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The Uniform-Tax Controversy

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1 Introduction

In recent years an interesting schism has appeared within the ranks of public finance experts and practitioners. On one side of the divide we have a group that espouses uniformity of rates in indirect (value added) taxation and in tariff schedules. On the other side we have those who do not accept uniformity as a goal and who develop economic analyses showing how uniformity of indirect taxation is less than optimal.

This paper attempts to juxtapose these two views, and to explore the merits and limitations of each case. Without a doubt the bulk of those who argue for uniform value-added taxation do so from a real-world policy orientation, while their main intellectual antagonists argue on the basis of economic theory.

One important message of this paper might be summarized as saying that uniform taxation can best be defended on pragmatic policy grounds—it is hardly ever the best (the theoretical optimum), but it is always a really very sound pattern of taxation. Its distortions of resource allocation may not be minimal, but they are very low compared to plausible alternatives. Moreover, a system of uniform taxation is robust to changes in tastes and technology. Once such a system is in place it can typically be left in place for many, many years. That is, the dynamic movements of tastes and technology are not likely to call for important or frequent changes. Defenders of uniform taxation are cautioned to stick to this kind of pragmatic underpinning in building their case, and not to claim a global theoretical superiority for their "product."

The counterpart of the above message is directed at the advocates of "Ramsey-Rule" taxation. Their case is built on a demonstration that to truly minimize the efficiency costs of taxation on some subgroup of commodities,

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one must in general apply higher rates to those goods which are poor substitutes for the commodities that are left out of the tax net, and lower rates to those that are especially good substitutes for the "left-out" group. While the mathematics underlying the Ramsey Rule solution cannot be denied, the message of this paper is that the Ramsey Rule solution requires far more knowledge of supply and demand relations than we actually possess. Moreover, changes in tastes and technology will tend to alter the optimum solution over time. Ramsey taxation is thus considerably more robust than uniform taxation. It also has to cope with the aura of "exploiting" situations of inelastic demand and supply in a way that comes close to mimicking what private economic agents do when they exploit monopoly or monopsony power.

Uniformity in tariffs is rooted in a somewhat different intellectual tradition from uniformity in indirect taxation. For tariffs, the main line of defense for uniformity is that only in this way can one guarantee equal effective protection for all possible activities of import-substitution within the country. The resistance to uniformity has come from those who are reluctant to see tariffs on inputs (raw materials, component parts, capital goods) raised in order to make them uniform with the rest.

This paper points out that there are several ways in which the pattern of effective protection might fail to be precisely uniform, even under a uniform tax for uniformity is that only in this way can one guarantee equal effective protection for all possible activities of import-substitution within the country. It is not easy to achieve uniformity for export goods that are used as inputs into the production of import substitutes, but we know of no case in which serious adverse consequences would result from a failure to make such a correction.

The most important argument presented in this paper's discussion of tariffs demonstrates that very important gains of productive efficiency are in-}
A Simple Tax Scenario

Economists can, at least to some extent, help us out of our ignorance and in an extracted version of this scenario. Assume that the tax is not a direct tax and in practice cannot ever be completely general, how can the tax be paid? What major decisions have to be faced? What are the consequences and is the tax shifted to the consumer? Our conclusion is that the tax is a 'tax on the rich' and that the tax is paid by the rich, and that the tax is a 'tax on the poor' and that the tax is paid by the poor.

In my view, the distinction between the 'tax on the rich' and the 'tax on the poor' is a matter of degree. In reality, this distinction is not so clear-cut as it may seem. While it is true that the rich pay more tax than the poor, this does not necessarily mean that the rich are the only ones who benefit from the tax. The poor may also benefit from the tax, either directly or indirectly.

For example, the poor may benefit from the tax by receiving welfare payments or other forms of government assistance. Alternatively, the tax may lead to a reduction in the cost of goods and services, which could benefit the poor as well. In other words, the tax may have a positive impact on the poor, even if they pay more of the tax than the rich.

In conclusion, while the distinction between the 'tax on the rich' and the 'tax on the poor' is a useful one, it is not always clear-cut. The benefits of the tax may be shared by both the rich and the poor, and the tax may have both positive and negative impacts on them.

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prime candidate for shifting to the taxed group would be anything that we might find in the untaxed group that had strong substitutes already under the tax.

The situation is more normal when the item we are contemplating to add to the taxed group does not appear to have any readily identifiable strong substitutes or strong complements. The most natural procedure in such cases is to rely on the phenomenon of generalized substitution that we know exists in economic activity. Under "generalized substitution" we would expect that the resources expelled from the newly taxed sector would be attracted to the (taxed and untaxed and groups) in rough proportion to the amount of resources already in each. If these two groups were of equal size, something like half of the expelled resources would go to the taxed sector, and in this case the resulting costs would be just matched by the rectangle of benefits.

As the tax gets more and more general, the presumption becomes greater at each step that the resources expelled from a newly taxed activity will go predominantly to already taxed activities. This clearly increases the benefit of widening the tax net.

This is not the place to embark on an extended development and application of the above analysis to other questions. Suffice it to say that the preceding analysis is built on the same analytical machinery that leads to the Ramsey Rule. The only important distinguishing feature is the presumption of a realistic level of ignorance about detailed facts (and in particular about precise substitution parameters).

The pragmatic lessons that follow from the above are

1. In deciding upon the set of items to be covered by a "general" tax (say a value added tax), try to keep "packages" of strong substitute items together (i.e., either all in the taxed group or all in the "left-out" group).
2. If a package of close substitutes contains some important items that by their nature are difficult to tax, then the course of prudence may well lie to leave the whole package in the untaxed sector rather than cause sharp tax-induced substitutions by introducing a tax just on a part of the group.
3. Once a "general" tax reaches a size worthy of the name, there is a reasonable presumption that shifting additional items from the "left-out" group to the taxed group will be beneficial in terms of economic welfare. This becomes of greater interest once it is realized that the addition of such items brings revenue increases as well.
4. Once a point of plausible generality is reached, the grounds for making the tax even more general are quite strong (see #3). Beyond this point the only strong technical arguments against further extending the scope of the tax are administrative in nature. Taxes that are easy to evade will no doubt be evaded. This may determine that whole packages of substitute items be left in the untaxed sector (see #2).

The preceding scenario has derived operating rules for a uniform, reasonably general tax like the VAT, and has done so under what I consider to be reasonable assumptions concerning the amount and generality of the information available (to technicians and policymakers). I certainly don't want to claim that the resulting general tax would be an "optimum" tax in the technical sense. But it surely would be a good tax, raising a lot of revenue at a relatively low efficiency or welfare cost.

For now let us leave the technical side. We have outlined a good tax, with low deadweight loss per peso of revenue. This comes from the technical side.

Now I would like to add some items that are perhaps more philosophical than technical. First, is it desirable for a tax system to depend very strongly on people's tastes? Ramsey Rule taxation strikes heavily those items that people prize most (in the sense of having a relatively inelastic demand for them), and least heavily those items about which people are relatively indifferent—"a-a" alternatives (as revealed in a relatively high elasticity of demand for them). On the supply side, likewise, Ramsey Rule taxation looks like a "search and destroy" mission aimed against economic rents. In a sense the job of a Ramsey Rule tax manager is to find out what are the conditions of supply and demand in the economy, and to set tax rates accordingly, imposing high rates where demand is less elastic, low rates where it is more elastic. (This statement holds where the taxed sectors are independent in demand. The correct technical condition is for taxes to be higher on goods that are poorer substitutes for the "left-out" group.)

One can argue that we shouldn't base tax policy on supply and demand parameters because we do not know enough about them, nor can we hope to in any foreseeable future. But while I would in general agree with that argument, that is not the line I am taking here as my second point. What I want to do here is to question whether we want our policy to be significantly dependent on changes in tastes and technology. I do not pretend to answer the ques-
tion. Rather, I simply note that a broad, general uniform tax of the type developed in the preceding scenario would not be seriously influenced by plausible changes in tastes or technology. Thus the above question—one that would prove to be of little import to people who worked and thought within the framework of our tax scenario—would likely prove quite troublesome to a Ramsey Rule advocate.

My third point is value-loaded in comparison to others. Here we ask whether we, in our own vision of the good society, think that the government should care about changes in tastes among its citizens? Should it want to change its tax laws because demand became more elastic for one good, supply less elastic for another, or because a new product was introduced or an old
III. The Case for a Uniform Tariff

Economists are quite naturally drawn to the idea of free trade, if only for the sake of the argument. But the idea of a free trade agreement with the United States seems to be more appealing to most people. In this way, the imposition of a tariff on the US market for the purposes of protectionism is justified. However, such a tariff does not necessarily benefit the world as a whole. Moreover, it can actually lead to a decrease in world welfare.
sures, though in a few of the poorer developing countries the revenue motive may also play a significant role. Protectionist pressure also explains why tariffs tend to be concentrated on finished goods. They typically leave primary inputs alone, except when there is a domestic primary-producing industry to protect. The protectionist motive thus also explains the pattern that rates of tariff (where they exist) tend to be highest on finished goods and lowest on primary inputs.

I believe that the standard case for a uniform tariff relies on the protectionist motive. Indeed, one needs the protectionist motive in order to sanction the idea that one should accept a domestic resource cost of 13 pesos for producing a dollar's worth of import substitutes while at the same time the domestic resource costs of generating a dollar via the export route is only ten pesos.

In my view, the uniform tariff argument says, let us accept that the virus of protectionism is rampant throughout the world, and that we cannot stamp it out. But let us try to contain the disease that the virus causes. Let us try to limit the damage it can do.

By accepting the idea that the virus of protectionism is with us to stay, the uniform tariff argument "justifies," or at least explains, why one "should" be content to have a higher domestic resource cost for import substitutes than for exports. But then the uniform tariff argument goes on to point out the absurdity (from an economic point of view) of paying a DRC of 22 pesos per dollar in one place, of 16 pesos per dollar in another and of 10 pesos per dollar in a third—all being cases of import substitution, with the last one being (typically) that of raw materials which enter duty-free.

There can be no doubt that, in the absence of monopsony power, a country gains by moving toward equalization of the domestic resource costs of different import substitute activities. In advocating this, the economists who developed the theory of effective protection and who extracted its principal implications were acting as responsible representatives of the economist's traditional role in policy-making.

I would characterize that traditional role as follows: economists favor efficiency, fight ignorance, and strive to represent the general interest. In the case of the uniform tariff, the efficiency goal is served (in a second-best sense) by equalizing effective protection. A uniform tariff fights ignorance in the sense that many citizens and legislators may think (wrongly) that a 30 percent tariff on each of a number of final products represents fair and equal treatment for each industry that is so protected. But effective protection analysis shows how these industries can be favored in dramatically different degrees, simply depending on how much they use imported inputs and on the level of tariffs applying to those inputs. The uniform tariff is thus precisely what is needed to give "fair and equal treatment" in the sense of equal effective protection and an equal willingness by citizens to bear an extra domestic resource cost for import-substituting activities.

### Uniform-Tax Controversy

The traditional role of economists in representing the general interest makes economists the "natural enemies" of special interest groups. This has indeed been their traditional role. I do not think it has been modified by modern efforts by a small subset of our profession to "explain" why some interest groups have more power than others, and therefore why some tariffs are high and some tariffs are low. Industries with more political "clout" can inflict more damage on the average consumer than industries with smaller influence on governments and legislatures. That may explain, but does not justify the exploitation of consumers and taxpayers, nor does it free economists from what I would consider a moral duty to oppose such exploitation.

Just as in the case of efficiency, some compromise of the general interest is involved in a uniform tariff, but the costs are widely shared and limited in amount. In particular, tariff uniformity does not favor powerful political interests in any obvious way. Indeed, the move from a differentiated tariff to a uniform one might be considered as a way to equalize the political "clout" of all domestic producers of import substitutes. The critical step in bringing about equal effective protection goes beyond raising tariffs on the products whose domestic producers are politically weak and ill-organized. The critical step is that in which the uniform tariff is extended to goods—like some minerals perhaps, and tropical fibers—that are not now, and probably never will be produced in the country. The same goes for complicated capital goods in developing countries. Who is there who will fight for tariffs on such goods? Only the domestic consumers and taxpayers have their interests at stake. The producer groups that exist will be on the other side, fighting for zero or very low tariffs, for these are goods that are inputs into their production processes. To the degree they succeed, they will get greater effective protection, imposing greater costs on consumers and taxpayers. Economists have a very big task here, in defending the general interest. One of the great virtues of the idea of a uniform tariff is that it gives economists a general principle to appeal to as they wage this struggle. The idea that a uniform tariff gives equal effective protection to everybody is a potential mobilizing force that can be brought to bear on the difficult political task of raising tariffs where no domestic producer group will benefit and indeed where producer groups from the input-using industries are fighting on the other side.

### IV. Tariffs on Inputs Revisited

Most discussions of the theory of effective protection commence by assuming a given tariff on some final products. They then proceed to demonstrate how the same final-product tariff can imply very different rates of effective protection, depending on whether imported input costs (here assumed to be free of duty) represent a high or low fraction of the world price of each input. As a final step they show that when the inputs are subjected to
Consider the general formula for the rate of effective protection $p_e$:

$$ p_e = \frac{p_m - p_i}{p_i} \times 100\% $$

where $p_m$ is the market price and $p_i$ is the input price. The rate of effective protection is the difference in price divided by the input price, expressed as a percentage.

In the case of input tariffs, we can see that the effective protection is zero if the input price is equal to the market price. This means that if the product is produced entirely from imported inputs, there is no effective protection.

However, in the case of output tariffs, we can see that the effective protection is equal to the percentage markup on the output price. This means that if the product is produced entirely for domestic consumption, there is no effective protection.

In the case of value-added taxes, the effective protection is equal to the percentage markup on the value-added tax rate. This means that if the product is produced entirely for export, there is no effective protection.

In the case of import duties, the effective protection is equal to the percentage markup on the import duty rate. This means that if the product is produced entirely for domestic consumption, there is no effective protection.

In the case of export subsidies, the effective protection is equal to the percentage markup on the export subsidy rate. This means that if the product is produced entirely for export, there is no effective protection.

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tariffs up to the common level within a general context of a reform bringing final product rates toward uniformity. Speaking more broadly, I believe that the proceeding analysis strengthens the case for uniform tariffs, **viv-a-viv** almost any real-world alternative other than free trade.

**V. Conclusions**

In this paper we have followed a different path than most tax analysis. We have not followed the common practice of looking only at individual tax changes as if they were the only distortions in the picture. At the same time we have also diverged from the less common practice of trying to find a second-best “optimum” package of tax rates, taking certain constraints as given. Instead we have taken as “our world” one in which some effort has already been expended to achieve a uniform rate of tax (or tariff), at least on some commodities.

In the case of value added taxation, we recognize from the outset that a fully general coverage is unattainable. Instead we examine possible guidelines that might help a policymaker to decide where to draw the line between a “covered” group of activities and a “left-out” group. Our broad conclusion is that a left-out activity should be added to the covered group so long as a) the move does not entail excessive costs of administration and b) the move does not shift one commodity into the covered group, while leaving important close substitutes in the “left-out” group. Conclusions a) and b) imply that, if some activities are themselves hard to bring into the tax net, it may be wise to leave their close substitutes outside the net as well.

In considering import tariffs, we explore the arguments for equalizing the domestic resource costs of saving a dollar through different activities of import substitution. They have a degree of merit once it is taken for granted that import substitution has some positive value. (Otherwise, there is no basis for having different DRGs for import substitutes than for export goods.) The practical problems arise from the fact that to implement a uniform tariff in a real-world setting one must typically increase the rates applying to imported inputs and (possibly) capital goods. This stimulates a political resistance on the part of the input-using industries, which must be surmounted if the reform is to succeed. I believe that the best basis on which to base a campaign for increasing tariff rates on inputs is to establish the notion of the intrinsic fairness of a system that aims at uniform effective protection.

A final issue concerning increases in tariff rates on inputs is treated in Section IV. There it is shown that gains in welfare tend still to be positive even when one raises the rates of input tariffs quite a distance above the rate applying to final products. This result stems from the fact that input tariffs tend to offset the protective effect of any pre-existing tariffs on final products.

Uniform-Tax Controversy

To push input tariffs up to the point of an already existing uniform tariff on final products has the effect of bringing rates of effective protection into greater uniformity. Pushing input tariffs beyond this level can be thought of as a rather scattershot way of reducing protection still further, on at least some final products. Rather than urge this, most economists (myself included) would prefer simply reducing the uniform rate of tariff, once it had been achieved.

It should be clear from the above analysis that one cannot treat uniform value-added taxation or uniform tariffs as desirable and unquestioned goals on which all economists should in principle agree. Their justification is far more subtle and judgmental than that. It is important, therefore, for supporters of uniform taxation to recognize that their conclusion requires a well-reasoned defense. By the same token, those who argue against uniform taxation should quite clearly go beyond simple Ramsey Rule mathematics in defending their position, and should directly face some of the subtle arguments (philosophical as well as strictly technical) that comprise the best case for uniform taxation.

Résumé

L'auteur montre qu'il est impossible de traiter l'imposition d'une TVA ou de droits de douane uniformes comme des buts souhaitables et incontables sur lesquels tous les économistes devraient, en principe, être d'accord. Leur justification est beaucoup plus subtile et subjective. Les partisans de la taxation uniforme ont donc tout intérêt à admettre que leur conclusion exige une défense bien argumentée. De même, il incombe à ceux qui rejettent la taxation uniforme de dépasser le simple cadre mathématique de la règle de Ramsey pour défendre leur position et répondre à certains des arguments les plus subtiles (d'ordre philosophique et strictement technique) qui militent le mieux en faveur de la taxation uniforme.