

Size and Trade Tax Dependence

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**A comment on paper on ‘Fiscal Reform and Compensatory Mechanisms’, by
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My comments are set against the recurrent theme of heterogeneity among developing economies. The particular aspect that concerns me is heterogeneity of size. The Commonwealth/World Bank Report on Small States lists some 32 states whose population is 1.5 million or less¹. There are some 86 WTO members whose foreign trade is less than 0.05 percent of world trade; together the 86 account for less than 1.5 percent of total world trade². Within the Latin American and Caribbean (LAC) region of course, there are very wide differences in size. A composite measure of size that combines land area, population, aggregate GDP, and endowment of physical and human capital of LAC countries places Brazil, the largest, at 10,874 times the size of St Kitts and Nevis, the smallest (population 42,000)³. The 12 states that are members of the Caricom Single Market and Economy have an aggregate population that is less than that of the city of Rio de Janeiro⁴; and their aggregate GDP (PPP) is about one thirty-fifth of Brazil’s.

The fall in total tax revenues following trade liberalization and the difficulty of recovering lost tax revenues with other sources in the domestic tax system, issues that are highlighted in Joaquim’s paper, have particular salience in the case of small and very small economies. Small economies have a higher degree of trade dependence than their larger counterparts. Their limited resource base and small domestic markets force them to specialize in the exports of goods and services. For similar reasons, many small economies are also ‘preference dependent economies’; they have tended to rely on market preferences for their principal export commodities from their main metropolitan trading partners. These preferences are being eroded as a result of the new rules of multilateral trading system under the WTO; for example the cases of the banana and sugar preferences granted to the ACP (African, Caribbean and Pacific) countries by the EU.

¹ *Small States: Meeting Challenges in the Global Economy. Report of the Commonwealth Secretariat/World Bank Joint Task Force on Small States.* April 2000

² Dr Roman Grynberg and Jan Yves Remy, “Small Vulnerable Economy Issues and the WTO”, 24th CPA Conference of Members from Small Countries, Quebec City, September 2004; p. 5; www.cpahq.org/SCC5_pdf_media_public.aspx; sourced 10 May 2006.

³ The ‘PSPH’ Index was developed by Mario Gutiérrez, *Observaciones respecto a las economías pequeñas en el proceso de integración económica en el Hemisferio Occidental.* El Trimestre Económico, Mexico (1996), pp. 1,171-1,227. Recent values are available in Norman Girvan, “Treatment of Asymmetries: Review of the Issues” (Report Prepared for the Rio Group, November, 2006), Table 1..

⁴ i.e. 6 million. The 15 countries that are members of the Caribbean Community have a population of 15 million; of which Haiti alone accounts for over 8 million.

The trade dependence of small economies translates into trade tax dependence of their fiscal systems. This is illustrated by data on the share of import taxes in fiscal revenue for several countries of the Caribbean Community, shown in Table 1. For the very small countries of the Organisation of East Caribbean States (O.E.C.S.), the share is generally between 40 and 60 percent⁵. The share is noticeably smaller in the larger economies of Caricom. Several of these small economies have achieved relatively high levels of human development. As the table shows, many of these economies have a higher global ranking in the UNDP's Human Development Index than their global ranking in per capita income. This indicates their relative success in converting per capita income into human development. This conversion takes place mainly through the fiscal mechanism, i.e. by means of public expenditure on education and health. One can therefore speak of the 'trade tax dependence of human development'. This situation is accentuated by preference dependence.

At the same time, small size poses particular difficulties in recouping trade taxes by other means such as value added or sales taxes. This is because administrative systems are constrained by the absence of a critical mass of human and administrative resources; a constraint that has been amply shown in the literature. In very small economies there is a single port of entry or at most, two or three. This is the primary point of collection of import duties and hence of fiscal revenues. Basically, a small number of officials working with long-established systems and procedures can collect the bulk of fiscal revenues. Now consider what happens when you try to shift over to a system of sales taxes and/or value added taxes. Suddenly you have thousands of tax collection points all over the physical space. Most of these are small and medium enterprises – SMEs. They are not accustomed to keeping regular or detailed accounts. Their transactions costs increase steeply. The tax authorities now have to cover the whole country, inventorising and monitoring taxable enterprises and individuals. You need a whole new system, staffed by a larger number of technically qualified and incorrupt officials. The cost of collecting the tax dollar goes up. Hence, net revenue (tax collections minus the costs of collection) declines. Is it any wonder that, as Joaquim's paper shows, the reduction of revenues in low-income countries is often permanent? And there is the further danger that gains in human development will be reversed as fiscal resources decline.

There are several ways in which this problem in small economies may be addressed. The international community could consider the provision of technical and financial assistance for the conversion of their tax systems. This would be useful, but remember that such assistance will at best be temporary, while there will be an increase in the recurrent costs of maintaining the new system. Second, small economies could be granted extended transition periods for tariff reduction under multilateral trade agreements, to take account of the time taken for transition to new tax systems. Third, small economies may be granted a 'special dispensation' to levy a tariff differential which represents the additional cost of collecting a given quantum of taxes via, say, a value added tax by comparison with a tariff. The beauty of it is that since small economies in the aggregate

⁵ The seven countries of the O.E.C.S. have a total population of 550,000 and an average population of approximately 80,000

account for a very small proportion of world trade, the total cost to the international community of any or all of these measures should be relatively small.

Table 1. Caribbean Community, Selected Statistics

<i>Countries</i> ^a	Population '000 2004	HDI ranking 2003	Import taxes % Fiscal Revenue 1999
CARICOM ^b	15,580	...	
Bahamas	317	High	52.7
Barbados	271	High	9.6
Belize	261	Medium	34.8
Guyana	767	Medium	12.1*
Haiti	8,988	Low	n/a/
Jamaica	2,676	Medium	10.4
Suriname	439	Medium	
Trinidad and Tobago	1,307	High	7.2
<i>OECS</i>	554	...	
Antigua and Barbuda	73	Medium	48.1
Dominica	79	Medium	14.6
Grenada	80	Medium	n.a.
St. Kitts and Nevis	42	High	43.6
St. Lucia	150	Medium	47.1
St Vincent & the Grenadines	121	Medium	43.2
Montserrat	9	...	

* 1998 data

Source: UNDP Human Development Reports; *The Fiscal Effects of Tariff Reduction in Caribbean Community*; CARICOM Secretariat; September, 2002