THE ECONOMICS AND POLITICS OF UNIFORM TARIFFS

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1. Introduction

In recent years, many developing countries have moved away from non-tariff barriers and a highly variegated structure of tariffs to a few tariff rates that do not discriminate heavily across sectors. The extreme example is that of Chile which did away with all its quantitative restrictions and, with very few exceptions, instituted a single, uniform tariff in the late 1970s. During late 1980s, Mexico had replaced virtually all trade restrictions by three tariff rates. Yet another example is Bolivia, which has adhered more or less to a single tariff rate since the early 1980s.

Is the replacement of non-tariff barriers by a single, uniform tariff a good idea? There are two schools of thought on this issue, one led by policy economists and the other by academic economists. Policy economists, frustrated by the complexities of trade policy regimes in most developing countries, find the replacement of all trade restrictions by a single uniform tariff as the most effective instrument of minimizing trade policy distortions.[1] By contrast, academic economists, working in the tradition of optimal tariff and tax literature, rarely think of a uniform tariff as a serious policy option. There are exceptions to this general tendency in both camps but they are sufficiently few to merely reinforce the rule.[2]

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[1]The reference here is to economists at international donor agencies such as the World Bank and International Monetary Fund and those working in the governments of many developing countries, particularly in Latin America. These economists have been the primary driving force behind the uniform-tariff movement.

[2]Among academic economists, Corden (1958, 1985) and Harberger (1990), both acutely aware of the limitations of a uniform tariff as the "optimal" structure, strongly favor it. In his academic writings, Corden (1971, 1974) has systematically shown why tariff uniformity is nonoptimal under most circumstances. Yet, in his policy writings and policy advice, he favors uniformity with strong conviction. In the policy world, economists trained in the tradition of modern optimal taxation theory a la Diamond and Mirrlees (1971), have been persistently opposed to tariff uniformity. For example, see Dahl,

The central purpose of this paper is to explain why policy economists favor a uniform tariff regime while academic economists oppose it. I argue that the differences between the two sides are the result of the failure of the latter to appreciate the complexities of policy making in developing countries and the advocacy by the former of a uniform tariff for wrong reasons. Academic economists rely primarily on theoretical models to show why under most circumstances the optimal structure of tariffs is non-uniform but fail to address how this structure is to be calculated and implemented in practice. Policy economists, finding theoretically derived optimal structures to be too complex to be of practical value, fall back on the uniform tariff as a practical solution to the problem of minimizing distortions.

To keep the arguments in sharp focus, it is important to clarify the context of the debate at the outset. Uniform tariffs are usually advocated in the context of a small, open economy. For many developing countries, this is a reasonable assumption.[3] Analytically, the assumption allows us to abstract from positive optimal tariffs resulting purely from market power in the world markets.

In the absence of exogenously specified non-economic objectives or political constraints resulting from, say, lobbying, the optimal trade policy for a small open economy is complete free trade. Therefore, any discussion of positive optimal tariffs must presuppose the existence of such objectives or constraints. Two objectives that have played an important role in the

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Devarajan and van Wijnbergen (1986), Heady and Mitra (1985) and Mitra (1987).

[3]Obvious exceptions to this are exporters of primary products who have a very large share in the world markets. These include, for example, large cocoa exporters such as Ghana and Cote d'Ivoire.

academic literature as well as policy discussions are protection and government revenue. In addition, the income distribution objective has received some attention.

In principle, trade taxes are rarely the first-best policy instrument. For example, when revenue is the objective, consumption or value added taxes are a superior instrument.[4] The focus on trade taxes in this context presupposes that domestic taxes are not available due to an absence of collection machinery. For many African and South Asian countries, this is a realistic assumption. Similarly, when protection is the objective, the superior instrument is a production subsidy. However, due to fiscal considerations, it is not a feasible option in reality. Because tariffs generate revenue while providing protection, in practice, they remain a preferred policy instrument.

2. Academic Economists' Objections to a Uniform Tariff

As already noted, the standard context in which uniform tariffs are advocated is that of a small open economy. It is further assumed that there are constant returns to scale in all sectors and no distortions anywhere in the economy.[5] The global optimum in this setting is achieved by setting all tariffs uniformly at rate 0, i.e., free trade. To make the tariff issue substantive, we

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[4]In the favorite model of trade theorists and policy makers, factor endowments--capital, labor and land--are assumed to be fixed. In this model, a uniform consumption or value added tax on all commodities leaves relative prices entirely undistorted from the world prices. Therefore, revenue can be raised at zero cost; essentially the uniform consumption or value added tax amounts to a lump sum tax. Unfortunately, the same cannot be accomplished via trade taxes. A uniform trade tax on all goods amounts to a tax on imports and subsidy on exports (negative imports). If trade is balanced, the subsidy paid on exports exactly offsets the revenue raised on imports. To raise positive revenue, a uniform trade tax cannot be imposed on all trade (including all exports) and relative prices must be distorted.

[5]These assumptions are a good starting point because in their absence, the case against a uniform tariff is trivial.

must introduce a noneconomic objective. We begin with the revenue objective.

2.1 The Revenue Objective

Suppose the government wishes to raise a certain amount of revenue through trade taxes. A distortion must now be introduced and global optimum sacrificed. The issue is what is the least distortionary set of trade taxes to raise the specified revenue. Clearly, tariffs that move the economy the least from the free trade equilibrium while raising the required revenue will do the trick. Ignoring cross-price effects, this amounts to taxing imports with low import-demand elasticity more heavily and those with high elasticity less heavily. For each dollar raised in revenue, the movement away from the optimum is less for goods with low elasticity than those with high elasticity. Therefore, it makes sense to introduce a proportionately larger tariff distortion in the former than in the latter. This is indeed the essence of the well-known Ramsey (1927) result which states that when lump sum taxes are not available, revenue raising taxes should be levied in inverse proportion to the elasticity of demand. Because import demand elasticities are usually different across commodities, optimal revenue raising tariffs will be non-uniform. Cross-price effects only strengthen this point.

2.2 The Protection Objective

Next, consider the protection objective. If the objective takes the form of protection targets by sectors as in infant-industry protection, a uniform tariff cannot be the right instrument. The objective in this case is to provide differential protection across sectors which a uniform

tariff aims to avoid.

The most favorable form of a protection objective for the uniform tariff is to require that the overall value added in the domestic import-competing sectors, measured at world prices, be above the free trade level. This objective can be best achieved by a uniform subsidy on value added to all sectors. Such a subsidy creates equal distortion at the margin in all sectors and creates no by-product distortions in the economy. The cost of achieving the objective is minimized.

As already noted, tariffs are a more convenient instrument of protection because they raise revenue while subsidies impose a fiscal burden on the economy. Proponents of uniform tariffs argue that absent subsidies a uniform tariff is the least distortionary instrument for achieving the protection objective. A uniform nominal tariff, applying equally to final goods and inputs, results in an equal ad valorem subsidy to value added in import-competing sectors. In a trade theorist's jargon, a uniform tariff leads to equal effective protection across all import-competing sectors.

Opponents of uniform tariffs are quick to point out at least four major problems with these plausible-sounding conclusions. First, if some import-competing sectors use one or more exportables or nontradables as inputs, a uniform nominal tariff fails to equalize effective protection across sectors. No tax is paid on exportables and nontradables used as inputs. Therefore, a uniform nominal tariff protects the value added in sectors using exportables or nontradables as inputs more than in other sectors. The marginal cost of protection is higher in the former than the latter sectors. The cost of providing the same overall protection to value

added can be reduced by applying a lower nominal tariff on sectors using exportables and nontradables as inputs and higher nominal tariff on other sectors.[6]

Second, if one or more imported inputs are used in some exportables or nontradables, a uniform effective rate of protection no longer minimizes the distortion cost of protecting value added in import-competing sectors. In addition to creating the desired distortion, i.e., a uniform effective protection in import-competing sectors, the uniform tariff now also distorts production in exportable and nontradable sectors using imported inputs. Lowering the tariffs on inputs used in exportables and nontradables and raising them on inputs used exclusively in import-competing sectors can reduce the distortion cost. This will shift the distortion away from where it is not desired (exportables and nontradables) towards where it is desired (import-competing goods).[7]

Third, tariffs distort not merely production but also consumption. If we assume that no imported inputs are used in exportables or nontradables and no exportables and nontradables are used in the production of import-competing goods, a uniform nominal tariff will coincide with uniform effective protection and, moreover, minimize the distortion in production. Yet, it will not minimize the overall cost of the protection objective. Since the by-product distortion in consumption is not desired, overall protecting the goods with inelastic consumption demand more than others can lower distortion costs. This change will increase the distortion cost in production, lower it in consumption, and up to a point lower it overall. Uniform tariffs--whether

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[6]Here and in the following paragraph, we abstract from distortion costs in consumption but turn to them soon after.

[7]I deliberately ignore the possibility of a duty drawback on exports here. In a strict sense, a duty

nominal or effective--are non-optimal.

Finally, if tariff evasion is possible via smuggling, even if the conditions for a uniform nominal tariff to be optimal are satisfied, its adoption will fail to yield the optimum. Not all goods can be smuggled with equal ease: automobiles are far more difficult to hide in a suitcase than wristwatches. A uniform nominal tariff on the books will translate into a non-uniform nominal tariff in practice.

2.3 The Income Distribution Objective

For completeness, we may also note the objection to a uniform tariff based on the income distribution objective. Sometimes, tariffs are used to curb the consumption of luxury goods. In this context, the case against a uniform tariff needs no elaboration. One point to note, however, is that a consumption tax on luxury goods may not be as infeasible as a general consumption or value added tax. Therefore, it may often be worth giving serious consideration to a consumption tax for income distribution purposes.

3. Policy Economists' Justifications for a Uniform Tariff

The academic case against a uniform tariff seems impeccable. How can then uniform tariffs be justified? There are three answers.

First, policy economists generally think in terms of the protection objective. Even in situations where they are aware that the objective is revenue, the strong tendency is to focus on

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drawback is itself a violation of the uniform tariff rule.

protective effects of tariffs. Furthermore, driven partly by the preferences of the policy makers, policy economists are quite willing to ignore the distortion in consumption. They then complement the uniform tariff recommendation with a duty exemption on inputs used in exports. Thus, some of the objections to uniform tariffs as an instrument of achieving the protection objective noted in Section 2.2 are overcome. The remaining objections--nontradables may use imported inputs, exportables and nontradables may serve as inputs in import-competing goods, and tariff evasion may be non-uniform across commodities--are usually ignored.

This justification for uniform tariffs is clearly flawed. If revenue is the true objective, the justification based on protection is wrong. When protection is the objective, academic economists are rarely willing to ignore the distortion in consumption. The fact that policy makers are "protected" from worrying about consumption distortion cannot serve as an acceptable excuse for policy economists to ignore it. An economist's role, in part, is to enlighten the policy maker on what is the right policy rather than share in his ignorance or politics. Moreover, quite apart from the consumption distortion, the defense is incomplete since it ignores several of the objections to the uniform tariff rule.

The second justification for a uniform tariff relies on practical difficulties in determining the true optimal structure of tariffs. Policy economists point out that even though in principle optimal revenue raising tariffs are non-uniform, in practice, it is impossible to determine them. Information on import demand elasticities is notoriously difficult to obtain. Therefore, the chosen tariff structure must involve some arbitrariness. Once this is admitted, uniform tariffs may be a good rule of thumb. Extra distortion caused by uniform tariffs is likely to be less than

other arbitrary tariffs that might get adopted.

This justification is potentially plausible. A key factor in evaluating its validity is to assess how much extra distortion do uniform tariffs relative to other tariff structures cause. Although some simulations have been done to address this point, we still lack a systematic treatment of it. We need to know how the extra burden varies when there are nontraded goods, pure imported inputs used in exportables, importables and nontradables, exportables and nontradables that are used as inputs in import-competing goods, etc. We also need to know whether reasonable gains can be made by exploiting whatever information may be available on import demand elasticities. For instance, does the available information allow us to determine a limited number of tariff rates, say, two to four, which will involve a significantly smaller loss of efficiency than a single rate?

A third and final justification for a uniform tariff given by policy economists is transparency and administrative simplicity. A complex tariff structure may be administratively frustrating for both customs officials and firms. Costs of administration may rise with the complexity of the tariff code. A uniform tariff leaves no room for misclassification of goods for evasion of tariffs. Customs officials can concentrate on ensuring that the value of the good is not understated; there can be no dispute concerning the rate of tariff to be paid. These factors can help reduce delays in clearing goods for delivery and generate gains especially when goods are to be used in the production of exports.

There is some truth to this justification. But logically speaking, it allows us at best to make a case for a limited number of tariff rates, not one. What this argument says is that the

standard efficiency analysis ignores the costs of administration and delays which accompany a complex tariff system. Once these considerations are taken into account, the number of tariff rates will be smaller than what is suggested by efficiency criteria alone. It is doubtful, however, that the number will be one.

4. Marrying the Two Approaches: Political-Economy Arguments

The discussion up to this point suggests that the case for a uniform tariff is at best weak and at worst nonexistent. This deepens the puzzle why policy economists are at odds with academic economists. I suggest that the answer lies in the fact that the former have not articulated their reasons which derive more from the politics of tariff making than conventional efficiency considerations.

During the past decade, Jagdish Bhagwati and others have repeatedly reminded us that we cannot satisfactorily design efficient policies without taking into account political processes that influence them. This is especially true of trade policy. In many countries, tariffs are greatly influenced by either lobbying pressures or the government's desire to favor certain sectors. Under such circumstances, tariffs are determined endogenously and the conventional view of the government as an omnipotent, social welfare maximizing agent cannot serve as the basis of the analysis. Once this is acknowledged, a tight case in favor of uniform tariff can emerge and has indeed been outlined formally in a recent paper by Panagariya and Rodrik (1991).[8]

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[8]Perhaps at a subconscious level, policy economists are influenced by the phenomena we are about to describe. In informal discussions, I have found the advocates of tariff uniformity argue that if uniformity

The key to understanding the force of a uniform tariff rule is to recognize that it can serve as a powerful instrument for restraining the overall level of tariffs. When tariffs are determined by lobbying pressures, their level may depend on the structure. Therefore, the imposition of a constraint on the latter in the form of a uniform tariff rule may constrain the former. As I argue shortly, the adoption of a uniform tariff rule can turn tariffs from a private to a public good. The usual free rider problem appears and lobbying activity is contained.

Consider an economy where the government is interested in maximizing the country's social welfare as defined conventionally but finds that it is too weak to resist lobbying pressures. Assume that the tariff rate for a sector is determined by the amount of lobbying pressure exerted by the latter. In the absence of a uniform tariff rule, the tariff is a private good for the sector as a whole. Each sector lobbies up to the point where the marginal cost of lobbying equals the marginal benefit yielded by the tariff.

Suppose now that the government adopts the rule that all tariffs must be the same: any tariff protection granted to one sector will be extended automatically to all the sectors. This will turn the tariff into a public good. Each sector investing resources into lobbying will find that the fruits of its efforts spillover largely to other sectors. The extent of lobbying will decline dramatically. Indeed, most sectors will choose not to lobby at all and free ride those who do. With lobbying curtailed, less resources will be used in a socially wasteful activity and efficiency

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is not imposed, lobbying pressures can escalate tariffs and lead to a tariff structure which is all over the board. In the literature, brief, informal discussions of the role of political factors in the choice of a tariff regime can be found in Harberger (1990) and Panagariya (1990).

losses from tariffs will be smaller.

At the outset, an important qualification to this argument in favor of a uniform tariff must be noted. In an extreme situation when the economy consists of a few large and many small import-competing sectors, the adoption of a uniform tariff rule may lead to a worse outcome than in its absence. The reason is that big sectors may have an incentive to lobby for a high tariff despite the free rider problem. Under the uniform tariff regime, the tariff these sectors are able to lobby for is granted automatically to other sectors. Therefore, it is possible that smaller sectors are protected more and that the damage to the economy is greater under a uniform tariff regime than in its absence. It may be argued, however that, in practice, this situation is not very likely to arise. But if it does, a uniform tariff rule will be counter-productive and should not be adopted.

A related argument in favor of a uniform tariff rule can be made when an enlightened government expects a future government to be selectively protectionist, favoring some sectors over the others. In this situation, a uniform tariff rule may be an effective instrument of tying the hands of the future protectionist government. For under a uniform tariff rule, the future government must pay a penalty for protecting the favored sectors in terms of protection to other sectors. This, in turn, will reduce the level of protection it will actually choose.

Finally, if there are imported inputs which are not produced domestically and are used primarily in import-competing sectors, a uniform tariff rule will be accompanied by a lower overall effective protection than when protection is differential across sectors. In the case of inputs not produced domestically, there is usually no lobby. Therefore, private benefits from

lobbying are greater when there is no threat of a tariff on those inputs. A uniform tariff rule creates this threat and reduces the incentive for lobbying by sectors that use the inputs. This effect is in addition to the free-rider effect discussed in the first model above.

5. Conclusions

The case for a uniform tariff based on conventional efficiency criteria is weak. The best one can do is to argue that the damage by a uniform tariff to efficiency will be less in practice than when tariffs are allowed to differ across sectors. There are two aspects of this argument. First, the information base may be so bad as to render the task of determining the optimal structure of tariffs in a given situation impossible. Then one must rely on some rule of thumb. A uniform tariff may be one such rule: it will definitely not be optimal but under most circumstances it will do less damage than other sets of tariffs. Here many economists will disagree because there is usually some information which can be used to improve upon the uniform tariff. Second, in practice, because governments are either themselves actively interested in protecting certain sectors or too weak to resist lobbying pressures, tariffs will not be chosen to maximize social welfare. In such a situation, a uniform tariff rule can impose a discipline on governments and interest groups not available otherwise.

A final point to note is that when the primary problem is not lobbying or a future government who is going to use trade policy for its own advantage, there is little sense in insisting on a total uniformity as the golden rule. In any case, most advocates of the rule are too

ready to allow their favorite exceptions such as a duty drawback on exports and no new tariffs on inputs imported freely at the time of reform. It may simply be wise to adopt a system of two to four tariff rates and exploit the available information. Although the issue is open for further research, I will conjecture that up to four tariff rates will be enough to exploit most of the efficiency gains without actually reaching the optimum. A small number of tariff rates will also meet the administrative-simplicity criterion.

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