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Walkenhorst, Peter

World Bank

15 September 2006

Online at <https://mpra.ub.uni-muenchen.de/12279/>

MPRA Paper No. 12279, posted 20 Dec 2008 07:28 UTC



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World Bank  
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## International Trade Department

By Peter  
Walkenhorst

These notes summarize recent research on global trade issues. They reflect solely the views of the author and not necessarily the views of the World Bank Group or its Executive Directors.

Trade Note 28

## COMPENSATING LOST REVENUE IN REGIONAL TRADE AGREEMENTS

The proliferation of free trade agreements and customs unions since the early 1990s has been remarkable. Today most countries are party to one or more regional trade initiatives (World Bank 2004). Economic integration at the regional level allows the members to reap benefits from specialization while accommodating the particular needs and adjustment capacities of the countries involved. Structural and fiscal adjustments cannot be avoided entirely, however, and in some cases special provisions to contain adverse impacts on countries and foster coherence among members have been devised. One type of provision compensates for losses of government revenue from intraregional tariff reductions.

### *Multilateral or regional trade liberalization does not necessarily lead to revenue losses*

If tariff reductions (to levels above zero) trigger a more-than-proportional increase in trade flows, government revenues from trade taxes may in fact rise. Moreover, revenues from taxes on value-added (sales) and income taxes are likely to grow because of higher domestic consumption arising from lower prices of tradables, as well as higher growth resulting from the improved allocation of resources in the

economy. If revenue shortfalls occur, however, countries with sound administrative capacity will often 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 (Keen and Lighthart 2001).

However, low-income countries, and particularly the least developed countries (LDCs), frequently lack adequate administrative capacity and a well functioning domestic tax system. They tend to rely heavily on trade taxes as sources of government revenue. Lowering or eliminating tariffs on trade with regional partners, therefore, can constitute a significant risk to a country's fiscal position (Baunsgaard and Keen 2005). For example, estimates of the prospective impact of the Economic Partnership Agreement between the European Union and the Economic Community of West African states (ECOWAS) indicate that some of the participating African countries could lose more than 20 percent of their government revenues as a result of preferential tariff reductions (Busse and Grossmann 2004).

To alleviate such potentially important fiscal effects, revenue loss compensation arrangements (RLCAs) have been introduced into some regional integration initiatives (RIIs). Most RLCAs involve the establishment of a compensation fund from which payouts for tariff revenue losses are made. Several examples can be found in RIIs in Africa (table 1). However, lack of progress in the underlying schemes has



often hampered implementation. For example in ECOWAS, some members have yet to implement their trade liberalization commitments or pay their contributions to the compensation fund. The RLCAs in the Common Market of Eastern and Southern Africa (COMESA) and the Economic Community of Central African states (ECCAS) appear even further away from effective implementation. By contrast, the revenue sharing funds in the southern African Customs Union (SACU) and the West African Economic and Monetary Union (WAEMU) have been operational for several years.

RLCAs differ in their design and implementation characteristics, particularly with respect to their duration and their handling or resource mobilization and payout criteria. We will discuss each of these features and describe an operational RLCA, SACU's revised Common Revenue Pool in Box 1 (page 5).

### ***Many ways to mobilize resources...***

There are many ways to raise resources to compensate for revenue losses. The resource mobilization schemes in existing RLCAs can be classified according to whether they rely on existing or new revenue sources, and again according to whether they are based on domestic or trade taxes.

- *Existing (or new) domestic and trade taxes.* Contributions are paid from general government revenues. A (non-operational) example is ECCAS, where the contributions of members to the compensation fund are determined according to the saved tariff expenditures on intraregional exports.
- *Existing trade taxes.* Customs duty revenues are allocated to a compensation or revenue sharing fund. An example is the customs component in SACU's Common revenue Pool.
- *New Trade taxes.* Tariffs on imports are increased to raise revenues for use as compensation. For example, ECOWAS and WAEMU apply surcharges to third country imports, while the Caribbean community and common Market (CARICOM) allows its less developed members to apply for the temporary

(re)introduction of intra-RII tariffs in order to overcome tariff revenue shortfalls.

All Existing RLCAs are based at least partly on trade taxes, and many on newly introduced ones. Import duties have the advantage of being relatively easy to administer. They represent, however, one of the most economically costly forms of taxation (Clarete and Whalley 1987). Moreover, in order to minimize distortions in the economy, it is generally desirable to first try to enhance revenue collection by broadening the tax base, e.g. by curtailing tax or import duty exemptions, before increasing tax rates.

Designated taxes are used in all existing RLCAs, except ECCAS, as the instruments to raise funds for compensation. This earmarking of revenue sources protects the compensation fund largely from annual budget discussions in member countries. On the other hand, it tends to expose the fund to volatility in the underlying revenue source, to which other funding arrangements, such as those based on the relative economic size of partner countries, would not be subject.

### ***... and to determine the payout to beneficiary countries***

RLCAs also differ in how payments from compensation funds are allocated. The criteria used in existing RLCAs to determine the pay out to beneficiary countries are based on intraregional trade shares or incurred revenue losses.

- *Trade Shares.* The funds available for compensation or revenue sharing are distributed among member countries in proportion to their shares in total intraregional imports. SACU's customs component payout is an example of a trade share-based compensation scheme.
- *Incurring revenue loss.* Compensation is paid on the basis of submitted customs declarations on intra-RII trade for the period under consideration and the loss in revenue associated with the non-application of most-favored-nation (MFN) tariffs to partner country trade. Such a scheme is operated, for example, by WAEMU (and envisaged by ECCAS and ECOWAS). The compensation payments are determined by multiplying MFN



tariff rates by intraregional trade flows after removal of intra-RII tariffs. This method overestimates the loss of tariff revenue, as the liberalization of intraregional trade will trigger an increase in the exchange of goods among partner countries. A scheme based on historical intraregional trade flows (that is, flows before establishment of the RII) would avoid this estimation bias, but it would not take into account changes in intraregional trade flows that might occur for reasons other than regional integration.

The administration and monitoring of a payout scheme becomes more demanding depending on the degree of precision the partner countries require in the calculating and tracking the tariff revenue losses. Schemes based on historical trade patterns or aggregate intraregional trade shares are much less cumbersome to handle than those centered on shipment-specific customs declarations, for example. Although customs operations in many countries are intensifying their use of computers and, hence, becoming more capable of treating large amounts of data quickly and reliably, considerable scope for error in handling RLCA-relevant information remains.

The establishment of RLCAs has often been propelled by concerns that benefits from regional integration might be unequally distributed and accentuate disparities in development levels within the region, with the stronger, larger economies gaining at the expense of weaker, smaller countries. In addition to being instruments of compensation for lost tariff revenues, therefore, RLCAs may be seen as vehicles of economic solidarity weighted in favor of the poorer countries in the group. For that reason many compensation funds also have a role in supporting development and cohesion. For example, the development component of SACU's Common Revenue Pool is distributed among member countries in inverse proportion to their per capita income, thus favoring less-developed members.

#### ***Many arrangements are of a temporary nature***

As intraregional liberalization leads to expanded trade, revenues from domestic value-added, excise, and income taxes can be expected

to increase, reducing the necessity for revenue redistribution over time. Many RLCAs, though not all, are therefore of a temporary nature.

- *Fixed duration.* The period of operation for the RLCA may be limited to a certain number of years. For example, for ECOWAS the duration of the arrangement is four years; for WAEMU, six years.
- *Duration determined by administrative decision.* The period of operation of the RLCA may be decided case by case. Such an arrangement exists in CARICOM, where the Council for Trade and Economic Development accepts applications for the revenue safeguard fund from less-developed members,
- *Duration not determined.* The duration of the RLCA may be open-ended. Such an arrangement exists in SACU.

The compensation payments in ECOWAS and WAEMU are scheduled to be scaled down over time before the RLCA expires. A similar development might occur in SACU, as further bilateral or multilateral trade liberalization reduces customs revenues and hence the funds available to compensate for revenue losses. The scaling down of RLCA payouts over time gives countries an incentive to pursue their fiscal reform processes and strengthen non-trade sources of government.

#### ***Provisions on revenue sharing can be added to compensate for revenue loss***

For countries that have weak domestic tax administrations and rely heavily on trade taxes for government finances, lowering or eliminating tariffs on trade with regional partners can pose a significant fiscal risk. To pursue regional integration despite that risk, provisions on revenue sharing have been added to several RIIs, although not all are operational. Analysis of existing arrangements suggests several desirable design features for RLCAs - among them the use of domestic tax revenues instead of economically more costly trade taxes as the preferred means of raising revenues for compensation. Moreover, simple payout criteria, possibly historically based, facilitate the monitoring and administration of the mechanism. And finally, limited periods of duration and a reduction of compensation payments over time are consistent with the



revenue-enhancing effect of trade-induced growth and preserve the incentive for governments to pursue fiscal reforms

As our survey of RLCAs showed, there are very few examples of operational arrangements; even these are generally of a temporary nature. This means that most regional trade agreements do not foresee or implement provisions for revenue sharing or revenue loss compensation. Hence, countries that are confronted with markedly adverse impacts on their fiscal balance as a result of preferential liberalization can not rely on designated resources from regional partners but must cope with the revenue shortfalls domestically through complementary policy reforms. In some cases, improvements in customs collection through better compliance with existing regulations may be sufficient to offset the revenue losses. In others, more comprehensive reform measures to broaden the tax base and shift revenue generation away from trade taxes will be required. Such fiscal reforms are not easy to design and implement, but they are often necessary to complement trade reforms and reap the full benefits of economic integration.

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**Box 1: The example of SACU's Common Revenue Pool**

In October 2002, the members of SACU (Botswana, Lesotho, Namibia, South Africa, and Swaziland) signed a new agreement that revised the union's revenue sharing arrangements, the purpose of which is to increase members' fiscal stability. The arrangement stipulates that all customs, excise, and additional duties collected in the common customs area are to be paid into a Common Revenue Pool. The pooled revenues are then categorized into components for distribution purposes. SACU members agreed that their respective shares during any financial year would be calculated from each of three distinct components, net of the budgeted costs of financing the administration of the arrangement.

- *The customs component*, consisting of all customs duties actually collected, is distributed on the basis of each country's percentage share of total intra-SACU imports, excluding re-exports. As South Africa currently has a large trade surplus with its SACU partner countries, its share in total intra-SACU imports is relatively small, and its payout from the customs component is less than proportional to the country's relative economic size. Conversely, the four less-developed SACU members receive a share of total customs revenues that exceeds their relative size.
- *The excise component*, consisting of all excise duties actually collected on goods produced in the common customs area (net of the development component), is allocated on the basis of each country's share in total SACU gross domestic product (GDP). The inclusion of excise duties in the common pool was motivated by the difficulty of administering separate excise regimes in a region with porous borders. Payouts from the excise component currently do not have a market redistributive effect.
- *The development component* is funded initially from 15 percent of the total excise component and distributed on the basis of each country's GDP per capita, with lower income countries receiving a larger than proportional share of the payouts.

The revenue shares of each component was supposed to be calculated from audited data on trade, GDP, and GDP per capita, as well as agreed customs and excise forecasts, with possible adjustments in the ensuing two years to reflect actual collections (Kirk and Stern 2003). The distribution of revenues is approximate and implicit, thereby avoiding a cumbersome handling of customs declarations in the compensation process. The flexible and symmetric setup also facilitates the possible expansion of customs union membership to other countries in the region. However, in practice the revenue sharing formula has provided countries with incentives to overstate their intra-SACU imports in order to obtain larger payouts, so that it has been very difficult – if not impossible – to reach agreement on the base for revenue distribution.

**Table 1: Characteristics of Revenue Loss Compensation Mechanisms in Regional Trade Agreements (December 2004)**

<b>Agreement</b>	<b>Stage of integration</b>	<b>No. of members (of which LDCs)</b>	<b>Financing mechanism</b>	<b>Allocation criteria</b>	<b>Period of operation</b>	<b>Remarks</b>
Caribbean Community (CARICOM)	Common Market	14 (0)	Imposition of intra-regional tariffs.	Retaining of revenues from intra-regional tariffs.	Temporary, according to decision by Council for Trade and Econ. Development.	On application by less developed members to Council for Trade and Econ. Development.
Common Market for Eastern and Southern Africa (COMESA)	Preferential/Free Trade Agreement	20 (13)	To be determined in Protocol.	To be determined in Protocol.		RLCM-Protocol in the process of finalization.
Economic Community of Central African States (ECCAS)	Cooperation Agreement	11 (8)	Saved tariff expenditure on intra-regional exports.	Lost tariff revenue on intra-regional imports.		RLCM not implemented.
Economic Community of West African States (ECOWAS)	Preferential Trade Agreement	15 (11)	Community Levy of 0.5% on imports from third countries.	Lost tariff revenue from intra-regional imports, according to customs declaration.	Four years (from Jan. 2002), degressive compensation.	RLCM not operational.
Southern African Customs Union (SACU)	Customs Union	5 (1)	Common Revenue Pool of all customs and excise duties.	Combination of projected intra-regional import shares and gross domestic product.	Not determined.	Parts of funds raised are used for other purposes than revenue loss compensation.
West African Economic and Monetary Union (WAEMU)	Economic and Monetary Union	8 (7)	Community Solidarity Surcharge of 1% on imports from third countries.	Lost tariff revenue from intra-regional imports, according to customs declaration.	Six years (from Jan 2000), degressive compensation.	Parts of funds raised are used for other purposes than revenue loss compensation.

*Source:* Author.