An Economic Analysis of the China-Maldives Free Trade Agreement

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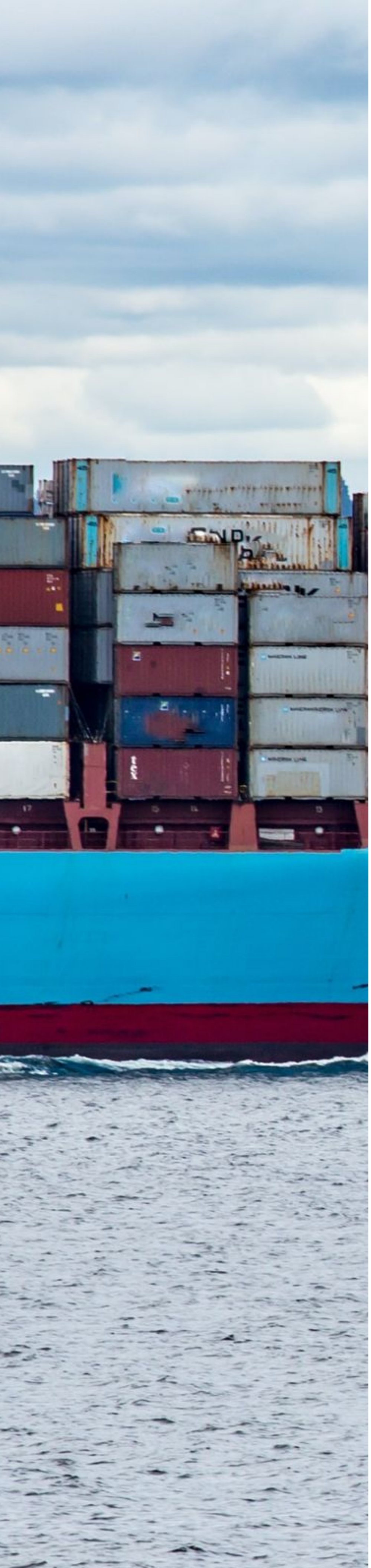
Contents



1. Introduction

1.1 Free trade agreements (FTAs), also known as regional trade agreements, are a catch-all term that refers to a formal agreement between two or more countries to reduce barriers to trade and investment. According to the WTO's Regional Trade Agreements Database[1], there are 355 such agreements in force around the world today.

1.2 The theoretical advantages of a free trade agreement stem from giving customers a bigger choice of goods and services with little artificial distortion to the prices caused by taxes. Theoretically, it should result in a reduction of costs to consumers, as the best / cheapest products, irrespective of nationality or point of origin wins over inferior / more expensive products. Traditional arguments of comparative advantage in trade also state that the reduction or elimination of import tariffs allows countries to specialise in those products they are comparatively better at, resulting in a better outcome for all.

1.3 This does not mean that FTAs will have positive impacts for everyone, especially in the short term. Naturally, those industries that have a competitive disadvantage will lose out, resulting in potential job losses in these sectors. Furthermore, import taxes may also constitute an important revenue stream for governments, which are lost as countries reduce tariffs.

1.4 The empirical evidence on whether free trade agreements yield better outcomes is mixed[2]. As outlined by the UK's Department for International Development (DFID)[3]:

> *"All but one of the 19 high or moderate quality primary studies that estimated trade growth found that the FTA had positive effects in at least some cases, and none found it to be negative. But the picture is mixed, with the range of estimated effects wide. In some cases the estimated trade effect was substantial, in others it was modest, and some partners were found to have gained nothing."*

1. http://rtais.wto.org/UI/PublicMaintainRTAHome.aspx
2. The impact of free trade agreements between developed and developing countries on economic development in developing countries Rapid evidence assessment, July 2015 (available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/448862/REA_FreeTradeAgreements.pdf)
3. Ibid pp.v

Maldives balance of trade and importance of import tariffs

1.5 The case of the Maldives signing an FTA is particularly interesting because it has such a negative balance of trade. Except for fish products, the country imports practically all that it consumes. Between 2015 and 2021, the value of its imports was on average $2.3 billion, while the value of its exports was on average $317 million. This imbalance is paid for by the revenue it earns from the services, most notably tourism. Therefore, there is arguably little 'protection' that import taxes provide to a domestic industry from foreign goods.

1.6 Furthermore, import taxes have always played a significant role in how the government of Maldives raises revenue. Traditional forms of taxation (income or corporate profit taxes) are relatively new concepts in the Maldives. In 2002, import taxes constituted 27% of all government revenue. This was higher than the direct revenue it received from lease of resorts (24%) or tourism tax (12%). The situation remained similar in 2011, with import taxes accounting for approximately 30% of total revenue.

1.7 The fiscal stance changed in 2012 with the introduction of more direct taxation, most notably Goods and Service Charges Tax (GST). From 2012 onwards, overall import taxes were halved, and fell to 14% of total government revenue. This shortfall was filed initially with GST targeted to the tourism industry, which made up approximately 20-25% of total revenue. GST was later introduced for the wider economy, and accounted for an additional 11-13% of tax revenue.

1.8 It must be noted however that while there has been a reduction in the relative importance of import tax revenue, it still remains an important source of revenue for the government. Import duty taxes have been amongst the top three tax revenue streams for the past three years, alongside Goods and Services Tax (GST) on locals and GST on Tourism sector.

1.9 This is also high in proportion to other Indian Ocean Island economies similar to the Maldives, most notably Mauritius and Seychelles. According to the World Bank, since 2010, customs and other import duties were, respectively, 1.5% and 6.4% of total tax revenue for these two countries.

1.10 The situation in the Maldives is important for the overall discussion in this paper for two reasons:

- A FTA with an exporting powerhouse such as China is likely to significant impact the import tax revenue stream.
- Mauritius has signed an FTA with China, but the relatively low importance of import taxes there means the fiscal impact there would be less of a burden on public finances

Free Trade Agreements of Maldives and China

The Maldives

1.11 The only Free Trade Agreement the Maldives is currently party to is the South Asian Free Trade Agreement (SAFTA). Established in 2006, it was regarded as an attempt to promote trade in the SAARC countries[5] by significantly reducing tariffs. Under this agreement, the Maldives charges a lower rate of tariffs for some items it imports from the region.

1.12 As noted by the World Bank[6], the agreement has had “little success” in promoting trade. It argues this is due to countries maintaining “sensitive lists” – which is a large list of products that are exempted from the liberalisation programme. Countries also maintain a list of “para tariffs” – sometimes in the form of regulatory fees, port development levies or supplementary duties.

1.13 As a result, the World Bank estimates that 36% of trade in South Asia falls outside the preferential trade regime. In other words, there are various forms of trade taxes applied on intra-regional trade on more than a third of all trade. In contrast, in the ASEAN there is no import duty on 96 percent of products between the ASEAN countries.

China

1.14 According to the Wolrd Trade Organization’s database of Regional Trade Agreements, China has an active FTA with the following countries and regional blocs:

1. ASEAN
2. Australia
3. Chile
4. Georgia
5. Korea
6. Mauritius
7. New Zealand
8. Singapore
9. Iceland
10. Peru
11. Pakistan
12. Switzerland

1.15 There does not appear to be any particular pattern in the above FTAs China has signed, but an understandable concentration around the South East Asia as well as Australia and New Zealand.

5.India, Pakistan, Sri Lanka, Afghanistan, Nepal, Bhutan, Bangladesh and Maldives
6.https://blogs.worldbank.org/endpovertyinsouthasia/how-south-asia-can-become-free-trade-area

2. Preliminary Impact Assessment of the FTA

2.1 The China-Maldives FTA was passed by the Maldivian People's Majlis (parliament), amidst great controversy, in November 2017. In November 2018, following President Yameen's defeat in that year's presidential election, it was reported that the Maldives would not move forward with the free trade agreement. Reuters quoted former president, and Speaker of the Majlis, Mohamed Nasheed, saying that the necessary enabling legislation to bring the agreement into force will not be passed by parliament. To date, the FTA has not been implemented in the Maldives.

2.2 This paper will not go into a detailed point-by-point analysis of the 1000+ page FTA. Instead, it will highlight key findings of the FTA, and attempt to quantify where possible its implications on both the Maldivian economy and government revenue.

Trade and goods and services

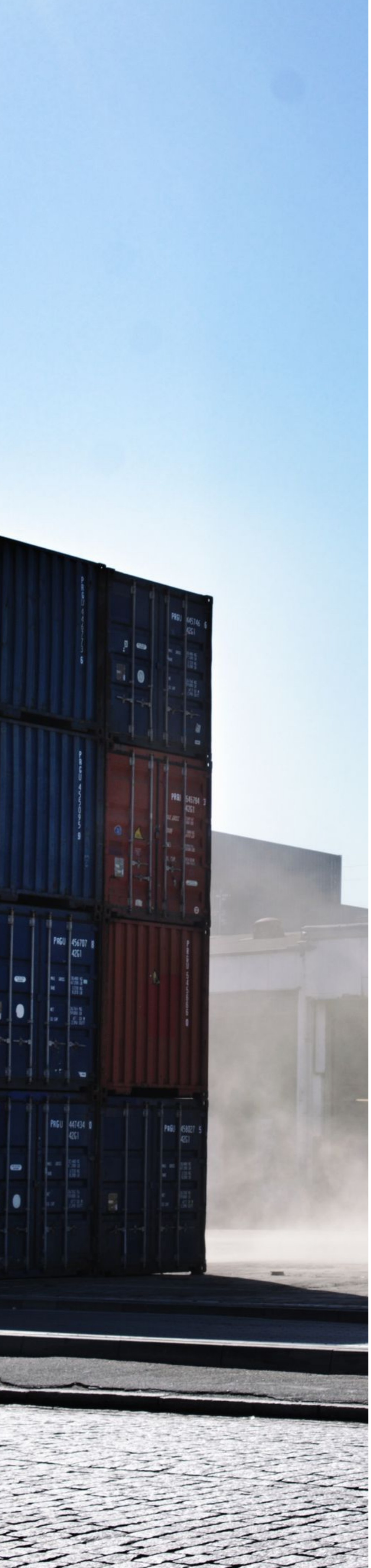
2.3 Leaving aside the issues related to the administration and management of the FTA (including specific "Rules of Origin" criteria for goods), the key point of analysis is the schedule for the reduction of customs tariffs outlined in Annex 1 of the FTA.

2.4 The FTA divides the tariff treatment by the Maldivian authorities on Chinese goods into three categories:

- Category A: goods on which all customs duties will be eliminated immediately from when the agreement enters into force.
- Category B and C: goods on which customs duties will be eliminated gradually over five years (Category B) and eight years (Category C) .
- Category E: goods on which customs duties will remain at 'base rates' as outlined in the FTA. Base rates were outlined as the rates that were in place at January 1, 2014

2.5 The vast majority of classifications of goods in the FTA are designated to categories A, B or C, which implied that had the Agreement gone ahead, within a 5-8 year period, a large number of goods that will flow to the Maldives would enter tariff free.

7. https://www.reuters.com/article/us-maldives-politics-china-exclusive-idUSKCN1NO0ZC
8. Rules of origin outline the proportionate make-up of the value or components of a good from which that good can be deemed to be "made" in a specific country. For example, a car will have a high number of components made all around the world. For that car to be labelled as 'made in China', a certain proportion of those inputs (and subsequent inputs down the supply chain) must also be manufactured in China.
9. By HS Codes or itemised classification of goods imported/exported)
10. The reductions are to be on a straight-line / gradual basis over the period in question for each category



2.6 Conducting a detailed estimate of the impact of the FTA on the customs revenue is difficult for a number of reasons. Firstly, the 200+ pages describing the categories of goods are currently in hard copy format. This will require a comprehensive data cleaning and entry exercise in order to cross-reference and analyse any patterns or rationale behind why some products are included or excluded in various categories.

2.7 However, an initial examination reveals that certain sensitive products (such as alcohol, pork or alcohol related products) with existing high levels of import duty have been put into the Category E (on which tariffs are not expected to be reduced). Furthermore, products such as vehicles or vehicular spare parts are also placed in Category E.

2.8 Secondly, the FTA applies to products which have been produced or manufactured in a certain country. Import statistics however refer to products that are being imported from a certain country. Therefore, if one were to import products made in China from Singapore, the statistics show this as an import from Singapore. Under the terms of the FTA, those goods that are produced in China would also be subject to import tax reductions. There is no publicly available data on the production origin of goods into the Maldives, but it would be safe to assume that a large proportion of goods imported from elsewhere may have been made in China.

2.9 The analysis that is possible is therefore to look simply at goods and services that have been imported from China. Maldives Customs data provides the relevant import tax applied on these product categories, thereby allowing us to estimate the tax revenue from these goods. Also note that we take 2019 as the most representative 'normal' year of operation considering the impacts of COVID-19.

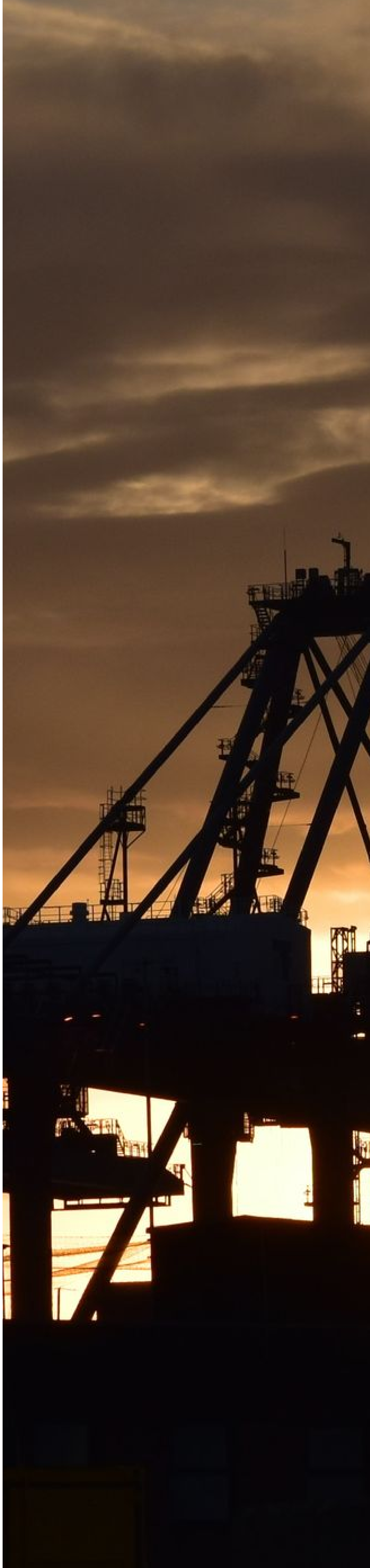
2.10 To start with, Table 1 below provides the top exporting countries to the Maldives and an estimate of the customs duty paid on these goods in 2019.

Country of Consignment	Value of Imports (USD Million)	Estimate of Customs Duty (USD Million)
China	467	53
Singapore	353	35
United Arab Emirates	541	29
India	289	19
Thailand	119	16
Sri-Lanka	165	16

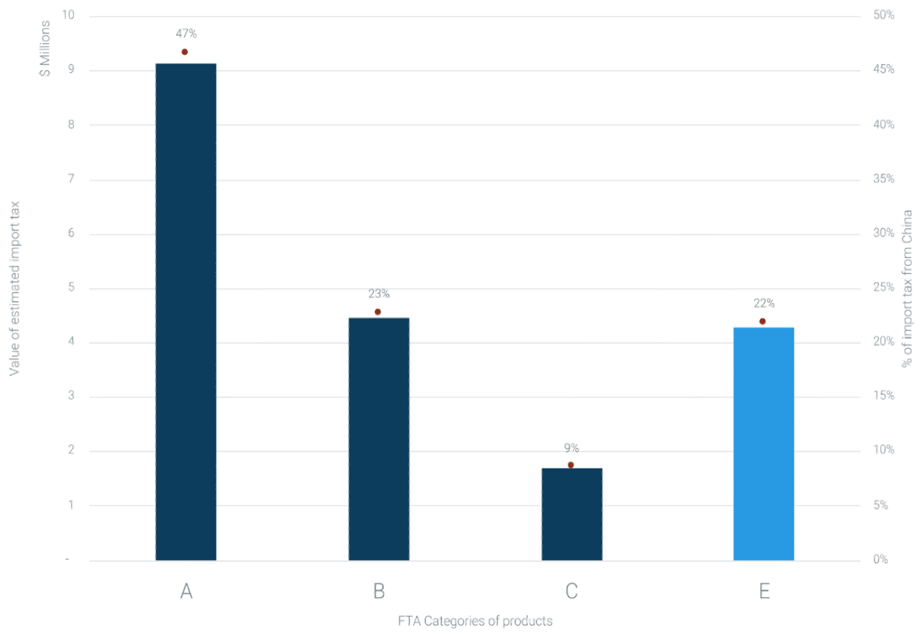
Country of Consignment	Value of Imports (USD Million)	Estimate of Customs Duty (USD Million)
Japan	35	14
Malaysia	191	11
France	46	10
United States	56	9
Canada	29	7
Germany	63	7
Ireland	24	6
Italy	44	6
Hong Kong	33	5
Great Britain	29	5
Indonesia	57	5
Australia	47	4
Vietnam	14	4
New Zealand	31	4
Other	241	20
Grand Total	**2,875**	**281**

2.11 As can be seen above, goods imported from China are the highest contributors of customs duty to the Maldives, making up approximately 19% of customs tax revenue. They are second overall in terms of total exports to the Maldives, second only to UAE. Therefore, even without going into the details of the products that constitute goods imported from China, it can be estimated that reducing taxes on these goods is likely to have a significant impact on custom tax revenues.

2.12 The precise impact will be determined by looking at the existing portfolio of products imported from China, and checking whether they sit under the various A-E categories of the FTA. Doing so for all the product categories of the FTA is beyond the scope of this paper for the data cleansing and entry reason outlined earlier. Instead, this paper looks at a sample of the top 25 product categories that is estimated to pay the highest proportion of import tax. We then look at how these product categories are treated in the FTA (i.e. whether the import tariffs on these will be reduced as per A,B,C or E).



2.13 The sample of the top 25 product categories in terms of import tax account for approximately 27% of all imports into the Maldives from China. It also accounts for 37% of all taxes from Chinese imports to the country. The breakdown of this sample into the FTA categories is provided below:



2.14 As can be seen from Figure 1 above, almost half of all the products that are currently imported from China would have had import duty eliminated from the time the FTA came into effect (i.e. category A). A further 30% or so would have duty reduced over a 5-8 year period, and only approximately 20% would have import duty unchanged from the current situation.

2.15 This research therefore implies that approximately 80% of the goods that are imported from China will not be subject to an import tax if the FTA was put into effect. Given our estimate of total import tax revenue from Chinese imports are approximately $53m, this implies that the FTA would have resulted in a lost tax revenue of $41m to the Ministry of Finance each year. This potential loss amounts to approximately 3% of total revenue to the Government.

2.16 This is a significantly lower bound estimate for two important reasons. Firstly, as outlined above, the import tax exemption applies for products made in China rather than just imported from China. Under the FTA, goods imported from other countries but made in China will also be subject to lower or no taxes. As a result, the total value of goods on which taxes will reduce will be greater than the products simply imported from China.

2.17 Secondly, there will also be a shift away from products that are currently made in other countries as they will be subject to higher taxes and therefore comparatively more expensive. This 'substitution effect' will further reduce import tax revenue for the government.

3. Impact on Prices:
Will Consumers Benefit from the FTA?

3.1 The above analysis represents primarily the impact on lost government tax revenue. However, it also implies that consumers in the Maldives will face lower costs of a similar magnitude. The key question here is whether these reduced costs will be passed on to the consumer, or whether it will be absorbed into corporate profits.

3.2 The extent to which consumers will see reduced prices will depend on the overall competitive nature of the product market in question or if any price controls are put in place by the government. Unless, such measures are put in place, products that are imported and therefore traded in markets with strong competition would see producers passing on those cost reductions to the consumer in order to gain market share.

3.3 There is little evidence on the overall competitive nature of the local economy. As such, the extent to which any reduction in taxes paid on goods by importers would be passed on to consumers is speculative. The extent to which the recently enacted Competitions Act will ensure consumers benefit from import tax reductions is also speculative given the relative lack of information about how it will be enforced[11].

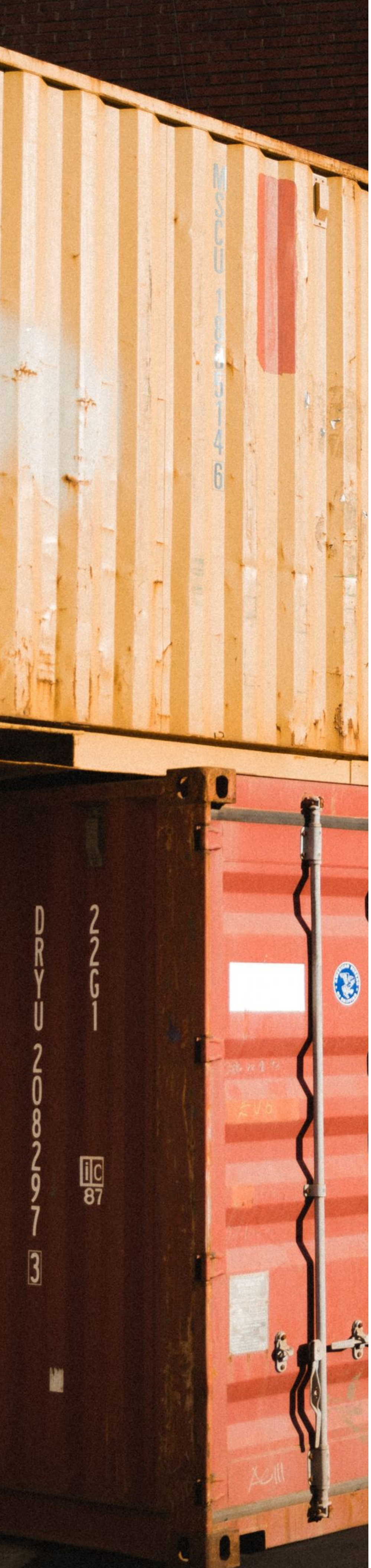
3.3 The other relevant question is who the "consumer" in question here, is. The Maldives has two separate groups of consumers: the local population and tourists. The import taxes paid by goods and services consumed by tourists may be seen as a net benefit to the local population. The question that follows from this is; what proportion of goods imported into the country are directly consumed by tourists versus the local population?

3.4 Using data for the months from COVID, in which there were no tourists in the country, allows us to estimate the proportion of imports that came in primarily for tourists' consumption. To do so, we can compare imports in the months of COVID (Q3 of 2020) vs the same period in 2019. The analysis indicates that the value of imports were approximately 50% lower in these months than in similar periods[12]. While it has already been noted that the FTA with China did exclude certain items, such as alcohol and pork products from having their taxes reduced, this analysis points towards a considerable proportion of import taxes currently being paid by tourists to the Maldives. While it can be argued that the reduced import taxes will lower the cost for tourists, and boost tourist arrivals into the country, these goods will make a relatively small proportion of the overall tourist product (cost of labour, capital costs…etc), it is unlikely that the reduction in import taxes can significantly reduce overall tourism prices.

3.5 Although there will be some benefit to local consumers from the FTA, given the absence of information into the specific policies supporting the implementation of the FTA, it is yet difficult to determine the the extent of the net benefit of reduced tariffs that will be felt by local consumers.

11. For discussion of the competition act, see https://www.ctlstrategies.com/latest/competition-act/

12. Noting that there are potentially lags of non-perishables that may have been imported prior to their arrival. There was also significant disruption in international trade as a whole during the COVID period and as such may also explain the difference in trading / import volumes.



4. Key Lessons and Findings

4.1 Free trade agreements can potentially be an important facilitator of trade and its resultant benefits to consumers. Trade provides choice to consumers, and incentivises producers to innovate and become more efficient. It is especially useful if two parties to an agreement have items that they are relatively better at producing.

4.2 The Maldives is almost entirely dependent on imports to function as a country. These imports are paid for by the revenue Maldives' earn from services. The country has also had a high level of import taxes, which continue to be an important revenue source for the government.

4.3 China, by contrast, is one of the world's largest exporters. According to some estimates, it makes up over a ¼ of all goods made and traded in the global economy. As a result, the flow of trade in goods is primarily going to be one-directional.

4.4 For a country like the Maldives, a free trade agreement with a major producer such as China is likely to significantly reduce a major revenue source (import duty) to the Government. According to current trade patterns, and looking only at those goods imported from China rather than made in China, the immediate estimate is a reduction of total revenue by $41m, or approximately 3% of all government revenue. The true figure will be significantly higher as taxes will be exempt on all imported goods made in China. Furthermore, goods that are made in other countries (on which tax is paid) will, over time, be substituted for tax-free goods made in China, resulting in further lost tax revenue to the Government.

4.5 Whether this lost tax revenue is a net benefit to local consumer would depend on the extent to which these savings are passed on to the end consumer. Regardless of the savings being passed to the end consumer, SMEs, startups and wholesalers would benefit from the savings from import duties. However, again a deeper analysis into these savings are required to determine the benefit to these different groups.

4.6 A key lesson therefore from looking into the case of the Maldives-China FTA is the need for reviews prior to signing such an agreement. The data from which to measure the impact of such a deal, at least on the level of trade, exists because of the existing requirements to submit values for all imports. Therefore, analysing this data to see the impact on overall tax revenues is a key initial piece of analysis. A further disaggregated analysis, in collaboration with a deeper level of customs data, may also provide answers as to whether the tax cuts primarily benefit the locals or tourists.

4.7 Finally, surveys and market analysis on how a reduction in prices of imports filter through to local businesses, such as through a devaluation of relative importing country currencies, may illustrate the potential 'pass-through' effect on the local economy.