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# Text of Discussion Paper on Fiscal Policy in Relation to Export Promotion

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## Introduction

The sufficient and timely availability of foreign exchange is a key factor in accelerating the economic and social development of developing countries. Apart from the efforts being made to get external assistance in the form of softer loans and grants the developing countries have generally accepted the need for an intensification of their efforts to get additional export earnings. This need is all the more pressing in view of the falling receipts from exports of traditional commodities and the rising burden of external debt servicing. There is especially increasing quantum of external borrowing resorted to by African developing countries to finance development expenditures. In many African countries the interest on public debt accounts for over ten per cent of all central government expenditures. There is in addition the problem of repayment of principle. All this involves payment in foreign exchange and since these are contractual obligations these cannot be avoided unless some concessions are granted by the donors.

The success of the various countries in their export promotion drive would depend on a variety of factors and development of institutions the effect of fiscal policy though quite important is just one of the many facets of the problem.

## Basic features of External Trade of Developing countries

Generally speaking, the exports of developing countries are concentrated in a few primary goods, which form a large proportion of their total exports while their imports are much more diversified. Predominant in their import list are various types of capital goods and manufactured articles. The prices of primary export commodities of developing countries have a tendency to fluctuate markedly. Since each such country exports one or two products it means that these countries have placed all their eggs in one basket for their foreign exchange earnings are also liable to large fluctuations. Changes in terms of trade have generally adversely affected the developing countries in the recent past. An adverse long-term trend in the prices of primary commodities relative to manufactured goods means an increase in the amount of primary goods an under-developed country has to supply to import a given quantity of foreign manufactured goods. This situation continuously exerts pressure on the balance-of-payments of developing countries with the result that they are always busy trying to adjust their commercial policies to relieve this pressure.

## Revenue Importance of Export Taxes

With the rapidly rising public sector expenditures the need for raising revenues is great. The fiscal policies of many countries are designed with this end in view. This situation makes it difficult for developing countries to do away with export duties where they contribute

a substantial portion of Government revenues. The revenue objective is no doubt important. However, there is urgent need for making desirable adjustments in cases where some of the fiscal or other measures might be having an adverse effect on the promotion of exports. Unless this is done on a continuous basis even the effect of some of the export promotion incentives may be nullified.

Generally speaking the export duties are retrograde in principle and discourage exports. The objective should be to replace them eventually when other forms of taxation can be successfully applied to raise revenues. In any case the export duties as a source of Government revenues are of an uncertain character in view of the effect of the changes in world market prices. The sooner, therefore, a country is able to replace these with more stable and growing revenue sources the better. Fluctuations of revenues from export taxes pose problems of treasury management and in this respect therefore, are also disadvantageous.

Though generally much less important than in the Korean War boom period of 1950-1956 export taxes still accounted for in mid sixties ten per cent or more of the tax revenues of the central Governments of Uganda, Sudan, Nigeria, Chad and Malagasy Republic.

In cases where the percentage of total tax revenues obtained from export taxes exceeds the ratio of exports to GNP (as was the case in Uganda, Sudan and Nigeria, this fact indicated that the export sector was being more heavily taxed in relation to the value of final output than the other sectors as a group.

Here it may be stated that the basic inelasticities of the tax systems in many African countries have not been given the attention they deserve because these are often obscured by movements exogeneous to the national economies. When foreign exchange is available, whether from higher prices of major export commodities or otherwise exports are expanded and the yield of import taxes rises. When the foreign trade revenues decline the foreign exchange becomes over-valued and the real value of foreign trade taxes falls.

In addition to the direct dependence of Governments on foreign trade taxes, many other taxes depend directly or indirectly on foreign trade for example sales tax on imports or income taxes paid by Corporations which depend on either imports of raw materials or exports.

## Incidence and Economic Effects of Export Taxes

The legal incidence of export taxes generally is on the "exporter" from whom the government collects the tax. However, in many cases these are shifted backward or forwards and they rarely rest on the exporters.

These may be shifted forward to buyers that is paid by foreign consumers, and these may be borne by domestic producers or these may fall on landowners or workers. The final incidence may in time be diffused amongst consumers middlemen, producers, landlords and labour.

Elastic supply and inelastic demand are conducive to shifting of a tax forward to consumers, where as under conditions of inelastic supply and elastic demand the tax tends to rest on producers.

Supply is inelastic when the resources engaged in the production of a commodity are highly specialized in that use and cannot easily transfer to other activities owing to technological conditions or the absence of alternative employment opportunities. Also conducive to inelasticity of supply are lack of information about opportunities, insensivity to economic incentives and other conditions resulting in immobility.

Supply tends to be elastic with respect to price when the resources required for the production of an item are not highly specialized and when alternative employments exist and are known to resources owners who are able and willing to take advantage of them. Elasticity of world demand depends on consumers tastes, prices of competing commodities and the technical possibilities of substituting other natural or synthetic materials for the commodity, or of modifying production processes to vary the amount of a particular raw material entering into a finished product.

If any individual country is in a monopolistic position in the world market, it is conceivable that the whole or a large part of the tax can be passed on to the foreign consumers without any appreciable reduction in the volume of sales. Moreover if export tax is imposed at a time when exporters incomes are rising whether through larger outputs or higher prices or both this may simply amount to a tax on windfall gains and in principle such taxation is acceptable and even desirable.

While these generalizations offer a framework for analysis, incomplete knowledge of demand and of producer's behaviour in the developing countries often precludes firm conclusions about particular export taxes.

One fact is however, quite clear, when supply shows positive price elasticity, an export tax by reducing the net price will ordinarily cause a reduction of exports and a reduction in production, if as is usually true, the domestic market is relatively small. In the long-run, the taxation of export crops tends to bring about a relative contraction in production of the commodity taxed, in the absence of other offsetting factors. Ordinarily a decrease in production will result in a decrease in export volume. However, in cases where exports are controlled by an international commodity agreement as in case of coffee, or similar arrangement, the linkage between supply inelasticity and export volume may be loose. In the

absence of controls, production will tend to exceed export quotas, particularly in countries that enjoy the greatest comparative advantage in producing the commodity. In these conditions a country may be unconcerned about the possible adverse effects on production associated with an export tax as a convenient means of limiting production.

If the export tax rates are properly manipulated relative to export prices through changes in the tax law or through the application of sliding-scale rates their dis-incentive effects can be greatly mitigated. This system would also capture part of the gains arising from a rise in world prices and also help in insulating the economy from the effects of export fluctuations. However, continuation of high rates of duty into a period of falling prices is likely to be burdensome and to damage export earnings.

It would be necessary to pin-point here some of the more important disincentive effects of export taxes.

Generally speaking the export taxes discriminate between taxed and non-taxed commodities. As a consequence the allocation of resources may be affected in three ways:

(a) Firstly there will be a tendency for exporters of taxed commodities to divert output to the home market or to find illicit channels of export;

(b) Insofar as there are any export goods not subject to export taxation there will be some shift of resources towards them;

(c) Insofar as export taxes cover the whole range of goods going abroad there will be a tendency to concentrate on other lines of output destined for domestic consumption-and possibly a further tendency to retreat into the subsistence sector of the economy.

It is clear that the disincentive effects of export taxes are so great that undue reliance should not be placed on them as fiscal instruments.

It is argued sometimes that as the effective levying of income taxation on farmers is so difficult, export taxation measures provide a reasonable substitute. This may be tolerated in the short-run, but the snag here is that export taxation by definition only taxes output not assigned to the home market. Its yield will fluctuate more than proportionately with the volume of exports and conceivably with the prices as well.

Role of the Marketing Boards

This discussion would not be complete without some reference to the role played by the marketing boards or statutory monopolies established by various governments to sell particular export commodities.

In most of the African countries these boards were originally established for stabilization purposes and for improving facilities for the marketing of major export crops. However, in course of time they have been instrumental in raising considerable sums of revenue to build up huge reserves which were diverted to development uses. These revenues were raised by them through trading surpluses by paying the producers less than the world prices. Well known examples of the marketing boards have been those in the four West African countries of Ghana, Nigeria, Sierra Leone and Gambia, although there have been others in East and Central Africa and elsewhere.

In Nigeria, the marketing boards developed the formula of retaining 70 per cent of the profits for stabilization and allocating 22½ per cent for development and 7½ per cent for research. The development allocations were generally made by them to the Regional Production Development Boards.

The disincentive effects of export taxation already mentioned apply equally to the surpluses accumulated year after year by the marketing boards. There is a strong body of opinion holding the view that as long as a country has to rely heavily on export taxation, the marketing board trading surpluses should be converted through appropriate adjustment of the fiscal structure into export duties and treated identically with other government revenues. In this way the development responsibilities of the government would be clearly separated from other functions now being performed by the Marketing Boards, such as intra-seasonal price stabilization, orderly marketing and soforth, which can more reasonably be considered to reflect the farmer's interests. Moreover, as the opportunity for direct taxation of other sources of income appear, one would hope for a more equitable and less distorting tax structure.

Purpose of Tax Incentive

The purpose of a tax incentive is presumably to induce someone to do something the Government thinks desirable; therefore administrative efforts should be devoted to making the benefits as widely available as possible within the framework of the law; in preference to limiting them to those who fall within a narrow interpretation of the letter of the law. There are two ways of granting special tax concessions, narrowly, by administrative discretion on application and broadly to all who fall within the legislative provisions. The first approach has much to be said in terms of effectiveness per dollar of revenue foregone if three conditions are fulfilled:

(i) the administrators know what they are doing;
(ii) the benefits are substantial and;

(iii) there is public acceptance of such discretionary concessions or the "need" is urgent, whether acceptable or not. Administrative arbitrariness under such a narrow scheme may be restrained to some extent by giving wide publicity to all the administrator's decisions. This sort of argument leads one to favour a more general and automatic system like the investment allowance and bonus on exports of manufactured goods.

Insofar as tax concessions are granted, they should be as general and as open as possible in order to avoid wasting the scarce human resources of both public and private sectors on needless administrative procedures and delays. A sound tax system with a few general encouragements to investment and exports should give better results within a good development programme (especially with a good foreign exchange budget) than any system of special concessions. Without a good development programme no tax system, plain or fancy can be of much help.

It goes without saying that inspite of various constraints, the developing countries themselves can take a variety of measures for promoting the expansion of their manufactures and semi-manufactures. These may take the form of tax concessions, special treatment in the allocation of import licences or export bonuses and favourable transport rates etc. The provision of credit at reasonable rates for export expansion is also accepted as a **rational** policy goal to be followed by all countries.

Since all incentives, whatever their nature involve a cost directly or indirectly to an economy, there is need for a close study of the incentive schemes by means of a cost-benefit analysis so that a best mix devices or incentives could be evolved suited to the conditions of any given country. Before we conclude, let us identify some of the broad incentives that could be used for export promotion.

(i) Direct subsidization of manufactured products. This has of course to be seen in relation to the problem of revenue raising. It needs hardly to be mentioned that basic to the success of any export drive is an abundant and increasing domestic supply of goods that can be diverted to the export market. This means that alongwith the consideration of fiscal and other incentives for export promotion, vigorous steps should be taken to increase the production of exportable commodities;

(ii) Exchange rate manipulation. Devaluation is an accepted cure for balance-of-payments disequilibrium of a fundamental character. It is equivalent of a uniform tariff on all imports combined with a uniform subsidy for all exports;

(iii) Tariff protection in individual cases combined with export subsidies. However, protection through tariffs must be seen in relation to value added and tariffs on imports must be taken into account when assessing the effects of export promotion subsidies. It is particularly important to avoid a situation where export subsidies actually create what has been called a "negative value added". This means that the income from exports of a particular product when calculated at unsubsidized world prices falls short of the cost of inputs into the products in question, the latter also calculated at world prices. The export subsidy rates generally speaking should be kept simple and uniform and on advalorum basis as far as possible. In considering a subsidy policy developing countries will have to be bear in mind the effects which such action might have on world prices of such exports, and in those products where they are highly competitive, the question of a subsidy may not arise. If a developing country provides an export subsidy, and this is offset by a countervailing duty in the buying country, then the government of the developing country has in fact transferred revenue - i.e. the cost of the subsidy or the return from the customs revenue - to the government of the other country and on balance exports may not increase;

(iv) Export Bonus Schemes, import entitlement or exchange retention schemes operate or have operated in a number of countries. These are really partial devaluations. Export industries encounter difficulties where there is an over-valued exchange rate associated with tariffs and import restructions. Imported inputs have to be paid for by them at world prices and costs of the exporting industries are also apt to be raised by internal inflation. A natural remedy for these difficulties would be to allow exporters to retain some of their foreign exchange earnings. They will then be able to buy inputs and capital equipment at world prices and to sell some of their remaining foreign exchange at a rate more favourable than the official rate. In relation to the official exchange rate, this really means that exporters are subsidized by the amount of bonus or premium they can obtain on the market for foreign exchange above the official rate. Exporters may be permitted to retain part of their foreign currency earnings and to use it for importing raw materials or machinery for their own use or for export promotion or marketing expenditures abroad;

(v) Exemption from or refund of tariffs or internal taxes on inputs used in export industries. It is however, often difficult to distinguish the inputs that have gone into exports from those contained in home market sales and consequently there may be practical difficulties in administering such schemes;

(vi) The subsidization of the use of capital by encouraging capital to move into export industries rather than into other industries. Some of the ways of subsidizing the use of capital in export industries are:

(a) foregoing of taxes that might otherwise be charged;
(b) financial assistance for export promotion as well as the provision of export credit facilities and export credit insurance at charges below their normal commercial cost.

(viii) Exemptions for Exports from Tax on value added or similar taxes. If a developing country taxes production whether by sales or value-added taxes such taxes may be used to encourage particular types of production at the expense of others. For example an export exemption might be provided without a border tax on imports, in which case particular encouragement to exporting in preference to import replacement would be given. Alternatively the adjustments might be applied to manufactures and not to primary products, in which case an encouragement would be given to manufacturing relative to primary production.

Let me conclude, this discussion, by emphasizing that since all incentives entail a cost, it is essential to make sure that the ends justify the means used and the ends should as far as possible be achieved at the minimum cost. The use of fiscal policy and various incentives for export promotion must be dealt with on a pragmative basis and related to the actual needs of any particular country particular attention need to be paid to their administrative and financial aspects.