

## COMMUNICATION FROM THE INTERNATIONAL MONETARY FUND

The following contribution has been received from the staff of the International Monetary Fund. It has been prepared in response to consultations between the WTO Director-General and the Deputy Managing Director of the IMF on how the IMF can provide support to the WTO Secretariat and Members in areas of its expertise.

### EXPORT FINANCING AND DUTY DRAWBACKS

#### Note on Issues Raised by Developing Countries in the Doha Round<sup>1</sup>

#### EXECUTIVE SUMMARY

Developing countries have proposed that they should be allowed to offer financing to their exporters at LIBOR or on terms offered by the credit agencies of developed countries. The analysis in this note suggests that both these proposals would involve export subsidization because the terms of financing would — from analytical and empirical perspectives — be more favorable than those available in the market to exporters. Further, the case that developing country exporters should receive concessional finance because of distortions in developing country capital markets is not compelling.<sup>2</sup> These distortions are typically policy-induced, and even where they are not, it is highly unlikely that they will systematically work to the disadvantage of exporters. The most appropriate policy response would be to eliminate the underlying distortion rather than introducing new ones through the provision of subsidized credit to exporters.

On drawbacks, developing countries have made two proposals. First, they should be allowed to provide a uniform duty drawback for all exporters (or all exporters in a sector) regardless of their actual use of imported intermediate inputs. Second, duty drawbacks should be extended to all inputs, including capital goods. This note comes to the following conclusions with regard to these two proposals.

- If countries have a sufficiently strong administrative capability in implementing domestic indirect taxes, particularly the crediting mechanism under the VAT, it would be desirable that any duty drawback system be administered similarly to the VAT crediting mechanism.
- While a good case can be made, in principle, for extending drawbacks to capital goods, doing so may not be easy in practice.

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<sup>1</sup> This Note was prepared by Stephen Tokarick and Arvind Subramanian, Research Department, International Monetary Fund.

<sup>2</sup> This Note does not take a view on whether developing countries should nevertheless be allowed to offer concessional financing to their exporters *because* developed countries are permitted to do so.

- In terms of the two proposals, this implies that countries with relatively strong tax administrations should not favor the uniform drawback scheme and could be allowed to extend duty drawback to capital goods.
- Where tax administrations are not strong or are being strengthened, the administrative and political economy benefits of the uniform drawback scheme may be significant, strengthening the case for its adoption, but only for small exporters.

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1. Developing countries have made a number of proposals in relation to exports, two relating to export financing (discussed in Section I) and two to duty drawback schemes (discussed in Section II).

## **I. EXPORT FINANCING**

2. The two proposals relating to export financing are:

### ***Proposal 1***

*Export credits given by developing countries shall not be considered as subsidies so long as the rates at which they are extended are above the London Interbank Offered Rate (LIBOR).*

### ***Proposal 2***

*The language of Annex I of the Agreement on Subsidies and Countervailing Measures (SCM), particularly item k, shall be reviewed to permit developing countries to provide competitive export financing vis-à-vis the conditions found in the international market or those offered by the credit agencies of developed countries (controlled by or acting under the authorities of the governments).*

3. This note will analyze these two proposals in terms of the following questions:

- Would the provision of export financing to developing country exporters at LIBOR (Proposal 1) or on terms offered by the credit agencies of developed countries (Proposal 2) amount to export subsidization?
- Even if such financing involves export subsidization, should it be permissible because of the special circumstances of developing countries?

4. The first is a positive or factual question that can only be analyzed against a benchmark rate, for example, the rate of interest that developing country exporters are likely to obtain in a well-functioning domestic or international capital market. The second is a normative question with an explicit special and differential treatment perspective: given the general prohibition against export subsidization in the WTO Agreement on SCM, should developing countries be exempted from this prohibition in view of their special circumstances?

### ***Export subsidization and market rates of interest***

5. LIBOR is a well-established and understood benchmark interest rate in international financial markets. But the “terms offered by the credit agencies of developed countries (controlled by or acting under the authorities of the governments)” is less well-known. In practice, the latter refers to the *Arrangement on Guidelines for Officially Supported Export Credits* (henceforth referred to as “the *Arrangement*”) which was reached in 1978, with a series of amendments since that time, and which aims at avoiding competition among countries for the most attractive financing terms. The *Arrangement* is not a part of WTO rules. Rather, it is a “gentlemen’s agreement” among its participants (OECD countries) and it has been incorporated into European Community law. The *Arrangement* established a set of rules which govern the use of official support for exports of goods or services, or financial leases that have repayment terms of two years or more. It applies to export

credits given through direct credits, financing, interest rate support, guarantee, or insurance. Special sectoral arrangements apply to official support given to exports of ships, nuclear power plants, and aircraft, while the *Arrangement* does not apply to military equipment or agricultural products.<sup>3</sup>

6. In practice, countries that have agreed to adopt the provisions contained in the *Arrangement* and that offer interest rate support must apply minimum interest rates, known as commercial interest reference rates (CIRRs).<sup>4</sup> These rates are determined as a fixed margin of 100 basis points above a base rate, which varies between a three to seven year government bond yield.<sup>5</sup> CIRRs are published for about twenty different currencies, all of which are for borrowing in currencies of countries that are members of the OECD.

7. Figure 1 compares LIBOR with the CIRR. It should be noted that these two interest rates are not directly comparable, in that the longest term LIBOR rate that exists is for one-year borrowing, while the shortest term CIRR that exists is for credit to be repaid between two and five years. Thus, a comparison between LIBOR and CIRR is not for the same maturity. Nevertheless, for the period between January 1995 and September 2002, Figure 1 compares the one-year LIBOR rate on U.S. dollar denominated deposits with the CIRR on U.S. dollar credits due in less than five years. As shown, the CIRR exceeded the LIBOR rate for the entire period and the average gap between the two rates was one percentage point between 1995 and 2002.

8. Would the provision of financing to exporters at LIBOR or at the CIRR amount to export subsidization? This question presupposes the need for a benchmark: a market rate of interest. The market rate charged to any borrower would comprise the risk-less rate plus a margin for the underlying risk of lending to a particular borrower. For developing country borrowers, this risk in turn consists of three elements: country-risk, the credit risk related to the particular exporter, and if the borrowing and lending is in local currency, the risk faced by the lender that the currency will depreciate. These risk elements vary across time, countries, sectors, and firms.

9. It follows therefore that both LIBOR, which is a risk-less rate, and CIRR, which is a risk-less rate plus a *fixed* margin would both lie well below the market rate for developing country exporters. Both LIBOR and the CIRR rate bear little relationship to the nature of the transaction being considered, especially the degree of risk, and hence would clearly amount to subsidization.

10. To evaluate the proposal empirically, it would be useful to compare LIBOR and the CIRR with a market interest rate that an exporter would have to pay in a market where there are no distortions. This market rate would obviously depend on the country and the currency denomination of any loan. To assess where LIBOR and CIRR would lie in relation to such a market rate, it is useful to construct an interest rate that could serve as a reference point. Abstracting from any currency risk (and therefore only considering borrowing in U.S. dollars), a useful reference interest rate is the U.S. prime interest rate, plus a margin for country risk, plus a margin for exporter-specific risk. The U.S.

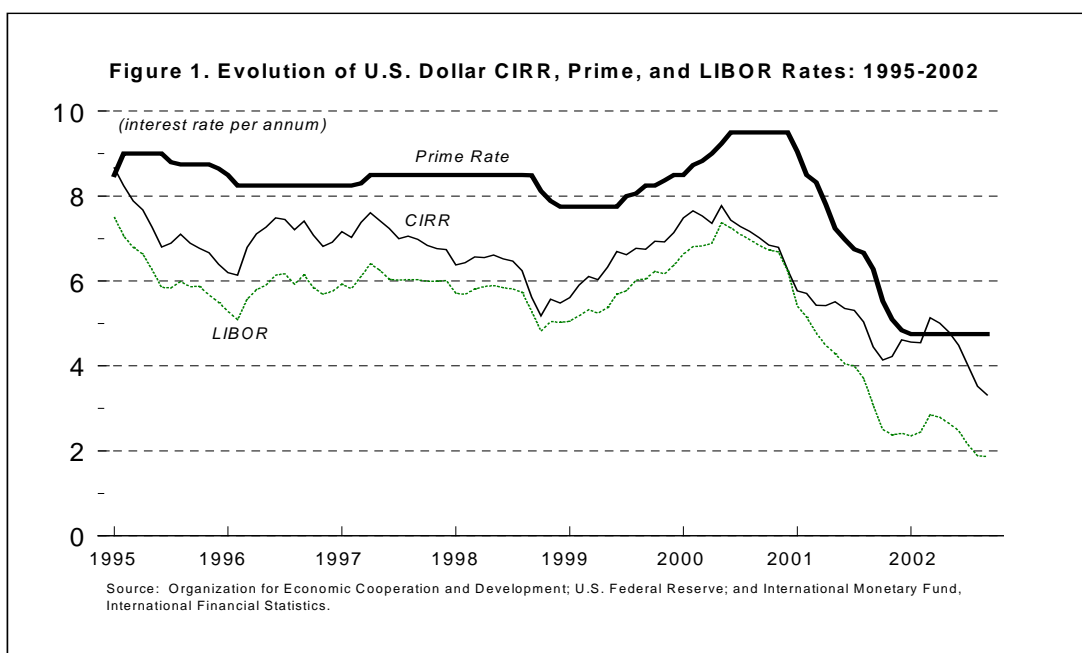
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<sup>3</sup> Article 10 of the WTO Agreement on Agriculture mandates that countries agree to work toward a set of internationally agreed disciplines on the use of export credits, export credit guarantees, and insurance programs, and to use these measures only in accord with the agreement. To date, however, no such international agreement exists in agriculture.

<sup>4</sup> The general principles that govern the establishment of CIRRs are: (i) they should represent final commercial lending rates in the domestic market; (ii) should correspond to the rate for first-class borrowers; (iii) they should not distort domestic competitive conditions; and (iv) they should closely correspond to a rate available to first-class foreign borrowers.

<sup>5</sup> The first base rate is: (i) three-year government bond yields for repayment up to 5 years; five-year government bond yields for repayment between 5 and 8½ years; and seven-year bond yields for repayment over 8½ years. The second option for the base rate is the five-year government bond yield for all maturities. The exceptions to this two base rate system is the yen CIRR, which is based on the long-term prime rate less 20 basis points for all maturities, and the ECU CIRR, which is based on the secondary market yield on medium-term ECU bonds on the Luxembourg stock exchange plus 50 basis points.

prime rate is chosen to construct a market interest rate because it is determined in a well-functioning, distortion-free market and represents the rate that a bank would charge its most creditworthy customers. Figure 1 plots the U.S. prime rate for the period 1995 through 2002. As shown, the U.S. prime rate far surpassed LIBOR over the entire period, and it averaged  $2\frac{1}{2}$  percentage points above LIBOR in each year. If country risk and exporter-specific risk were added on top of the U.S. prime rate, the gap between market rates and the two reference rates would be even larger. In short, the subsidy implicit in using LIBOR or the CIRR would be substantial.



*Should export subsidization through concessional export financing be permitted?*

11. The two proposals on export financing suggest that developing countries have not sought an exemption for export subsidization in general. The exemption that is sought has a narrower focus, relating to export financing. This note therefore does not address the broader question of the merits or otherwise of export subsidization in general.

12. It should also be emphasized that this note does not take a position on whether developing countries should be allowed to offer concessional financing to their exporters *because* developed countries are allowed to do so under paragraph k of Annex 1 of the WTO SCM agreement. This is a political question that WTO members will need to decide. This note focuses instead on the analytical issues relating to concessional export financing.

13. The implicit case for subsidization that developing countries appear to be making is that imperfections in domestic and international capital markets handicap developing country exporters. Concessional financing is then a way of overcoming these imperfections. Evaluating the merits of this argument requires, however, that the distortions be identified, and their impact assessed which would then allow conclusions to be drawn about the appropriate remedial action.

14. Three types of distortions in capital markets could affect developing country exporters.

- First, developing country capital markets could be financially repressed, with below-market rates of interest, and rationing of the consequential excess demand for credit;

- Second, developing country markets could be characterized by very high rates of interest because of unsustainable macroeconomic policies and loss of confidence; and
- Third, capital markets could be free of policy-induced distortions but nevertheless be inefficient because of inherent problems of asymmetric information (adverse selection and moral hazard).

#### A. POLICY-INDUCED DISTORTIONS: FINANCIAL REPRESSION

15. Financial repression is a policy-induced distortion that leads to excess demand for, and hence rationing of, credit. Borrowers that get access to credit implicitly receive a subsidy and those that are rationed out are implicitly taxed. Three questions are pertinent here:

- Is financial repression pervasive?
- Does it impact adversely on exporters?
- Even if it did, would subsidization of exporters be the best response?

16. The available evidence suggests that while financial repression was a pervasive feature of developing country capital markets, during the period 1960-1990, because of financial instability, high inflation, and government intervention, it is less prevalent today.<sup>6</sup> Even when financial repression did exist, there was little evidence that the rationing systematically led to the exclusion of exporters from credit. In fact, quite the converse. Exporters often obtained preferential access because of policies of directed credit that typically favored exporters. Finally, even in the unlikely event that exporters were systematically hurt, the appropriate policy response would be to eliminate the policies that give rise to financial repression rather than adding a further distortion by providing subsidized credit to exporters. In addition to the administrative difficulty and the rent-seeking costs that a policy of subsidized credit would give rise to, other agents in the economy could advance claims of being credit-rationed which the government would find difficult to refuse.

#### B. POLICY-INDUCED DISTORTIONS: HIGH DOMESTIC INTEREST RATES

17. Countries often experience high real interest rates as a result of excessive fiscal deficits, and high nominal rates generated by expansionary monetary policy. In addition, high real interest rates are maintained by countries, at least temporarily, as part of the package of measures to sustain confidence in domestic policies in the face of financial crises. Such rates, it is alleged, increase the cost of doing business, thereby impairing the competitiveness of developing country exporters. In this case too, the questions similar to the ones posed above, particularly the latter two, are relevant.

18. As an analytical point, it is worth mentioning that high interest rates need not adversely affect the export sector.<sup>7</sup> In a simple trade model with two factors of production — labour and capital—high real interest rates are likely to reduce the profitability of the capital-intensive sector relative to the labor-intensive one. Insofar as developing countries have comparative advantage in labor-intensive sectors, high real interest rates are more likely to adversely affect the import-competing sector than the export sector; in other words, they are more likely to work to reinforce rather than work against existing comparative advantage. At the very least, there can be no presumption that the export sector will be systematically disadvantaged.

19. Most importantly, of course, even if it can be demonstrated that exporters are particularly affected, the most appropriate policy response would be to address the underlying source of the

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<sup>6</sup> Mehran et. al., 1998 suggest that, although the functioning of the financial sector remains far from fully efficient in Sub-Saharan African countries, substantial progress has been made in eliminating conditions of financial repression.

<sup>7</sup> Unlike with financial repression, high real interest rates under conditions of financial crises and lack of confidence do not represent a disequilibrium phenomenon that requires or involves rationing of credit.

distortion, namely the underlying policies — macroeconomic and financial — that lead to high real interest rates. Addressing this policy-induced distortion by subsidizing exporters would entail costs similar to those mentioned above.

### C. INHERENT DISTORTIONS: ADVERSE SELECTION

20. Even in the absence of policy-induced distortions, it is well-established that capital markets are susceptible to inefficient outcomes because of the problem of asymmetric information and herd-behavior (Stiglitz and Weiss, 1981; Calvo and Mendoza, 1999). In this context, it is possible that exporters could be systematically credit-rationed because of creditors' tendency to categorize them as bad risks, when in fact they are good customers. However, there is little evidence that creditors behave in this manner.

21. Indeed, quite the converse appears more likely. Problems of adverse selection are aggravated because of the inability of good borrowers to signal their true credit type. But the very fact of being an exporter is a signal of being able to compete successfully in international markets. Magaestae and Patillo (2002) provide evidence from Africa that exporters are generally more efficient and productive than other firms. Thus, creditors are more likely to favor exporters and ration other borrowers who cannot demonstrate similar market-based performance. Harrison and Mcmillan (2002) finds evidence from work on sub-Saharan Africa that domestically-owned firms are more likely to be credit-constrained than foreign-owned firms that are more export-oriented than domestic ones. In addition, the fact that exporters can access international capital markets more easily than other agents is another reflection of their advantageous position in overcoming adverse selection problems.

### Conclusions

- The proposal by developing countries that their exporters be provided with credit at LIBOR or on terms offered by the credit agencies of developed countries would involve subsidization because these rates are — analytically and empirically — well below what exporters would typically be able to obtain from the market.
- The case that developing country exporters should receive concessional finance because of distortions in developing country capital markets is not compelling.<sup>8</sup> These distortions are typically policy-induced, and even where they are not, it is highly unlikely that they will systematically work to the disadvantage of exporters. The most appropriate policy response would be to eliminate the underlying distortion rather than introducing new ones through the provision of subsidized credit to exporters.

## II. DUTY DRAWBACKS

22. Developing countries have made two proposals relating to duty drawback schemes.

### **Proposal 1**

*“Aggregate and generalized rates of duty remission should be allowed in case of developing countries even though individual units may not be able to establish the source of their inputs” (hereafter referred to as the uniform drawback rule), and*

### **Proposal 2**

*“The definition of “inputs consumed in the production process” (footnote 61 of the Uruguay Round Agreement on Subsidies and Countervailing Measures (SCM)) needs to be expanded to include all inputs, not just physical units, which may have contributed to the determination of the final cost price of the exported product” (hereafter referred to as the capital goods drawback proposal).*

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<sup>8</sup> This note does not take a view on whether developing countries should nevertheless be allowed to offer concessional financing to their exporters *because* developed countries are permitted to do so.

### *Theoretical considerations*

23. Tariffs on imports lead to, indeed are, a “tax” on exports. The tax arises in at least two ways. First, and most importantly, tariffs raise the price and profitability of the import-competing sector relative to the exportable sector in the domestic market, inducing resources to flow away from the latter towards the former.

24. The second manner in which this tax arises, and the one that is the focus of this note, relates to the impact of tariffs on imported inputs in raising the cost of export production, thereby hurting the competitiveness of the export sector. In practice, countries have sought to eliminate this source of the tax on exports<sup>9</sup> by instituting duty drawback and similar schemes, which aim at providing exporters access to imported inputs at world prices. (Table 1 provides an illustrative list of practices relating to duty drawbacks in a number of developing countries).<sup>10</sup> The need for drawbacks is obviously related to the magnitude of tariffs on intermediate goods imports. The lower these tariffs, the smaller is the burden on exports, which reduces the need for drawback schemes.

25. Duty drawback schemes are related to the broader objective of ensuring, as is the norm<sup>11</sup>, that, indirect taxes bear only on domestic consumption (are applied, that is, according to the “destination principle”).<sup>12</sup> They relieve exports of the burden of domestic indirect taxes and helps maintain neutrality of incentives between importables and exportables (Grossman, 1980). Achieving these objectives requires that:

- No domestic indirect taxes are levied on export sales;
- All indirect taxes paid on intermediate inputs, including capital goods — domestic and imported—that are used in export production are rebated back to the exporter;

26. Under a destination-based VAT, the zero-rating of exports achieves these objectives, ensuring that the VAT is neutral between importables and exportables. Moreover, if the aim is to achieve neutrality of incentives for the entire domestic indirect tax system, not only indirect taxes but also tariffs on imported inputs need to be rebated back to the exporter. This is the purpose of drawback and similar schemes that are now very important in practice.<sup>13</sup> In this context, it is useful to recall that

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<sup>9</sup> This note does not address the issue of the optimal drawback scheme, which is complicated and depends on the objectives of a country and the structure of the economy (Panagariya, 1992). It takes as a given that countries wish to provide full drawback and addresses issues relating the design of drawback schemes and their consistency with related aspects of the domestic indirect tax system.

<sup>10</sup> Temporary admission schemes and manufacturing in-bond arrangements are administratively different from drawback schemes but they are all alike in their aim of relieving exports of the tax burden emanating from tariffs on imported intermediate inputs.

<sup>11</sup> Throughout the analysis, it is assumed that the domestic indirect tax typically takes the form of a consumption-based VAT applied according to the destination principle. Virtually all developing countries have introduced or are close to introducing a VAT (Table 2). The vast majority of countries have opted for a pure consumption-based VAT applied according to the destination principle. Exceptions include a number of small island economies that do not have a VAT and a few former CIS-countries that (until 2001) applied an origin-based VAT on some bilateral trade, but now do so only for trade in energy products. Although the United States levies a retail sales tax rather than a VAT, it is applied according to the destination principle.

<sup>12</sup> Exceptions arise when excise taxes are levied to deal with externalities associated with production, for example, the environmental consequences of petroleum use.

<sup>13</sup> One difference, it should be noted, is that whereas the VAT chain eliminates all VAT paid on inputs, drawback (and similar schemes) do not eliminate the indirect burden of customs on exporters arising from their use of domestically-produced inputs whose prices reflect the tariffs on competing imports. Some countries do permit indirect drawback for inputs imported by a firm that are used to manufacture an intermediate good that is sold to an exporter. However, this is rare as it requires a sophisticated paper trail and a willingness on the part of one firm to “give” away its drawback rights to another.

a tariff is a combination of consumption tax and a production subsidy. As a consumption tax, its impact on exports should not be different from other “domestic” consumption taxes such as the VAT.

*Uniform drawback rule*

27. In order to implement an ideal duty drawback scheme, the tax authorities need to have information from every exporting firm on the quantity exported, the quantity of imported intermediates used in export production, and the tariff on the imported intermediates. These requirements can be onerous, leading to delays in the rebating of import taxes, thereby hurting the competitiveness of exporters. In order to simplify drawback procedures, developing countries have proposed that exporters receive a uniform drawback of taxes on imported intermediates and that this drawback be provided to all exporters, without verifying the types and quantities of imported intermediate inputs they have used.

28. Developing countries have not elaborated in detail on their proposal. But the spirit of the proposal appears to be to institute a rule whereby all exporters (or all exporters within a given sector) would receive the same (percentage) rebate based on documenting how much they have exported.

29. This proposal has two important advantages. First, it would be straightforward to calculate and easier to implement, compared with the alternative of requiring exporters to furnish information on the types and magnitudes of intermediate inputs that have been imported. This could prove beneficial to countries with weak administrative capacity and firms with poor record-keeping.

30. Second, an aggregate scheme that is given to all exporters on the basis of a predetermined rule regardless of their input use would reduce the incentives for misreporting information or lobbying for special treatment. By reducing the scope for discretion, an aggregate rebating scheme would thus considerably reduce the incentives for corruption and rent-seeking that can be very costly.

31. The rebating scheme proposed by developing countries would have to be implemented in a manner that does not lead to subsidization on average. Decisions would also need to be taken on whether the rebating should be economy-wide or sector-wide, i.e., whether the rebate would be the same for all exporters or just exporters in a given sector. Here there is a trade-off between ensuring that the rebate is “right” for a reasonably large number of firms, with pressure to adopt greater sector-specific differentiation. In turn, the finer the classification the greater will be the information requirements, for example, on input-output coefficients, rendering it more difficult and costly to implement.

32. Whatever the level of differentiation chosen, the magnitude of the rebate would need to be an average that reflects the different input-output coefficients and different input tariffs faced by firms across the export sector. By construction, a uniform drawback scheme would be inefficient in the sense that it would under-rebate some exporters and over-rebate others. This could lead to the risk of lobbying by exporters that are under-rebated based on claims of unfair treatment. If governments give in to these claims, a uniform drawback rule could result in export subsidization on average.<sup>14</sup> Presumably, some checks would need to be instituted to guard against the risk of setting a drawback rate that amounts to a systematic export subsidy.

33. The advantage of a uniform drawback scheme would thus depend on the trade-off between the inefficiency introduced compared with the administrative and political economy benefits that it yields.

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<sup>14</sup> This may not be a problem for countries listed in Annex VII of the WTO SCM agreement to which the prohibition on export subsidization does not apply.



34. Therefore, an important consideration in assessing this trade-off is the potential magnitude of the costs of a more elaborate drawback system where there already exists a tax administration system geared to dealing with drawback-like issues in the context of implementing the VAT.

35. As Table 2 illustrates, most developing countries have either implemented or are in the process of implementing a VAT. Having a VAT requires the tax authorities to deal with individual firms not only to ensure collection of taxes but also to efficiently implement the rebating of the taxes paid on intermediate inputs. Indeed, the rebating scheme--strictly speaking, the crediting mechanism by which registered traders are reimbursed for the taxes they have paid on their purchases of all intermediate inputs — is the essence of a VAT system.<sup>15</sup> Thus, the fact that duty drawback arrangements involve elaborate procedures and contacts between taxpayers and administrators need not be a decisive consideration in favor of a uniform drawback scheme where a VAT is in place.

36. Indeed, one of the primary benefits sought from the adoption of a VAT in many countries is precisely the development of the capacity to administer and comply with taxes on the basis of self-assessment, with taxpayers declaring their circumstances but subject to well-designed audit strategies. This is not an easy process — VAT refunds are a continuing area of difficulty — but they are being addressed in a number of ways.<sup>16</sup>

37. Moreover, given the analytical and procedural similarity described above between duty drawbacks and the rebating of taxes on intermediate inputs under a VAT, there is merit in treating them in a broadly similar fashion in relation to implementation. That drawback schemes and administration of the VAT need to be mutually consistent is reflected, for example, in Fund staff recommendations that drawback verification through audit be carried out at the same time and by the same audit team that conducts an audit of the VAT.<sup>17</sup> Information obtained in the course of implementing the VAT also helps in the audit of the drawbacks. Further, this recommendation of joint or parallel auditing is often made in conjunction with a recommendation to establish a separate unit for large taxpayers, as they are frequently large exporters and importers who should have no difficulty in maintaining the necessary records to support a drawback claim.

38. Where administration and compliance is weak, but the need to provide duty drawback is nevertheless considered pressing, a case could be made for developing countries to offer, temporarily, a hybrid duty drawback system. For large exporters, who should be expected to maintain the necessary records for the VAT, duty drawbacks could resemble the VAT rebating system and integrated with the administration of the VAT. For smaller exporters, however, the uniform drawback scheme could be applied to minimize the administrative costs and governance problems. The same thresholds that already apply under the VAT would need to be set to distinguish small from large exporters. Smaller exporters could even be offered the choice between the uniform drawback scheme and the VAT-type rebating scheme, subject to proper safeguards.

39. The detailed design of such a hybrid would need careful attention, but the essence is familiar from the operation of the VAT. In any case, even if a hybrid system were adopted, it would have to be time bound to reflect the fact that as tax administrations get strengthened, all firms should be covered by similar procedures.

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<sup>15</sup> In practice, tax authorities do not monitor every firm; rather, they rely on self-declaration by firms combined with selective ex post audits to ensure that abuse is minimized.

<sup>16</sup> See Ebrill, et. al., 2001 for a discussion of the difficulties associated with refunds and strategies for addressing them.

<sup>17</sup> This joint recommendation has been made to a number of developing countries.

*Capital goods drawback proposal*

40. The proposal put forth by developing countries that the definition of “inputs consumed in the production process” be expanded is really aimed at extending duty drawback to *capital goods*. On purely economic grounds, this proposal has merit. The remission of duties and all indirect taxes should apply to *all* inputs that may have contributed to the *final cost* of the exported product. Capital goods — to the extent they are “used up” in production — contribute as much to the final cost as do other intermediate inputs, including intangibles. Under a VAT, for example, the zero-rating of exports involves rebating domestic indirect taxes paid on all intermediate inputs, including capital goods. Hence, the current language in the WTO’s Agreement on Subsidies and Countervailing Measures which restricts drawback to inputs *physically consumed* does not have an economic rationale.<sup>18</sup> More generally, drawback should in principle extend to physical capital goods used up in the production process, and indeed to other types of inputs as well, such as computer software.

41. Administratively, however, extending duty drawback to capital goods creates potential difficulties, some of which also apply to rebating under a VAT, but some of which could be additional.

- First, there is the question of what constitutes a capital good. Under a consumption-based VAT, of course, there is no need to distinguish between capital goods and other intermediate inputs because they are all treated alike. Under a duty-drawback scheme, however, such a distinction needs to be made (see below) which could increase the complexity of administration.
- Second, there is the question of how much of the capital goods to be assigned to exports (for which drawback would be available) and how much to domestic sales. While this is a complication, the problems are not insuperable.<sup>19</sup>
- Third, and perhaps the most challenging in the present context, is the question of determining how much of the capital good is used up (i.e. depreciates) in production in any given year.<sup>20</sup> Analytically, this question presents itself in quite different ways in VAT and drawback contexts. Under a consumption-based VAT, the entire amount of taxes paid on intermediate capital goods purchased in any given year is rebated, because by definition a consumption-based VAT excludes capital goods and all other intermediates from the tax base. This immediate deductibility of the full tax paid on capital goods is not matched in a duty drawback context where the aim is to offset the *cost* impact on exports of tariffs on intermediates, and this cost is related to the *use* of capital goods. Hence, in a duty drawback context, countries will need to define what constitutes a capital good and to determine how “use,” i.e., depreciation, will be calculated. If a 100 per cent depreciation rule is adopted, the administration of duty drawback and crediting under the VAT would become similar and easy to administer, but this would be purchased at the cost of effectively subsidizing exports. Moreover, it would become necessary to track the use of capital goods throughout their lifetime in order to impose equivalent customs duty on any sales of the under-depreciated into domestic use.<sup>21</sup>

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<sup>18</sup> In the indirect tax area, an important aspect of modernization has been the removal of such language.

<sup>19</sup> A similar issue arises under the VAT in relation to traders selling both exempt and taxable outputs, since the input tax is creditable in respect of the latter but not the former. The standard procedure is to apportion inputs relative to the shares of the two types of sales in total revenue; despite the element of arbitrariness, this rule has proved workable.

<sup>20</sup> It should be noted that this is different from the question of the allocation between exports and domestic sales.

<sup>21</sup> In principle, the tax code will typically specify depreciation rates (for the purpose of the business income tax) that one might think of using for this purpose. These though are often accelerated relative to true economic depreciation in order to provide a modest incentive for investment, so that adoption of these rates would arguably amount to an export subsidy.

42. If these incremental administrative difficulties are large, it might be preferable for countries to avoid drawbacks on capital goods altogether or extend the uniform drawback scheme discussed earlier also to capital goods.<sup>22</sup> If they are not large, or at least no larger than those arising under a VAT, countries could choose to extend drawbacks to capital goods imports.

### *Conclusions*

- If countries have a sufficiently strong administrative capability in implementing domestic indirect taxes, particularly the crediting mechanism under the VAT, it would be desirable to have duty drawback systems that are administered similar to the VAT crediting mechanism.
- In terms of the two proposals, this implies that countries with relatively strong tax administrations should not favor the uniform drawback scheme (Proposal 1) and could, in principle, be allowed to extend duty drawback to capital goods (Proposal 2).
- Where tax administrations are not strong, the administrative and political economy benefits of the uniform drawback scheme may be significant, strengthening the case for its adoption, but only for small exporters.

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<sup>22</sup> Any decision to extend drawbacks would also depend on the magnitude of tariffs on intermediate capital goods: the lower the tariffs, the less the burden on exports, reducing the imperative for drawbacks.

## ANNEX I

Table 1  
Selected Country Practices With Regard to the Operation of Duty-Drawback Schemes

Country	Practices
Argentina	The drawback regime provides for the partial or total refund of import duties and the statistical tax on inputs used in the processing of products for export, as well as the VAT and excise taxes paid at different processing stages. To benefit from the drawback, the imported items must be substantially transformed or incorporated in the production of export goods and the exporter must be a direct importer of the inputs. Internal tax refund rates, calculated on the f.o.b. export value less the c.i.f. value of imported inputs, are currently applied at twenty different rates, ranging from 1.35 to 10 per cent, covering three fourths of all tariff lines.
Brazil	The system provides for the suspension or exemption of import taxes and other taxes when the imported goods are used to produce exportables or to package them. To receive the drawback, the value of imports is expected to be no more than 40 per cent of the value of exports.
Chile	Chile has two mechanisms in place, and exporters may choose to participate in either one, but not both. The first mechanism allows exporters to receive reimbursement of 10, 5, or 3 per cent of the f.o.b. value of the final goods exported. The second provides for "reimbursement (at the same rates) for inputs of domestic origin or imported against payment of import duties or taxes used or consumed in the manufacture, processing, or production of exported goods." The maximum values of exports which determine the rate of the refund are set each year and adjusted using a price index calculated by the Central Bank.
Dominican Republic	Exporters can request an income-tax-deductible bond, equal to 3 per cent of the f.o.b. value of exported goods, but not exceeding the value of the duties paid.
Egypt	Under the drawback scheme, exporters may obtain a full refund of customs duties paid on imports of inputs and components used in the manufacture of a finished product, provided it is exported to a free zone within one year from the payment of the duties. A partial drawback is available if the final good is shipped to an area receiving partial exemption from customs duties. All excise duties on local inputs are also refunded.
Guatemala	Under the Export Promotion and Maquila Law, imports by maquila enterprises are exempt from import duties and taxes, including VAT, subject to: i) the finished product must have been exported outside the Central American Common Market (CACM) within one year; and ii) it must be guaranteed that the inputs imported under this regime are for re-export.
India	India maintains a wide variety of drawback schemes. Under the most basic scheme, duty drawback is permitted on imported inputs used in the manufacture of goods that are exported. The rate of drawback, known as the "all-industry" rate, is calculated on the basis of broad averages of consumption of inputs, duties and taxes paid, wastage, and f.o.b. prices of export products. According to the Indian authorities, this scheme neutralizes about 70-80 per cent of the duty paid on inputs. If an exporter feels this drawback is inadequate, he may request "special brand rates" which is product and

Country	Practices
Indonesia	<p>exporter specific. These special rates neutralize between 90-95 per cent of the duties paid. Proof of duty payments by the exporter is required.</p> <p>Tariffs on imported inputs, as well as taxes paid on domestically purchased inputs, may be exempted or refunded. A prior exemption scheme, based on a self-assessment of import values and inputs used in products, is subject to an audit.</p>
Kenya	<p>There are two duty drawback schemes in place. First, under the Duty Remission Scheme, remission is available for duties and VAT on goods imported for use in the production of manufacturing goods for export, or for the production of raw materials for use in manufactured products for export, or for the production of "duty-free items" for sale domestically. The remission is subject to the posting of a bond to cover the amount of unpaid duty. In order to recover the bond, exporters must demonstrate, within six months, that the imports have been incorporated into the production of final goods that they have exported. Exporters of horticultural goods and agri-based products enjoy remission of import duties and of value-added tax on imports used in their production. Under the Manufacturing-Under-Bond scheme, firms exporting their total output are exempted from payment of import duties and VAT on inputs, including plant, equipment, and raw materials. This exemption is subject to posting of a bond.</p>
Malawi	<p>Full drawback of tariffs and excise duties are provided on a specified list of goods that are used in the manufacture of exports. For some products, drawback is available on all materials and components, while for others, it is available only on specified materials. Duty drawbacks are determined on the basis of the actual material used in export production. Therefore, manufacturers must maintain sufficient records.</p>
Malaysia	<p>Imports of machinery, equipment, raw materials, and components used for the manufacture of products for export are exempt from import duty and sales tax, where such items are not produced locally or, if produced locally, are not of acceptable quality and price.</p>
Nigeria	<p>Exporters may be reimbursed for import duties, levies, surcharges, as well as excise duties paid on imported inputs used in export production, by applying to the Duty Drawback Committee. Eligibility for a refund requires confirmation that the exports took place; from Customs that the imports took place; and from the Central Bank that the export proceeds were repatriated. The refund is based on a drawback rate calculated from an input-output matrix, with production coefficients computed by the Standards Organization of Nigeria. The refund may not exceed the amount of the duty actually paid. The Duty Suspension Scheme allows for raw materials and intermediate inputs to be imported free of customs, excise and other duties and surcharges when used for export production.</p>
South Africa	<p>Rebates, refunds, and drawbacks of import duties (full customs duties) are available to all manufacturing industries producing for export. The concessions are granted on imported inputs, including raw materials and components used in production of goods solely destined for export. Full rebates or refunds of customs duties are also granted on goods imported and then re-exported in the same condition or state. Goods for use in the manufacture, processing, finishing, equipping or packaging of products solely for export, may be recommended for temporary admission. Liability for the duty on any goods granted concessions ceases upon presentation of documentary evidence to the Customs administration that the goods were exported. Exporters qualify for VAT</p>

Country	Practices
	refunds for all goods and services incorporated in their exports.
Slovakia	Duties paid on imported inputs are reimbursed if used to process goods that are exported. Drawback is permitted where it is possible to identify the imported inputs in the processed products exported.
Turkey	Three schemes are in place available to all exporters. First, under the "conditional exemption for imports", suspension of duty and VAT on raw materials, auxiliary materials, semi-finished and finished products, and packaging materials. Second, under the "use of equivalent goods", refund of VAT, but not customs duty, after the realization of exports with imported inputs. Third, under the "repayment of duties collected on imports", refund of customs duty and VAT paid on imported inputs after the realization of exports. The refund is based on a drawback method.
Uganda	The government operates two schemes. The Fixed Duty Drawback Scheme operates on input/output coefficients already calculated in advance or estimated on the basis of information provided by the exporter. Duties paid on inputs that go into the production of exports are refunded so that the export is not rendered uncompetitive as a result of the duties. The scheme is intended to meet the needs of the exporters who do not rely on a large quantity of imported inputs. The second scheme is designed for companies that export 100 per cent of their output. The government allows duty-free imports or local products required as components of the final good to be exporter. To qualify, exporters must meet a number of conditions.
Zambia	Exporters can receive a duty drawback on most imported inputs. The drawback system is based on input-output coefficients at the firm or sector level. Capital inputs and mining inputs are not eligible for the drawback.

Source: World Trade Organization, Trade Policy Reviews, various years.

## ANNEX II

Table 2  
Current VATs: Dates Introduced and Standard Rate<sup>1</sup>

	VATs Rates <sup>2</sup> (in present)	
	Date VAT Introduced	Standard Rate
Albania	1996	20.0
Algeria	1992	17.0
Argentina	1975	21.0
Armenia	1992	20.0
Australia	2000	10.0
Austria	1973	20.0
Azerbaijan	1992	20.0
Bangladesh	1991	15.0
Barbados	1997	15.0
Belarus	1992	20.0
Belgium	1971	21.0
Benin	1991	18.0
Bolivia <sup>3</sup>	1973	14.9
Brazil <sup>4, 5</sup>	1967	20.48
Bulgaria	1994	20.0
Burkina Faso	1993	18.0
Cambodia	1999	10.0
Cameroon	1999	18.7
Canada	1991	7.0
Chad	2000	18.0
Chile	1975	18.0
China	1994	17.0
Colombia	1975	15.0
Congo Republic	1997	18.0
Costa Rica	1975	15.0
Côte d'Ivoire	1960	20.0
Croatia	1998	22.0
Cyprus	1992	10.0
Czech Republic	1993	22.0
Denmark	1967	25.0
Dominican Republic	1983	8.0
Ecuador	1970	12.0
Egypt <sup>6</sup>	1991	15.0
El Salvador	1992	13.0
Estonia	1992	18.0
Fiji	1992	10.0
Finland	1994	22.0
France	1968	20.6
Gabon	1995	18.0
Georgia	1992	20.0
Germany	1968	16.0
Ghana <sup>7</sup>	1998	12.5
Greece	1987	18.0

	VATs Rates <sup>2</sup> (in present)	
	Date VAT Introduced	Standard Rate
Guatemala	1983	10.0
Guinea	1996	18.0
Haiti	1982	10.0
Honduras	1976	12.0
Hungary	1988	25.0
Iceland	1990	24.5
Indonesia	1985	10.0
Ireland	1972	21.0
Israel	1976	17.0
Italy	1973	19.0
Jamaica	1991	15.0
Japan	1989	5.0
Kazakhstan	1992	20.0
Kenya	1990	18.0
Korea	1977	10.0
Kyrgyz Republic	1992	20.0
Latvia	1992	18.0
Lithuania	1994	18.0
Luxembourg	1970	15.0
Macedonia, FYR	2000	19.0
Madagascar	1994	20.0
Malawi	1989	20.0
Mali	1991	18.0
Malta <sup>8</sup>	1995	15.0
Mauritania	1995	14.0
Mauritius	1998	10.0
Mexico	1980	15.0
Moldova	1992	20.0
Mongolia	1998	13.0
Morocco	1986	20.0
Mozambique	1999	17.0
Namibia	2000	15.0
Nepal	1997	10.0
Netherlands	1969	17.5
Netherlands Antilles	1999	3.0
New Zealand	1986	12.5
Nicaragua	1975	15.0
Niger	1986	17.0
Nigeria	1994	5.0
Norway	1970	23.0
Pakistan <sup>9</sup>	1990	15.0
Panama	1977	5.0
Papua New Guinea	1999	10.0
Paraguay	1993	10.0
Peru	1973	18.0
Philippines	1988	10.0
Poland	1993	22.0
Portugal	1986	17.0
Romania	1993	18.0
Russia Federation	1992	20.0



	VATs Rates <sup>2</sup> (in present)	
	Date VAT Introduced	Standard Rate
Rwanda	2001	15.0
Samoa	1994	10.0
Senegal	1980	20.0
Singapore	1994	3.0
Slovak Republic	1993	23.0
Slovenia	1999	19.0
South Africa	1991	14.0
Spain	1986	16.0
Sri Lanka	1998	12.5
Sudan	2000	10.0
Sweden	1969	25.0
Switzerland	1995	7.5
Taiwan Province of China	1986	5.0
Tajikistan	1992	20.0
Tanzania	1998	20.0
Thailand	1992	10.0
Togo	1995	18.0
Trinidad and Tobago	1990	15.0
Tunisia	1988	18.0
Turkey	1985	16.0
Turkmenistan	1992	20.0
Uganda	1996	17.0
Ukraine	1992	20.0
United Kingdom	1973	17.5
Uruguay	1968	23.0
Uzbekistan	1992	20.0
Vanuatu	1998	12.5
Venezuela	1993	15.5
Vietnam	1999	10.0
Zambia	1995	17.5

Source: Ebrill et. al., 2001

<sup>1/</sup> As of April 2001. Revenue data are for most recent year available.

<sup>2/</sup> Rates are in tax-exclusive form (i.e., specified as a proportion of the net of tax price).

<sup>3/</sup> There are two thresholds in Bolivia: that shown is an income test. There is also a threshold of \$3,270 in terms of assets.

<sup>4/</sup> Tax exclusive rate (legislated tax inclusive rates are 9, 11, and 17 per cent, respectively).

<sup>5/</sup> On interstate transactions the tax exclusive rates are 9.89 and 12.36 depending on the region. The VAT for intrastate transactions varies from state to state, from a rate of 7–18 per cent (standard rate) to 25 per cent

<sup>6/</sup> The threshold of \$38,000 applies to retailers (from July 2001); that of \$18,000 to manufacturers and listed services.

<sup>7/</sup> For retailers.

<sup>8/</sup> Malta repealed the VAT in 1997; it was reintroduced in January 1999.

<sup>9/</sup> From July 1998 the GST was extended to the non-manufacturing sector above a threshold of \$100,000.

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