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Fiscal challenges facing Arab countries in the establishment of an Arab customs union

Summary

Arab countries face several challenges in the establishment of an Arab customs union (ACU), related to the selection of a suitable common external tariff (CET); the adoption of mechanisms for the collection and allocation of customs revenues; and compensation for revenue losses.

Analysis has revealed that, while some Arab States may face potential tax revenue losses due to ACU accession, others might see an improvement. The net effects at the country level depend largely on the CET chosen, the contribution of trade taxes to government revenues and on the diversification of indirect tax instruments. Accordingly, a careful analysis of the fiscal implications of alternative CETs should be undertaken at the country level to estimate potential costs and determine the appropriate compensation mechanisms. The objective is to select the optimal CET, one that will induce the lowest costs and highest gains on the fiscal, economic and social dimensions of development.

This document highlights the challenges related to the establishment of ACU. It examines the options for the selection of an adequate CET and the adoption of compensation mechanisms. It is submitted to the Technical Committee on Liberalization of Foreign Trade, Economic Globalization and Financing for Development in the Countries of the ESCWA Region for review and discussion.

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CONTENTS

Introduction

1.   The economies of Arab countries are characterized by a high degree of heterogeneity with variations in gross domestic product (GDP); development levels; the structure of trade; and the choice of, and dependence on, government revenue tools. Due to these disparities, Arab countries will experience different implications upon the establishment of an Arab customs union (ACU). This document presents these implications on two groups of countries: those that are dependent on trade taxes as a source of government revenues; and those that are less dependent.

2.   General features of Arab State members of the Greater Arab Free Trade Area (GAFTA) and potential members of ACU will first be reviewed. Disparities between them, namely in terms of their dependence on customs revenues, will be highlighted. Fiscal challenges of joining ACU will then be pointed out, as well as issues that must be dealt with in the establishment of ACU, namely those related to the selection of a suitable common external tariff (CET); and the adoption of mechanisms for the collection and allocation of customs revenues, and for compensation for revenue losses.

I. TRADE PROFILES OF GAFTA MEMBER STATES

3.   There are wide gaps between Arab countries in terms of their main characteristics and their levels of economic development (table 1). Oil-exporting countries are highly dependent on oil revenue, which explains their non-reliance on taxes as a source of public revenue. On the contrary, countries such as Tunisia and Morocco largely depend on tax revenues. These differences pose challenges to the formation of ACU, for which the harmonization of the related fiscal policies and the implementation of CET are required.

TABLE 1. MAIN ECONOMIC FEATURES OF GAFTA MEMBERS

Country	GDP per capita (US$)[a/]	Trade/GDP (percentage)[b/]	Oil revenues as a percentage of total public revenues (2013)
Algeria	5,361	67.8	61.9
Bahrain	24,613	128.1 (2011)	87.9
Egypt	3,314	46	5.4
Iraq	6,670	74.9	97.2
Jordan	5,214	116.4	..[c/]
Kuwait	56,367 (2012)	92.2 (2011)	93.6
Lebanon	9,928	143	..
Libya	12,167	96.1 (2009)	94.0
Morocco	3,109	81.6	..
Oman	22,181	108.9 (2011)	86.8
Palestine	2,530 (2012)	..	..
Qatar	93,352	87.9 (2011)	40.3
Saudi Arabia	25,852	81.3	89.8
Sudan	1,753	30.4	18.7
Tunisia	4,329	104.2	1.3
United Arab Emirates	41,692 (2012)	152.6 (2011)	68.3
Yemen	1,473	62.4	55.9

Source: Data on GDP are from the World Bank. Trade to GDP data are from the World Trade Organization (WTO) statistics.

a/   Data are for 2013, unless otherwise indicated.
b/   Data are for 2012, unless otherwise indicated.
c/   Two dots (..), as in all tables of this document, indicate that data are not available.

A. INTRAREGIONAL TRADE FLOWS

4.   The main motivations behind the establishment of a customs union include reducing trade costs among members and harmonizing external trade policy for various development reasons, including the creation of a large internal market and an enhanced preference for products produced within the union. An increase in intraregional trade is also expected and, consequently, the development of local productive capacities

as a result of higher demand and higher investment. The overall expected impacts are higher growth and lower unemployment.

5.   However, in a region characterized by low levels of inter-country trade, low trade complementarity and limited diversification, the expected benefits from the establishment of ACU will be limited, as there is considerable evidence to suggest that the higher the percentage of trade with potential partners, the more likely regional trade agreements will be welfare enhancing.[1]

TABLE 2. INTER-ARAB TRADE AS A SHARE OF TOTAL ARAB TRADE, 2002-2013

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Exports	8.5	8.2	8.7	7.7	8.5	8.9	9.3	11.8	10.8	9.0	8.7	8.6
Imports	12.0	10.7	10.8	12.4	13.3	12.1	13.5	12.1	12.6	13.5	13.4	13.1

Source: Arab Monetary Fund and others, *Joint Arab Economic Report 2014* (Abu Dhabi, 2014).

6.   As can be seen in table 2, inter-Arab trade has shown a slight growth since 2002. The highest rate of exports between Arab countries was registered in 2009 and the highest rate of imports in 2011. Intra-Arab exports as a share of total Arab exports declined by 1.1 per cent from 2012 to 2013; while intra-Arab imports as a share of total Arab imports decreased by 2.2 per cent between these two years. Political changes and internal conflicts affecting many countries played a major role in these performances.

7.   Inter-Arab imports have been stable over the last decade, ranging between 10.7 per cent of total Arab imports in 2003 and 13.5 per cent in 2011.[2] Conversely, Arab imports from the European Union have been declining steadily over the last 10 years, from 44.6 per cent in 2002 to 28.2 per cent in 2013; while Arab imports from Asia have increased by 64.11 per cent over the last decade, reaching 33.5 per cent in 2013.

8.   Inter-Arab exports have also been stable, reaching 8.6 per cent of total Arab exports in 2013, with the highest share recorded at 11.8 per cent in 2009. Arab exports to the European Union have also decreased over time, from 25.8 per cent in 2002 to 13.2 per cent in 2013. This can be attributed to a declining demand in the European Union, whose imports from fast-growing economies in Asia are increasing. Arab countries have also been steadily increasing their trade with Asian countries, shifting from Japan to China and other Asian partners. Arab exports to Asia as a share of total Arab exports grew from 25.6 per cent in 2002 to 47.8 per cent in 2013.

9.   Only a few Arab countries export heavily to other Arab countries. In 2013, their contributions to inter-Arab exports as a share of total Arab exports were as such: Jordan, 53.5 per cent; Lebanon, 51.4 per cent; the Sudan, 24.8 per cent; and Egypt, 32.6 per cent. Conversely, Algeria, Iraq, Kuwait, Libya, Morocco, Qatar, the United Arab Emirates and Yemen export mostly to non-Arab countries.

10.   With respect to inter-Arab imports as a share of total Arab imports, the following countries registered high figures in 2013: Jordan, 31 per cent; Bahrain, 31.3 per cent; Yemen, 29.7 per cent; the Sudan, 26 per cent; and Oman, 27.7 per cent. As for Algeria, Egypt, Libya, Saudi Arabia, Tunisia and the United Arab Emirates, they do not rely on other Arab countries for their imports.

11.   In general, inter-Arab trade remains mainly concentrated in dealings between neighbouring Arab countries. For example, in 2013, the bulk of the inter-Arab exports of Jordan were directed towards Iraq

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    [1] Evans and others, "Assessing regional trade agreements with developing countries: shallow and deep integration, trade, productivity and economic performance", Department for International Develoment (DFID) Project No. 04 5881 (March 2006).

    [2] Data in this section are retrieved from Arab Monetary Fund and others, *Joint Arab Economic Report 2014*.

(34.34 per cent of total Jordanian exports to Arab countries) and Saudi Arabia (25.34 per cent). Tunisia exported mainly to Libya (47.55 per cent) and Algeria (26.62 per cent); and 62.58 per cent of the Sudan's inter-Arab exports were to the United Arab Emirates.

12.   The geographical location of a country also plays a role in determining its import partners: in 2013, the largest part of the inter-Arab imports of Jordan were from Saudi Arabia, with a share of 59.27 per cent; while 42.4 per cent of Yemen's inter-Arab imports were from the United Arab Emirates; and almost 66 per cent of Tunisia's inter-Arab imports were from Algeria and Libya. Lebanon is considered the most diversified importer among Arab countries, as 75.54 per cent of its inter-Arab imports came almost equally from Egypt, Kuwait, Saudi Arabia and the United Arab Emirates.

13.   Traditionally, inter-Arab trade has focused primarily on manufactured products, minerals and fuels, followed by agricultural products. Inter-Arab exports of manufactured products reached 46.2 per cent of total inter-Arab exports in 2013; followed by minerals and fuels at 26.2 per cent; and agricultural products at 20.9 per cent. On the imports side, manufactured products registered a share of 44.3 per cent of total inter-Arab imports in 2013, while minerals and fuels reached 35.1 per cent and agricultural products 16.1 per cent.

B. DEPENDENCE ON CUSTOMS REVENUES

14.   Table 3 presents the dependence of countries on international trade taxes as a source of total government revenue. According to available data, the region can be divided into two general groups of countries: those that show a high dependence on trade taxes and those that show a low dependence on these taxes. Lebanon and the Sudan fall into the former category. Comparatively, Gulf Cooperation Council (GCC) countries have a very low dependence on trade taxes. Egypt, Iraq, Jordan, Libya, Morocco, the Syrian Arab Republic and Yemen all have a low dependence on trade taxes as a source of government revenue. The characteristics of the two groups will be further examined in the following section.

15.   Moreover, the definition, systems and tools adopted by countries with regard to international trade tax differ, which may explain the above-mentioned disparities. GCC countries, for example, have only implemented tariffs or customs duties; tariffs are therefore their only means of extracting revenue from imports. Alternatively, the high dependence of Lebanon on trade taxes can be explained by the fact that the country derives a significant proportion of its trade tax revenue from indirect taxes on imports.[3]

16.   Countries that apply taxes on imports beyond just tariffs will more easily be able to compensate losses resulting from their accession to ACU. Egypt, Jordan, Lebanon, the Sudan and Tunisia apply value-added taxes (VATs), excise duties and other taxes on imports. As a result, while their accession to ACU will eliminate tariffs on goods traded within the union, their imports will still be subject to non-tariff taxes. They will fare better than countries that depend solely on tariffs to retrieve revenue from imports, such as Yemen, since such tariffs will no longer be imposed on imports within ACU.

17.   Table 4 presents the simple average bound, simple average most favoured nation (MFN) applied and trade weighted average rates in Arab countries for which data are available. The bound rate represents the highest customs duties rate that a country can apply, which is negotiated upon its accession to World Trade Organization (WTO) membership and is difficult to raise once established. Iraq, Lebanon, Libya and the Syrian Arab Republic are not members of WTO and thus do not have bound rates. However, the related data is still relevant to our analysis. As most countries are WTO members, any CET agreed upon within ACU will have to comply with the agreements that member States have already concluded with WTO. Saudi Arabia's bound rate of 11.3 per cent is the highest CET that ACU could impose while allowing all member States to honour their commitments to WTO. A CET higher than 11.3 per cent would require a renegotiation of the Saudi Arabia-WTO agreement.

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[3] Indirect taxes on imports are defined as VAT, excise and other type of taxes on imports.

TABLE 3. TOTAL REVENUES, TAX REVENUES AND CUSTOMS REVENUES
IN SELECTED GAFTA MEMBERS

Country	2012							2013						
	Total revenues and grants (in USD Millions)	Total tax revenues (in USD Millions)	Tax revenues as a % of total revenues & grants	Tax revenues as % of GDP	Customs revenues as % of total tax revenues	Customs revenues (in USD Millions)	Customs revenues as % of total revenues	Total revenues and grants (in USD Millions)	Total tax revenues (in USD Millions)	Tax revenues as a % of total revenues & grants	Tax revenues as % of GDP	Customs revenues as % of total tax revenues	Customs revenues (in USD Millions)	Customs revenues as % of total revenues
Algeria	81,743	24,611	30.1	12.0	17.7	4,356	5.3	75,529	25,662	34.0	11.4	19.9	5,107	6.8
Bahrain	8,063	363	4.5	1.2	83.5	303	3.8	7,823	348	4.5	1.1	87.9	306	3.9
Egypt	50,532	34,519	68.3	13.2	7.1	2,451	4.9	54,238	38,843	71.6	14.3	6.7	2,602	4.8
Iraq	102,759	1,982	1.9	1.1	41.0	813	0.8	97,571	2,467	2.5	1.3	43.1	1,063	1.1
Jordan	7,088	4,727	66.7	15.3	8.5	402	5.7	8,090	5,152	63.7	15.3	8.9	459	5.7
Kuwait	109,632	1,182	1.1	0.7	68.3	807	0.7	113,902	1,248	1.1	0.7	73.9	922	0.8
Lebanon	9,396	6,758	71.9	15.8	22.1	1,494	15.9	9,420	6,710	71.2	14.9	21.3	1,429	15.2
Libya	63,062	2,459	3.9	3.0	7.2	177	0.3	43,625	1,963	4.5	3.0	7.2	141	0.3
Morocco	26,256	23,055	87.8	24	4.5	1,037	4.0	27,216	23,255	85.4	22.1	3.9	907	3.3
Oman	35,044	2,366	6.8	3.1	27.5	651	1.9	36,624	2,454	6.7	3.1	27.6	677	1.8
Qatar	94,155	16,143	17.1	8.5	5.6	904	1.0	84,971	10,687	12.6	5.3	3.8	406	0.5
Saudi Arabia	332,395	17,125	5.2	2.3	33.5	5,737	1.7	307,342	20,399	6.6	2.7	27.7	5,651	1.8
Sudan	6,212	4,365	70.3	6.4	30.1	1,314	21.2	9,572	6,745	70.5	10.9	28.2	1,902	19.9
Tunisia	14,324	12,553	87.6	27.7	6.0	753	5.3	14,834	13,719	92.5	29.1	6.0	823	5.5
UAE	103,263	9,133	8.8	2.5	32.3	2,950	2.9	110,954	9,457	8.5	2.4	32.3	3,055	2.8
Yemen	11,215	2,547	22.7	7.9	15.9	405	3.6	9,661	2,848	29.5	7.9	17.0	484	5.0

Source: Arab Monetary Fund and others, *Joint Arab Economic Report 2014*.

TABLE 4. TABLE OF CUSTOMS TARIFFS APPLIED BY SELECTED ARAB COUNTRIES

Country	Simple average 2012[a/]		Trade weighted average 2011[b/]
	Bound	Most favoured nation applied	
Bahrain	34.4	5	6.4
Egypt	36.7	16.8	10.0
Jordan	16.3	10.9	10.0
Kuwait	97.2	4.7	..
Lebanon	..	6.3 (2010)	..
Morocco	41.3	12.9	13.1 (2010)
Oman	13.7	4.7	5.4
Qatar	15.9	4.7	4.8 (2010)
Saudi Arabia	11.3	5.1	4.7
Sudan		21.2	..
Syria		14.2 (2009)	
Tunisia	57.9	15.5	14.4 (2010)
United Arab Emirates	14.3	4.7	..
Yemen	21.1	7.5	6.1

Source: WTO, *Trade Profiles 2013*. Available from http://www.wto.org/english/res_e/booksp_e/trade_profiles13_e.pdf.

a/ The "simple average final bound", as defined by WTO, is the simple average of final bound duties excluding unbound tariff lines; and "simple average most favoured nation (MFN) applied" is the simple average of MFN applied duties.

b/ The "trade weighted average" is, as defined by WTO, the Harmonized System (HS) six-digit MFN tariff averages weighted with HS six-digit import flows for traded products (or "tariff lines").

18.   Any CET lower than 11.3 per cent could prove problematic to Arab countries, except for GCC countries, as well as Lebanon and Yemen. Currently, the Sudan, Egypt, Tunisia and Morocco have simple average applied MFN rates of 21.2 per cent, 16.8 per cent, 15.5 per cent and 12.9 per cent, respectively. Jordan applies a rate of 10.9 per cent and therefore has a range, albeit a narrow one, within which it would be unaffected by the 11.3 per cent ceiling.

II. FISCAL CHALLENGES POSED BY ACU

19.   The fiscal impact of ACU on its member States will depend, to a large extent, on the reliance of each country on customs revenues for total government revenues; other indirect taxes on imports; and the weight of intraregional trade. Indeed, adopting zero intra-Arab tariffs and a CET will place pressure on fiscal revenues collected from trade-related taxes. This document presents the implications for two general groups of Arab countries: (a) those for which trade taxes account for a significant proportion of total government revenue; and (b) those for which trade taxes do not contribute largely to overall revenue.

A. COUNTRIES WITH HIGH DEPENDENCE ON TRADE TAXES

20.   As shown in table 3, state revenues of both Lebanon and the Sudan depend to a large extent on taxes from trade. When including indirect taxes on trade through VAT and excises, trade taxes also account for a high share of state revenue in Tunisia. High dependence on trade taxes implies a greater potential loss from accession to ACU. However, these countries also have alternative revenue schemes and other characteristics which may mitigate such adverse effects.

21.   These country-specific characteristics are as follows: in 2010, Lebanon had a relatively low simple average MFN applied tariff rate of 6.3 per cent, and imports from countries that consider joining ACU formed an average of 11.9 per cent of the country's total imports during 2009-2013. However, taxes from international trade constituted a large portion of government revenue, and their share had in fact remained stable since 2007.

22.   Fiscal tools that Lebanon has already implemented should enable the mitigation of potential losses resulting from the country's accession to ACU. Lebanon applies a 10 per cent VAT and has adopted a corporate tax system. Furthermore, taxes on international trade are not solely derived from tariffs and customs duties; 65 per cent of total taxes on international trade are excise duties collected on cars, tobacco, gasoline, and alcoholic and non-alcoholic beverages.[4]

23.   The Sudan currently applies an average tariff of over 20 per cent, the highest among tariffs adopted by the countries considered in this document. Over the last 10 years, taxes on trade have accounted for 7 to 21 per cent of government revenue, a share relatively larger than in many other countries of the region. The country's trade with other Arab countries amounts to more than one third of its trade activity: 24.8 per cent of its exports and 26 per cent of its imports were intraregional in 2013.

24.   These fiscal and trade balance characteristics of the Sudan indicate that there would be potential losses from the country's accession to ACU. However, it has several tax instruments at its disposal, which would not only mitigate the fiscal impact of ACU but also serve to further build government revenues. The country has adopted a comparatively high VAT of 17 per cent on most goods and a corporate income tax of 15 per cent, among other measures, providing a strong base which can be expanded upon to increase revenue collection.[5]

25.   Tunisia applies a relatively high average tariff of 15.5 per cent; and the share of its imports from Arab countries stands only at 8.8 per cent of its total imports. While trade taxes only directly account for just over

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[4] Data are from the Lebanese Ministry of Finance.

[5] IMF Article IV data; and WTO, *Trade Profiles 2013*.

5 per cent of government revenue, when indirect taxes, excises and VAT on imports are taken into account, this figure rises to over 20 per cent.[6]

B. COUNTRIES WITH LOW DEPENDENCE ON TRADE TAXES

26.   For countries with low dependence on trade taxes, there will naturally be fewer negative fiscal implications upon accession to ACU. However, while non-tax sources account for the largest shares of government revenue in this group of countries, for some of them, trade taxes are still a significant contributor.

27.   This is, for example, the case of Egypt. In 2012, Egypt had an average tariff level of 16.8 per cent, higher than the levels found in most Arab countries. Nearly a third of Egypt's exports flow to other Arab countries; but its intraregional imports, standing at 13.2 per cent of total imports in 2013, are relatively low. Furthermore, taxes on trade contributed only 4.8 per cent of total government revenue in Egypt in 2013.

28.   In this context, accession to ACU might still have some negative implications for Egypt: a relatively lower CET will place negative pressure on government revenue from trade. In addition, Egypt earns greater customs fees from higher value-added imports.[7]

29.   However, as total trade taxes account for a relatively small proportion of government revenue, and few are the imports from Arab countries that would subsequently have duty-free status, the fiscal impact of ACU accession may remain low for Egypt. Indeed, its fiscal adjustment will be aided by the variety of alternative sources already contributing to revenue, or planned to be harnessed in the near future. Revenues have been rising, due to an expanding tax base and the addition of new sources.[8] Corporate and personal income taxes standing between 20 and 35 per cent, and a 10 per cent sales tax, provide steady revenue sources for the Government, and the planned VAT will assist in mitigating the fiscal effects of ACU and in streamlining means of indirect taxation.

30.   The case of Jordan is comparable to that of Egypt in some respects. In 2013, it had an average tariff of 10.9 per cent, comparable to the average tariff applied in GAFTA member States. Dependence on international trade taxes for government revenue has decreased in the last decade, from 14.51 per cent in 2001 to 207 per cent in 2013.

31.   Nevertheless, the potential loss of revenue from tariffs can be mitigated because Jordan, like Egypt, already has other tax instruments in place. The country has a relatively high goods and sales tax of 16 per cent and high special taxes on specified goods, reaching 100 per cent on cigarettes and 180 per cent on alcohol. Additionally, Jordan has a progressive corporate income tax ranging from 14 to 30 per cent, and a progressive personal income tax. These tools could be expanded to cover a larger tax base: the former could cover currently exempt financial institutions, and the latter could also cover foreign employees.[9]

32.   As for the Syrian Arab Republic, in 2009, it applied an average tariff rate of 14.2 per cent. Imports from Arab members of GAFTA stood at a relatively low rate of 14 per cent of total imports and, in 2011, only around 5 per cent of government revenue was derived from taxes on international trade. As a result, potential accession to ACU should result in little loss.

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[6] Based on IMF Article IV data.

[7] Egypt, Ministry of Finance, *New Customs Tariff* (Cairo, 2009) Available from http://www.mof.gov.eg/mofgallerysource/ English/new-customs-tariff/New-Customs2009.pdf.

[8] Egypt, Ministry of Finance, *Egyptian Economic Monitor* (Cairo, December 2010).

[9] Data on Jordan, the Syrian Arab Republic, Yemen and GCC countries presented in this section are from the Arab Monetary Fund, "Economic statistics bulletin of Arab countries for 2013" and "*Joint Arab Economic Report 2013*"; and WTO, *Trade Profiles 2013*.

33.   The country has adopted a progressive corporate tax system, with rates ranging from 10 to 35 per cent, and a consumption tax has been imposed on certain services and luxury goods. There had also been discussion of a VAT to be introduced in 2011 that was never implemented; and given the current events, available data are not necessarily representative of a post-crisis Syrian Arab Republic.

34.   Yemen applies a tariff rate of 7.5 per cent, which is low compared to rates of other GAFTA member States, excluding GCC countries. The country relies heavily on intra-Arab trade, with approximately one third of its total imports originating from those Arab countries that are seeking to join ACU. However, taxes on international trade only contributed to 5 per cent of government revenue in 2013. As a result, potential ACU accession should result in little loss. In addition, Yemen has already adopted alternative methods to raise government revenue, such as a progressive income tax system, with rates ranging from 10 to 20 per cent, and a general sales tax of 5 per cent. The country does have a high dependence on oil revenue, but that revenue is decreasing. Other fiscal tools should thus be explored, such as VAT and excise taxes.

35.   GCC countries have similar tariffs, with an average of 4.7 per cent. Duty exemptions are applied for GCC members and revenues from trade taxes are low. An expanded customs union would thus only reinforce existing trade characteristics of GCC countries and would have limited negative impact. Implications for some GCC members are detailed in the following paragraphs.

36.   Data on the United Arab Emirates indicate that, in 2013, intra-Arab trade stood at 6.5 per cent of exports and 7.6 per cent of imports, and revenue flows from trade duties represented only 2.8 per cent of government revenue. However, trade taxes did represent nearly a third of all tax revenues. Alternative fiscal tools can thus be devised to improve the country's ability to generate revenues. The United Arab Emirates do not apply VAT, nor taxes on profits, incomes, capital gains on remittances. ACU would also present fiscal opportunities for the country, for example, through the proposed 5 per cent VAT.

37.   In the case of Kuwait, exports to other Arab countries represented only 2.5 per cent of total exports and trade taxes represented less than 1 per cent of government revenue in 2013. Thus the impact of ACU accession would be minor. However, given that trade taxes represented over 73.9 per cent of total tax revenue in 2013, alternative fiscal tools may also be explored. For example, the country applies a 15 per cent corporate income tax on foreign firms. This tax can be expanded to cover domestic firms and consumption as well. The country has also been considering the introduction of VAT.

38.   Oman does trade extensively with other Arab countries and 30.2 per cent of its imports are intraregional. Despite trade taxes accounting for as much as a quarter of tax revenue, income from these has remained at around 2 per cent of government revenue for the past 10 years. The country will thus not incur any significant loss in revenue from ACU accession. VAT is under consideration and a 12 per cent corporate income tax is applied, both being alternative sources of revenue to the potential fall in trade taxes as a proportion of total tax revenue.

III. OPTIONS FOR THE ESTABLISHMENT OF ACU

A. ECONOMIC AND POLITICAL INCENTIVES

39.   There are both economic and political reasons for establishing a customs union instead of only maintaining a free trade area. The primary effect of a union is to expand trade among members at the expense of trade with other countries, thereby contributing to substantial economic gains for member countries.

40.   The expected expansion of intraregional trade can either result in trade creation or trade diversion. The first case is when more efficient suppliers in member countries replace domestic suppliers of goods; the second is when more efficient third-party suppliers are replaced by less efficient suppliers in partner countries. According to Jacob Viner's analysis in 1950, when trade diversion is more important than trade

creation, custom unions tend to be welfare reducing.[10] The degree of trade diversion is often affected by the levels of common external protection agreed upon by the union members.

41.   Notwithstanding the level of external protection, a customs union creates a large single market, through which member countries combine their market size and increase their market power. On the one hand, it can generate economies of scale, translating into lower business costs, greater benefits for consumers and increased competitiveness of member countries. On the other hand, a customs union may also create pressure for more protectionism and member States may decide to implement a high CET to improve their terms of trade. Members may also, as part of a jointly set trade policy, lower demand on a specific imported product by charging a high CET, thereby interfering in its price.[11]

42.   When huge discrepancies at the level of economic development exist between countries, as is the case in the Arab region, a polarization phenomenon might occur when customs unions are formed. This phenomenon occurs when industries cluster in more developed member countries, perceived as having lower risk and therefore able to attract more investments, allowing also for substantial internal and external economies of scale.

43.   Customs unions are also perceived as a prerequisite for the establishment of political unions or, at least, some deeper form of economic integration, such as a common market. They are often pursued by countries interested in attaining the political objectives of security or democracy. For example, in the case of the European Union, Robert Schuman, French Foreign Minister and co-founder of the Union, stated in May 1950, in the Schuman Declaration which proposed the creation of the European Coal and Steel Community, that "the solidarity in production thus established will make it plain that any war between France and Germany becomes not merely unthinkable, but materially impossible".[12] The Southern Common Market (MERCOSUR) and the Caribbean Community (CARICOM) also helped their members to reduce tensions between them, strengthen their States, pool their market power, coordinate trade policies and combine efforts to negotiate with the rest of the world.

44.   Another reason for creating a customs union is to avoid trade deflection while enhancing trade levels among member countries. Trade deflection is the result of goods being shipped from outside a free trade area to a country imposing low tariffs with the aim of later shipping the goods tariff-free to a country with high duties. This practice reduces the tariff of every free trade area member to that of the lowest-tariff partner and could cause friction among member countries. The application of CET in a fully implemented customs union eliminates the potential for trade deflection.[13] Finally, the establishment of a customs union can also affect the power of lobby groups, although it is not clear whether the effect would be to dilute their powers or make them stronger.

B. COMMON EXTERNAL TARIFF

45.   CET is a basic feature of a customs union as a form of economic integration. It is a common tariff structure that all union members agree to adopt in trade with third-party countries instead of their own individual tariffs. Imports to the union only have to clear customs once and can then move freely within the union's area.

46.   The choice of an appropriate and agreed-upon CET is an important element to any successful customs union. Economic research has concluded that trade creation in a customs union is likely to dominate when

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[10] Jacob Viner, *The Customs Union Issue* (Carnegie Endowment for International Peace, 1950).

[11] Andriamananjara, S., "Customs unions", in *Preferential Trade Agreement Policies for Development: A Handbook*, Jean-Pierre Chauffour and Jean-Christophe Maur, eds. (Washington, D.C., World Bank, 2011). Some of the theoretical parts of this document are based on Andriamananjara's paper.

[12] http://europa.eu/about-eu/basic-information/symbols/europe-day/schuman-declaration/index_en.htm.

[13] Andriamananjara, S., "Customs unions".

the common external tariff is low and when there are unexploited potential complementarities between partners, creating opportunities for specialization and increased trade.[14] However, the experience of existing custom unions has demonstrated that negotiations between Governments of member countries with different interests and often conflicting positions tend to be complex and long, due to the challenges of designing and implementing the most appropriate CET. The process of setting mechanisms for the collection and distribution of customs revenues, and of adopting compensation schemes for the loss of revenues can also be as challenging. The difficulties of agreeing on CETs have sometimes led to flawed customs unions, which included country- or sector-specific exceptions and sensitive lists. For example, member countries of CARICOM are allowed national derogations in addition to tariff reductions and suspensions; and CET in MERCOSUR does not cover all sectors.

47.   The optimal tariff is one that improves people's well-being, to the extent that welfare improvements exceed the customs revenue losses incurred in the union process. Member countries may choose between a cascading tariff structure and a uniform tariff structure. The cascading tariff structure, in which higher tariffs are applied to final goods rather than production inputs, promotes local industries that would otherwise be unable to compete with internationally produced goods in the domestic markets. The priority in this type of structure is the design of the various tariffs according to their position in the production process to achieve domestic competitiveness. This renders the structure difficult to design and implement amidst conflicting lobbying interests, which puts pressure on Governments to make tariff adjustments. As for the uniform tariff structure, it is one where the same tariff is applied to all goods equally. This structure is easier to design and implement; it is also more transparent and reduces the incentive to lobby for protection.[15]

48.   Another important factor that affects the selection of CET is the role that asymmetric members of customs unions play, those being members with different trade characteristics and powers. When a customs union is established, it is typically the member that is relatively well-endowed or has relatively elastic consumer preferences that takes the lead in CET choice.[16]

49.   In the case of ACU, any CET imposed by the union will have to honour member countries' agreements with, and commitments to, WTO, as reflected in the bound rate of countries. The lowest bound rate will represent the highest CET that ACU can impose. With a ceiling of 11.3 per cent, corresponding to the lowest bound rate in the region, any CET set within ACU will have an impact on the majority of GAFTA members, as they currently apply MFN tariff rates that are higher than 11.3 per cent.[17]

C. MECHANISMS FOR THE ALLOCATION AND COLLECTION OF CUSTOMS REVENUES

50.   The collection and allocation of customs duties are important issues that should be considered during negotiations prior to the establishment of customs unions. Losses of tariff revenues could indeed occur from the adoption of a CET or from changes in trade patterns. One of the first questions that arises is whether customs revenues are to be treated as community property or the property of each of the union members.

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[14]   Evans and others, "Assessing regional trade agreements with developing countries".

[15]   Lord, M. J., "Moving towards a common external tariff regime in ASEAN", Munich Personal RePEc Archive (MPRA) Paper, No. 41154 (Florida, InWEnt – International Weiterbidung und Entwicklung gGmbH – and ASEAN – Association for Southeast Asian Nations – Secretariat, December 2008).

[16]   Melatos, M., and A. Woodland, "Common external tariff choice in core customs unions", 22 July 2008. Available from http://www.etsg.org/ETSG2008/Papers/Melatos.pdf. For more information on the types of CETs that can be used in a customs union, see Park, I. and S. Park, "Free trade agreements versus customs unions: an examination of East Asia", November 2008, p. 12. Available from http://www.nottingham.ac.uk/shared/shared_levevents/IPARK.pdf.

[17]   See Andriamananjara, S., "Customs unions", p. 114, for an extended analysis of the implications of CET adjustment on two subgroups of a union's member countries: those that used to apply lower tariff rates than the agreed CET prior to their accession and those that used to apply higher tariff rates than the agreed CET.

Pooling customs revenues would require the establishment of a regional institution and a certain degree of trust between member countries.

51.   The European Union is the only existing customs union that treats customs revenues as community property, to be used by all Member States to cover budgetary expenditures. The Union's budget was designed to balance administration costs with the benefits received by each State. Expenses were prohibited from exceeding 1.24 per cent of the gross national income (GNI) of the European Union, which is also not allowed to run a budget deficit. Article 269 of the Treaty establishing the European Community states the following: "Without prejudice to other revenue, the budget shall be financed wholly from own resources."[18] There are three categories of such own resources: traditional own resources; VAT-based resources; and GNI-based resources. Traditional own resources include customs duties and the sugar and isoglucose levies that are collected by Member States on behalf of the Union. Initially, Member States were allowed to retain 10 per cent of the amounts collected to cover collection costs; however, this rate was increased to 25 per cent in 2000 by a Council Decision.[19]

52.   A fraction of the customs revenues collected is used by the European Union for regional development initiatives and to support poorer countries. In the 1980s, the Union began implementing its own regional policy through the established structural funds – the European Regional Development Fund whose aim is to redress regional imbalances in the Union, and the European Social Fund whose aim is to invest in people, with a focus on improving employment and education opportunities across the European Union. In 1994, the European Union also established the Cohesion Fund, which aims to assist those Member States that have a per capita GNI below 90 per cent of the Union's average, thus reducing economic and social disparities and promoting sustainable development. Due to the fact that tariff revenues constitute a small portion of total government revenues for most Member States, they were more willing to forgo them and cede them to the Commission.

53.   In other cases, customs unions treat customs revenues as the property of individual member States, and there are two basic types of allocation mechanisms applied.

1. *Allocation according to the place of consumption*

54.   Most customs unions allocate customs revenues following the 'final destination principle', according to which customs duties are collected at the first port of entry into the customs territory and transferred to the member where the goods are to be consumed. This method requires the identification of the destination of all shipments entering the union, in order for the destination country to claim its duty. This mechanism can be implemented by keeping the imported shipment in bonded facilities until it reaches the final place of consumption where the tariff is paid. Although this principle is simple in theory, it is not easily applied, especially to raw materials or imported shipments that undergo transformation in an intermediate country before reaching the final destination. To ensure that the member country of the first port of entry does not collect revenues on imports, which would then be transformed and shipped duty-free within the union, instead of the member of final destination, a complex system of rules of origin, transit and guarantee mechanisms, and internal border controls might be needed to determine the appropriate allocation of customs revenues to each member country. The New Computerized Transit System (NCTS), based on exchanges of electronic messages, has been fully implemented among the Member States of the European Union, the four European Free Trade Association member States (Iceland, Liechtenstein, Norway and Switzerland) and Turkey. The East African Community has also implemented the Revenue Authority Digital Data Exchange (RADDEx) system for systematic exchanges of information on transit goods. This could discourage the

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[18]   http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:11997E269.

[19]   European Commission, *European Union Public Finance – Fourth Edition* (Publications Office, 2008).

establishment of regional value chains or processing chains, or the generation of retail and wholesale services in intermediate locations between the initial port of entry and the final place of consumption.[20]

2. *Allocation based on a pre-agreed formula or percentage*

55.   Although no existing customs union allocates customs revenues on the basis of the point of first entry, a mechanism could be put in place that is similar to the European Union in that member States collect the duties on behalf of the union, but customs revenues are then fully allocated to member States according to some predetermined formula or percentage. This mechanism has certain advantages: member States no longer need to monitor the movement of shipments across their border, which greatly improves efficiency by reducing transportation and transaction costs, thereby maximizing the economic gains of the union. However, it requires the existence of an institutional capacity to administer the revenues in an equitable fashion. The revenue sharing formula could provide for a simple reallocation based on negotiated and fixed shares, or it could involve a more complex range of economic and demographic variables.

56.   The Southern African Customs Union (SACU) has adopted a fairly complicated revenue sharing formula, which is applicable to all members and is limited by the size of the customs and excise duty pools. The formula was designed with the aim of providing a degree of revenue security to the smaller member States, namely Botswana, Lesotho, Namibia and Swaziland (BLNS). SACU expected real tariff revenue to decline over time, which justified the inclusion of excise duties, thereby ensuring greater revenue stability and transfers to less developed economies. The revenue is shared following three basic components:

(a)   Total collected customs revenues are distributed according to each country's share of total intra-SACU imports; countries that import most from within the union will receive the largest share of revenues, thereby providing implicit compensation for the "cost-raising" and "polarization" effects of the union;

(b)   85 per cent of excise revenues are distributed on the basis of each country's GDP; since South Africa is the largest economy in SACU, it usually retains the largest share of excise revenues;

(c)   15 per cent of excise revenues are distributed in near equal shares (20 per cent) to all member States, through a development component which acts as an additional compensation mechanism and is not designed to achieve specific development objectives; thus, South Africa will receive an equal share of the development component, although it funds 93 per cent of the component, in effect, and is considered its only net contributor.[21]

57.   The implementation of the SACU revenue sharing formula has revealed a number of opportunities and problems, from which Arab countries can learn for the establishment of their own union. Because all customs and excise duties are collected at the first point of entry, member States no longer have to worry about internal border controls and logistical costs are reduced substantially. Furthermore, the redistribution of the customs pool provides sufficient compensation for the "cost-raising" effects of the SACU tariff, while providing a large net fiscal transfer to BLNS.[22] However, the following problems have also arisen:

(a)   There is a lack of clarity in the definition and components of intra-SACU trade, which is the basis for the implementation of the customs component in the revenue sharing formula; this is always a source of conflict, as when one member reports an increase in its share of total intra-SACU trade, it comes at the expense of another member's share of customs revenues;

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[20] Andriamananjara, S., "Customs unions".

[21] Kirk, R., and M. Stern, "The new Southern African Customs Union Agreement", Africa Region Working Paper Series No. 57, (Washington, D.C., World Bank, 2003). Available from http://www.worldbank.org/afr/wps/wp57.pdf.

[22] Flatters, F., and M. Stern, "SACU revenue sharing: issues and options", August 2006. Available from http://qed.econ.queensu.ca/faculty/flatters/writings/ff&ms_sacursf_2006.pdf.

(b) The allocation of customs duties based on the value of intra-SACU trade creates the need for border controls and documentation, which raises rather than diminishes internal barriers to trade;[23]

(c) The structure of the current revenue sharing formula does not create an incentive for existing members to expand the membership of SACU, as members would shy away from including countries that trade heavily with SACU because they would benefit the most from the allocation of customs duties; this goes against the objectives of SACU, namely improving economic integration and increasing intra-union trade;

(d) The less developed economies of SACU rely heavily on the customs pool for a large portion of their fiscal revenues; however, intra-SACU trade is difficult to predict on an annual basis and might be subject to volatility; therefore, budget planning by Governments is difficult;

(e) The existing structure of the revenue sharing formula benefits BLNS most, as main beneficiaries of the duties collected on their own imports and the imports of South Africa; therefore, these countries have a strong incentive to maintain or even increase import tariffs and to avoid serious tariff reforms.[24]

58. For these reasons, specialists have suggested unbundling the development assistance from the customs collection objective in the SACU revenue sharing formula.[25] This would untie the development budget from the unstable trends and fluctuations of customs and excise revenues, thereby removing the incentive for member States to resist the liberalization of tariffs, while enabling the proper design of development programmes suitable to the needs of the less developed economies. It is clear that the issue of collection and allocation of customs revenues is a difficult one for member States, especially in the case of the Arab Customs Union, which will be composed of highly disparate members.

D. COMPENSATION MECHANISMS

59. There are three implications of establishing a customs union that should render it a Pareto improvement for all members. Therefore, there should be no need for transfers or compensatory payments:

(a) When customs revenues are collected at the first port of entry, member countries benefit from a free movement of goods within the union; minimized intra-union border controls; and a decreased cost of customs administration;

(b) When customs unions are formed, more commodities are purchased in bulk from outside the customs territory and are reconsigned to individual members; this creates economies of scale, which lower the unit cost of the imports, thereby benefitting all member States;

(c) The customs union creates a trade regime that eliminates border controls beyond the point of arrival of the goods, resulting in no need for complex rules of origin, which add costs and complications to trade.[26]

60. Positive effects of trade integration, known as trade creation effects, are triggered by the elimination of tariffs. Tariff reductions trigger a more-than-proportional increase in trade flows, which could lead to a rise in government revenues from trade taxes. Moreover, the removal of intra-union tariffs displaces the production of goods from the less efficient country to the more efficient one. The price of goods will thus be lowered, thereby increasing their domestic consumption, which will cause an increase in revenues from taxes

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[23] Development Network Africa, "Evaluation of an appropriate model for a SADC customs union", 3 September 2007. Available from http://www.dnaeconomics.com/assets/dlas/FILE_063020080157_FILE_062520080525_SADC_CU_Study_Final.pdf.

[24] Flatters, F., and M. Stern, "SACU revenue sharing: issues and options".

[25] Ibid.

[26] Grynberg, R., and M. Motswapong, *SACU Revenue Sharing Formula: The History of an Equation* (Botswana Institute for Development Policy Analysis, 2003). Available from http://www.africaportal.org/dspace/articles/sacu-revenue-sharing-formula-history-equation.

on value-added sales and income taxes. If there is a shortfall in revenues, countries with sound administrative capacity and well functioning tax systems will be able to recover the losses by strengthening domestic indirect taxes, broadening the tax base and increasing the efficiency of raising funds for the Government.[27]

61.   In the case of low-income countries, particularly the least developed countries (LDCs) that rely heavily on trade taxes as a source of government revenue and lack proper taxation systems and administrative capacity, lowering or eliminating tariffs can constitute a significant risk to a country's fiscal position. Furthermore, when some members of the customs union perceive that the outcome of the revenue sharing mechanism creates external costs and benefits that are not Pareto comparable, this gives rise to the perceived need for compensatory payments, which are necessary, not only for the fiscal position of Governments, but also to ensure countries' continuing membership in the customs union.[28]

62.   Compensation mechanisms can be introduced by enacting lump-sum transfers to countries that suffer net welfare losses from the establishment of a customs union. These mechanisms have two main objectives: (a) compensation for revenue loss due to the adoption of a lower import duty; and (b) compensation for trade diversion impacts.

63.   Revenue losses can arise as a direct consequence of adopting a different tariff structure and eliminating import tariffs on intra-union trade. They are referred to as first order effects of customs unions. For countries that will experience revenue losses when a lower CET is imposed as compared to their national rate, losses would be offset by welfare gains by users of the imported goods, due to a reduction in average import duty rates. The opposite is true in the case of the 'winning' members, due to the fact that users of imported goods would be burdened by higher import duties.

64.   As for trade diversion, this occurs when more efficient third-party suppliers are replaced by less efficient suppliers located in partner countries, due to the preferential liberalization of trade. This leads to suboptimal allocation of scarce resources and an unwanted loss of national welfare. The consumer gain from lower-cost imports from partner countries is less than the tariff revenue lost by the Government because, if the partner country is a less efficient supplier, the domestic price in the home country does not fall to the world price level.

65.   The level and structure of CET are important factors in the creation of trade diversion effects. A structure of high rates, especially on goods produced by predominantly import substitution industries in one or two member countries, would substantially increase the risk and costs of trade diversion in a union. If, on the contrary, the formation of a union is used as an opportunity to rationalize the overall external tariff structure and increase the integration of the region in the global economy, the amount and costs of trade diversion would be reduced.

66.   Most compensation arrangements for revenue loss involve the establishment of a compensation fund, from which payouts for revenue losses are made, and include specific implementation procedures, namely resource mobilization strategies, payout criteria and set durations. Compensation arrangements are also seen as vehicles for economic solidarity weighted in favour of the poorer members. Therefore, many include a development component.

IV. SUMMARY OF FINDINGS

67.   The establishment of ACU is a tremendous opportunity for member countries, which are expected to benefit from economic integration and the creation of a regional market with more than 350 million consumers.

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[27] Walkenhorst, P., "Compensating lost revenue in regional trade agreements", Trade Note, No. 28 (Washington, D.C., World Bank International Trade Department, 15 September 2006).

[28] Grynberg, R., and M. Motswapong, *SACU Revenue Sharing Formula*.

68.   Due to the disparities in the levels of economic development in Arab countries, negotiations to establish ACU might prove difficult. Any discussion of the implications of joining ACU must begin with an understanding of the current dependence of States on taxes from international trade. An analysis of the implications should also factor in the specific tax systems and instruments that different countries have implemented. While some depend solely on tariffs to derive revenue from imports, other countries have multiple tax tools in place, such as a VAT and/or excise taxes. Those States with a varied tax policy have a lower dependence on tariffs and a higher dependence on indirect taxes on imports and, as a result, will be more easily able to compensate for losses experienced after the adoption of a lower CET and a loss of tariff revenue on imports from other ACU member States. Those States that rely entirely on tariffs to generate revenue from international taxes will face a greater challenge in compensating for the loss resulting from joining ACU.

69.   The benefits of ACU will also differ depending on the tariff structure adopted. The net economic effect of ACU depends on how the adjustment of the external tariff affects the degree of discrimination vis-à-vis non-member States. Moreover, moving from an existing tariff structure to a CET will affect trade volume and patterns as producers, consumers, traders and investors adjust to changes in the tariff regime. It will also affect member States that will have to increase tariffs on certain products while reducing them on others, with the actual impact being dependent on the balance chosen.

70.   It is expected that the establishment of ACU will yield a CET that is lower than some countries' national tariff rates. In this case, government revenues are expected to increase, although with lower tariff rates, due to the fact that the liberalization of trade will increase imports of member countries from the rest of the world. Furthermore, and although adopting a lower CET may not lead to tariff-jumping investments, the higher returns associated with the more liberal economic environment may attract efficiency-seeking investments to member countries.

71.   In order to reap equitable benefits from a customs union, mechanisms would be required to allocate and redistribute customs revenues among countries; and a compensation mechanism may be introduced for countries that suffer net welfare losses from the establishment of ACU.