive effects of such measures are often very large but are seldom, if ever recognized or quantified.

#### *Rules are better than discretion in programs to remove NTBs and reduce tariffs*

- Clear rules for the process of NTB removal eliminate uncertainty and are less likely to create opportunities for continuation of rent-seeking. For example, if it necessary to provide temporary additional tariff protection to compensate for loss of NTB protection, it is preferable to use a simple rule such as: all sectors with tariff protection above  $x$  percent will get no additional tariff protection; those with tariffs below  $x$  percent will get a temporary import tariff surcharge of  $y$  percent, which will be phased down to one-half of  $y$  after one year and zero after two years.
- Indonesia made the mistake of trying to compensate on a case-by-case basis for losses of NTB protection, on the basis of each industry's "need". This led to large and unnecessary delays in reform, and diverted entrepreneurial energies from increasing the competitiveness of their business practices to lobbying officials for protection.
- The same lesson applies to rules for tariff reduction rather than made-to-measure reductions.

#### *Complex tariff structures breed corruption*

- Complex tariff schedules (especially when combined with high average rates) increase both the discretionary authority of customs administrators and the benefits from importers from manipulation of import classifications. They also provide perverse economic incentives to investors.
- Sources of costly and unnecessary complexity include: wide ranges of tariff rates; complex HS classification schemes; classification of imports for tariff rate or exemption purposes based on end users, end uses, etc.
- While, in a perverse way, corruption might achieve a certain degree of *de facto* rationalization in a highly protected environment, it is a) very costly (illustrated by the experience of port and customs reform in Indonesia), and b) a major obstacle to measures aimed at reducing protection and increasing transparency.

#### *Increasing protection does not stop smuggling*

- Protection is a subsidy to smugglers. Thus increases in protection increase the incentive to smuggle.

- Replacing NTBs with tariffs and lowering tariffs to reasonable levels reduces smuggling, puts competitive pressure on producers, helps users of imported goods, and enhances state revenues.

*Partial trade liberalization for particular users or uses can have perverse and unintended effects*

- The governments of Thailand and Laos have made agreements to relax quotas and tariffs on a selective basis on certain Lao agricultural products to be used in Thai processing industries. Contrary to what would have been the effect of general liberalization of Lao-Thai trade in these products, there have been no benefits to Lao farmers or Thai food consumers. All of the rents from this special “free trade” arrangement have accrued to large Thai food processing producers and their well-connected agents in Laos.
- Regional trade liberalization and associated rules of origin can have a wide range of similar perverse and unintended effects.

*Anti-dumping is a dangerous game*

- Vested interests who are opposed to increased integration often argue that anti-dumping procedures are necessary in order to protect liberalized domestic industry from unfair foreign competition.
- In developing country markets, almost all claims of dumping are actually statements about a firm’s inability to compete rather than about the behavior of an external competitor. Furthermore, in practice, the existence of dumping is costly and almost impossible to determine. This is in large part because dumping is very rare in international markets, and especially in very small markets such as SADC. Therefore anti-dumping procedures should not be developed unless to clarify the difficulty and unlikelihood of a petitioner’s succeeding with a claim.
- At the same time, a small country might be well advised to develop the expertise and resources to help deal with anti-dumping charges levied on its own producers by foreign countries. This would include mobilizing the support of international investors engaging in local production for export.

## **2. Some Implications for Tariff Boards**

*Recognize and understand the national interest in tariff rationalization*

- Rationalization of tariffs is an essential element in a strategy to promote sustainable and equitable development. It is open economies that have been the most successful in taking advantage of the opportunities provided by globalization, and this is especially true among developing countries. Tariff rationalization is especially important in promoting the competitiveness of domestic industries.

- Recognition of the national interest in tariff reform is critical in order to avoid the folly of entering multilateral, regional and bilateral trade negotiations with the false view of tariff reductions as “concessions” to other countries.

*Do not confuse the national interest with the exaggerated pleas of narrow vested interests*

- Consideration of the effects of tariff changes on all relevant national stakeholders, including consumers and industrial users of protected goods is necessary to make informed tariff rationalization decisions.

*Aim for simplicity and transparency in the design and implementation of tariff reform*

- Keep tariff schedules simple and rates reasonable. Do not allow exceptions based on end uses or users.
- Eliminate deep-seated sources of corruption in import administration. Simplicity and transparency of rules will help. But more might be necessary. Indonesia removed its customs service from almost all aspects of import administration for 10 years in order to reduce the costs of international trade.

*Rely on general rules and clear timetables for tariff and more general trade policy reform*

- Make rules applicable to all sectors and all activities. Otherwise the system will be overwhelmed by pleas for special treatment, and reform will be frustrated

*Plan for the obsolescence of all tariff boards*

- When a simple and uniform tariff structure has been achieved, there should be no need for a tariff board. Petitioners for special protection should be directed to a telephone number, a web site or an office door with a very simple message: “No.”